



*Insight beyond the rating.*

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## DBRS Criteria: Trust Indentures – Representations and Warranties, Covenants and Events of Default

A trust indenture is a formal document under which debt is issued and whose covenants provide rights and protections to debt holders. Trust indentures set out the rights of debt holders, define any restrictions on the issuer's operations and financing activities, assign the relative ranking of the indebtedness, and bestow the rights and remedies that are available to debt holders if the provisions of the trust indenture are violated. Trust indentures are often complex and weighty documents, however, for rating purposes three aspects of trust indentures, representations and warranties, covenants and events of default are particularly relevant.

### *Representations and Warranties*

Representations and warranties (commonly referred to as reps and warranties) refer to statements of fact, opinions and estimates which investors require issuers to put into writing as a condition of funding. Common representations and warranties usually address issues such as the issuer's existence and solvency, the issuer's power and capacity to enter the transaction, and the enforceability of the transaction agreements against the issuer. Representations and warranties typically address basic factual matters that are essential to the issuer's ability to enter the transaction and meet its obligations.

### *Covenants*

Covenants are undertakings given by the issuer to debt holders that the issuer will do, or will not do something. Covenants are designed to protect the security of debt holders under the trust indenture. This is accomplished by controlling changes to either the capital structure or the operations of the issuer. Covenants to take a certain action are referred to as positive covenants. Typical positive covenants include covenants to pay obligations under the indenture as they come due, and to maintain the issuer's existence. Covenants not to do something are referred to as negative covenants. Typical negative covenants include covenants not to issue additional debt or dispose of all or substantially all of the issuer's assets.

Covenants pertaining to the issuer's financial status are known as financial covenants and may be positive covenants or negative covenants. Financial covenants typically address financial ratios, debt levels, liquidity levels or other indicators of financial health that the issuer must maintain. Financial covenants can play a role in determining the latitude that an issuer has in meeting its financing requirements. Any future issuance of debt must not violate existing financial covenants.

Most trust indentures include a variety of positive and negative covenants. It is typically the case that highly-rated issuers have lighter covenant packages while non-investment grade issuers (at the time the covenants were established) have more stringent covenants.

Although covenants alone will not change the base credit quality of the issuer, they can provide additional comfort to the rating by limiting the issuer's ability to take actions that would either be negative for bondholders directly, or would increase the overall risk profile of the entity in general.

On the negative side, there are instances in which covenants unduly restrict an issuer's flexibility during difficult times. Overly restrictive financial covenants may hinder efforts to recapitalize or restructure,



leaving a choice of breaching existing covenants and facing a potential default on outstanding debt, or taking measures necessary to restructure. As such, overly restrictive covenants can add additional pressure on credit ratings during times of financial stress.

There are significant limitations on the enforcement of covenants. Enforcement by the note trustee usually requires approval by a certain percentage of debt holders. This can be a significant problem if prompt action is required. Once enforcement action is taken, the subsequent litigation will generally be characterized by significant time delays and costs and there is typically a degree of uncertainty regarding the final result. In addition, the enforcement of covenants may be limited and/or lessened by bankruptcy law and reorganization procedures under insolvency statutes. In this respect, in the assessment of an issuer's rating, the ultimate protection for debt holders is not driven by covenant restrictions, but by the fundamental strengths of the issuer.

### *Events of Default*

A trust indenture will describe events of defaults which will allow the note trustee, on behalf of note holders, to accelerate the maturity of the notes and demand immediate payment in full.

Certain events of default can be considered standard or boilerplate provisions. These would include a failure by the issuer to pay an obligation arising under the trust indenture when due, a breach of a covenant or if a representation and warranty given at closing is subsequently determined to be untrue. An event of default will also be triggered in circumstances where the issuer becomes a party to a statutory bankruptcy or restructuring proceeding either voluntarily or due to the actions of creditors.

Events of default that reference another entity or debts of the issuers other than those issued under the trust indenture are known as cross default provisions. Cross default provisions can reference other obligations of the issuer so that any default under these other obligations would result in a default under the indenture. Often there will be a threshold dollar amount given so that in order to trigger an event of default, the other default would have to exceed a specified amount.

Cross default provisions that reference other entities or the obligations of other entities are common where the issuer is a subsidiary or a part of a larger corporate group. If a default or a bankruptcy by an entity other than the issuer could lead to an event of default under the indenture, the credit of that other entity will be material to the rating and may be determinative.

Events of default will be subject to cure periods so that the occurrence of a specified event will not result immediately in a default under the indenture. A number of days, or a cure period, will be provided for during which the issuer can take steps to cure the default. A default which is cured will be deemed to have not occurred.

At DBRS, a trust indenture is examined to understand what would occur should there be a breach, how likely such an occurrence is and the ability of the issuer to react to such a situation.

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