February 21, 1991

TO THE CHIEF EXECUTIVE OFFICERS OF
ALL STATE MEMBER BANKS, BANK HOLDING COMPANIES,
AND DOMESTIC OFFICES OF FOREIGN BANKS
IN THE SECOND FEDERAL RESERVE DISTRICT

SUBJECT: Highly Leveraged Transactions

The staffs of the three Federal bank regulatory
agencies have compiled a number of frequently-asked questions
concerning the definition of Highly Leveraged Transactions (HLTs)
and, in response, are providing additional guidance to examiners
to assist them in the consistent application of this definition.
Among other things, this guidance generally exempts debtor-in-
possession (DIP) loans from HLT status and makes additional
criteria available for delisting credits from HLT status.

This treatment of DIP loans does not suggest that these
credits will receive any less careful supervisory review. As
with other loans and investments, examiners will continue to
review the credit quality factors and risks associated with DIP
financings at examinations.

In order to keep you informed of these developments, a
copy of the interagency statement is enclosed for your informa-
tion. This document supplements the Federal Reserve's existing
supervisory guidelines on HLTs that were dated February 16, 1989,
October 25, 1989, and February 6, 1990. Copies of these docu-
ments are available from the Circulars Division of this Bank
(Tel. No. (212) 720-5216). If you have any questions regarding
this matter, please contact Gerald P. Minehan, Assistant Chief
Examiner, Multinational Banking Department (Tel. No. (212) 720-
5881) or Jennifer R. Zara, Examiner, Multinational Banking
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Yours sincerely,

[Signature]

Chester B. Feldberg
Executive Vice President
GUIDANCE ON HIGHLY-LEVERAGED TRANSACTIONS

The Federal bank regulatory agencies have compiled a number of frequently-asked questions from examiners and others and, in response, are providing additional guidance to assist in the consistent application of the highly-leveraged transaction (HLT) definition.

Q1: Practically speaking, how is the HLT definition applied?

A: A highly-leveraged transaction is a type of financing which involves the restructuring of an ongoing business concern financed primarily with debt. The purpose of an individual credit is most important when initially determining HLT status. Once an individual credit is designated as an HLT, all currently outstanding and future obligations of the same borrower are also included in HLT totals. This includes working capital loans and other ordinary credits, until such time as the borrower is delisted.

Q2: What is the regulatory purpose of the HLT definition?

A: The regulatory purpose of the HLT definition is to provide a consistent means of aggregating and monitoring this type of financing transaction. It must be pointed out that the HLT designation does not imply a supervisory criticism of a credit. Before any HLT or any other credit is criticized, an examiner should review a whole range of factors on a credit-by-credit basis. These factors include cash flow, general ability to pay interest and principal on outstanding debt, economic conditions and trends, the borrower's future prospects, the quality and continuity of the borrower's management, and the lender's collateral position. Participation of banking organizations in highly-leveraged transactions is not considered inappropriate so long as it is conducted in a sound and prudent manner, including the maintenance of adequate capital and loan loss reserves to support the risks associated with these transactions.

Q3: To whom should HLT questions be referred?

A: Borrowers should refer questions to their bankers first. Bankers should then refer only questions they cannot answer to the bank's primary Federal regulator.
Q4: When applying the 50 percent leverage test, how should the "doubling of liabilities" be determined? Further, how should a "doubling of liabilities" be determined when an operating division of a company is acquired by another company?

A: The level of "new" debt in a transaction is what is important when applying this HLT test. Therefore, one should look at all liabilities of companies involved in a transaction on a consolidated basis both before and after the transaction. If new debt doubles the old debt associated with the companies and leverage exceeds 50 percent, then the transaction is deemed to be an HLT.

(Note: Any refinanced portion of old debt in a transaction should continue to be treated as old debt for purposes of applying this leverage test. Further, if there was no debt in either company prior to the transaction, then any new debt will result in a "doubling of liabilities.")

In an acquisition involving one or more operating divisions of a company (as opposed to stand-alone subsidiaries), existing liabilities of the seller associated with specific operating assets being transferred in the transaction may be allocated to the resulting company for purposes of applying the "doubling of liabilities" test. The burden of proof is on the resulting company and its financial institution(s) to substantiate that the allocation of the seller's liabilities to the resulting company is appropriate.

Q5: The HLT purpose test encompasses the buyout, acquisition, or recapitalization of an existing business. For purposes of satisfying this test, does a "recapitalization" result from refinancing existing debt in a company?

A: No. For purposes of satisfying the HLT purpose test, a leveraged recapitalization involves a replacement of equity with debt on a company's balance sheet by means of a stock repurchase or dividend payout.

Q6: How should the HLT tests be applied in an acquisition involving an assumption of old or existing debt with no new debt involved in the transaction?

A: In an acquisition involving a pure assumption of debt with no new debt issued, the transaction is not designated an HLT unless the resulting company's aggregate outstanding HLT purpose-related debt (from all previous transactions) is significant (generally 25 percent or more of total liabilities) and the 75 percent leverage test is satisfied.
Q7: Can a company be considered an HLT on a consolidated basis without all of that company's subsidiaries being designated as HLTs?

A: No. If a company satisfies the HLT purpose and leverage tests on a consolidated basis, then a loan to any part of the organization is deemed to be an HLT.

Q8: Can a subsidiary be designated an HLT without causing its parent organization to become an HLT?

A: Yes. If a subsidiary satisfies the HLT tests, then the subsidiary could "stand alone" as an HLT; however, if the subsidiary's debt level is significant enough to cause the consolidated organization to meet HLT leverage criteria, then all debt of the entire organization is designated HLT.

Q9: Do irrevocable, unconditional guarantees of payment by a parent company affect an HLT designation?

A: Yes. If a parent company supplies an irrevocable, unconditional guarantee of payment on behalf of its subsidiary and the leverage of the consolidated organization does not meet HLT leverage criteria, then the subsidiary will generally not be designated an HLT. On the other hand, if the subsidiary's leverage is significant enough to cause the consolidated organization to meet HLT leverage criteria, then all debt of the entire organization is accorded HLT status.

Q10: Is there an exception for guarantees supplied by third parties or affiliate subsidiaries under the same corporate umbrella?

A: No. Third-party guarantees and guarantees by related subsidiaries of a company have no affect on the HLT designation. While these types of guarantees offer credit enhancement benefits which will be taken into consideration during the review of individual credits by examiners, they generally lack the stronger bonds of support inherent in the relationship between a parent and its subsidiary.

Q11: Will foreign parent companies providing the equivalent of an irrevocable and unconditional guarantee of payment on behalf of a subsidiary affect the HLT designation?

A: Yes. The subsidiary's debt will normally not be designated as HLT debt as long as the consolidated organization does not meet HLT leverage criteria and the following two conditions are met:

(1) Written opinions from legal counsels in the country of origin and the United States are provided which state
that the equivalent of a written guarantee of debt repayment exists which is irrevocable and unconditional; and

(2) The credit files in the U.S. banking organizations lending to the subsidiary contain consolidated financial statements for the foreign parent stated in U.S. dollars under U.S. accounting rules.

Q12: When calculating HLT leverage, how should "double leverage" be treated?

A: If a parent company uses "double leverage" (that is, takes on debt and downstreams it as equity to a subsidiary) to assist a subsidiary in an HLT purpose-related transaction, then the debt at the parent company will be considered HLT purpose-related debt when calculating leverage for the company on a consolidated basis.

Q13: Is perpetual preferred stock considered equity for purposes of calculating HLT leverage?

A: Generally, yes. However, exceptions could be made on a case-by-case basis if the stock has characteristics more akin to debt than equity.

Q14: Are loans to debtors-in-possession (DIPs) operating under Chapter 11 of the U.S. bankruptcy code considered highly-leveraged transactions?

A: The agencies have further considered the question of whether some DIP loans should be included in the HLT portfolio. One important consideration in this regard is that the bankruptcy estate is considered a legally separate and distinct borrower from the pre-bankruptcy borrower. In addition, loans to DIPs generally do not meet the HLT purpose test. Further, the Chapter 11 bankruptcy code is designed to promote DIP lending and, thereby, affords significant protection to DIP lenders in order to preserve the value of the bankruptcy estate and to promote rehabilitation of the debtor. Therefore, court-approved debtor-in-possession (or trustee-in-possession) financing for a business concern in Chapter 11 reorganization proceedings will generally be exempt from HLT designation. All pre-petition debt of an HLT borrower and any post-reorganization debt (after a company emerges from Chapter 11 bankruptcy) will continue to be included in HLT exposure until delisting occurs.
Q15: Are there any additional specific options being made available for delisting credits from HLT status?

A: Yes. Options are being added to the specific HLT delisting criteria that make borrowers eligible for delisting from HLT status when all direct buyout, acquisition, or recapitalization debt satisfying the HLT purpose test has been paid and when companies perform well over an extended period of time, despite operating with high leverage. Further, the wording of the initial specific delisting criteria pertaining to exposures designated as HLTs because of the 75 percent leverage test is being made consistent with these new options. The general delisting criteria are reiterated below along with the four specific ways to become eligible for delisting from HLT status.

(a) General Criteria — For credits to become eligible for removal from HLT status, a company must demonstrate an ability to operate successfully as a highly-leveraged company over a period of time. Under normal circumstances, two years should be sufficient for the credit to show performance and to validate the appropriateness of projections. The banking organization should conduct a thorough review of the obligor to include, at a minimum, overall management performance against the business plan, cash flow coverages, operating margins, status of asset sales, if applicable, reduction in leverage, and industry risk.

(b) Specific Criteria — In addition to these general criteria, at least one of the following specific criteria must be met to become eligible for delisting:

   (1) For exposures that were included because of the 75 percent leverage test, exposures are eligible for delisting from HLT status when leverage is reduced below 75 percent, and the company has demonstrated an ability to continue servicing debt satisfactorily without undue reliance on unplanned asset sales.

   (2) If two years have passed since a company's most recent acquisition, buyout, or recapitalization satisfying the HLT purpose test, then the borrower's credits are eligible for delisting from HLT status if all debt satisfying the HLT purpose test is repaid in full, even if the borrower's total liabilities to total assets leverage ratio continues to exceed 75 percent. The refinancing of HLT purpose-related debt through additional borrowings does not constitute a repayment of HLT debt. Rather, the repayment of debt must occur from cash generated from operations, planned sales of assets, or a capital injection.
(3) For exposures that were included because of the 75 percent leverage test, a borrower's credits are eligible for delisting when the borrower satisfies the general performance criteria for delisting for at least 4 consecutive years since its last buyout, acquisition, or recapitalization involving financing; the company has a positive net worth; and the company's leverage ratio does not significantly exceed its industry norm. Although this criteria does not require leverage to be reduced to less than 75 percent, the borrower must demonstrate an ability to continue servicing debt satisfactorily without undue reliance on unplanned asset sales.

(4) For those exposures that arose under the "doubling of liabilities to greater than 50 percent" leverage criteria, delisting is acceptable based upon the general criteria in (a) above and a demonstrated ability to satisfactorily continue to service the debt.

As was stated in previous guidance, any significant changes in the borrower's financial condition after delisting should cause the exposure to be reviewed for relisting.

Cross-references:  October 1989 HLT Definition  
February 1990 HLT Interpretation

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