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MARKET ALERT: SYNTHETIC UNRESTRICTED SUBSIDIARIES IN U.S. LOAN DOCUMENTS

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Market Alert: Synthetic Unrestricted Subsidiaries in U.S. Loan Documents

The Bottom Line:™

- Some loan documents in the broadly syndicated market have tricky provisions that can be used to create synthetic unrestricted subsidiaries, and this flexibility could be exploited in an LMT.

Overview

Loan documents in the broadly syndicated market frequently allow for designations of “unrestricted subsidiaries,” which are subsidiaries that are not subject to the covenants in the loan documents. *Covenant Review* subscribers are likely familiar with the concept. These unrestricted subsidiaries can be used in a number of ways that are potentially detrimental to lenders, as has been seen in many recent [LMTs](#). However, there are ways in some loan documents that borrowers can achieve essentially the same thing without needing to designate an unrestricted subsidiary.

Earlier this year, Xerox executed a transaction using a joint venture that most likely did not meet the definition of “Subsidiary” under the bond and loan documents, and as a result was essentially the same thing as an unrestricted subsidiary. See our report on the Xerox transaction [here](#) and our report on whether Xerox could use the same structure for another transaction [here](#). In light of the Xerox transaction, *Covenant Review* subscribers have been asking whether loan documents have other loopholes that can be exploited to create such a synthetic unrestricted subsidiary

In this report, we examine certain loopholes that are present in some U.S. loan documents that could give borrowers similar flexibility to create a synthetic unrestricted subsidiary.

What are Unrestricted Subsidiaries?

Before we can assess *synthetic* unrestricted subsidiary flexibility, it is first critical to understand exactly what unrestricted subsidiaries are. An unrestricted subsidiary is a subsidiary of the borrower or issuer that is *not* subject to the restrictions and requirements imposed by a debt agreement’s covenants. For example, a Debt covenant tells the borrower and its restricted subsidiaries that they can only incur debt under certain limited circumstances—unrestricted subsidiaries, on the other hand, are not so beholden and can incur debt above and beyond what is prescribed in a negative covenant.

Moreover, unrestricted subsidiaries are *also* not counted for financial metric purposes (i.e., in calculating EBITDA, total assets, or other metrics, unrestricted subsidiaries are ignored).

For purposes of this report, the focus will primarily be on the applicability (or inapplicability) of the covenants. In short, a “synthetic unrestricted subsidiary” is essentially any entity that is (1) not an unrestricted subsidiary and (2) not subject to the limitations of the covenants of an existing debt agreement.

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The Xerox transaction

In this report, we will not rehash the full details of the Xerox transaction (subscribers can read our report for the full details). The high-level summary is that Xerox created a joint venture, with third parties as the joint venture counterparties, that likely did not meet the definition of “Subsidiary” in the credit agreement (which generally required that such subsidiaries be at least majority-owned). As a result, the joint venture was a synthetic unrestricted subsidiary, as the covenants applies to restricted subsidiaries, and an entity must be a subsidiary in order to be a restricted subsidiary. This allowed Xerox to circumvent very tight Debt covenants in its bond and loan documents. Of note, is that the Xerox bond and loan documents allowed for designations of unrestricted subsidiaries but included a J. Crew blocker that limited Xerox’s ability to transfer material IP to unrestricted subsidiaries. Xerox wanted to borrow against IP assets, so using an unrestricted subsidiary was not a viable option. Using a synthetic unrestricted subsidiary solved this problem, as the bond and loan documents restricted transfers of material IP to unrestricted subsidiaries but did not prohibit transfers of material IP to *other entities* (including entities that are not subsidiaries at all). Xerox then borrowed at the synthetic unrestricted subsidiary and distributed the proceeds back up to the existing credit group, effectively stripping the existing lenders of the collateral invested in the synthetic unrestricted subsidiary and using it to support the new debt.

The Xerox synthetic unrestricted subsidiary structure could likely be utilized by many companies, as most credit agreements have similar definitions of “Subsidiary” and the covenants almost always only apply to restricted subsidiaries in U.S loan documents. However, it also has its drawbacks. A company would need to find a willing JV partner and structuring the entity in a way that keeps it outside of the definition of “Subsidiary” while protecting the parties’ interests could have significant challenges. So, while the Xerox synthetic unrestricted subsidiary structure could be a possibility under many U.S. loan documents, companies may look to simpler options.

Limiting the scope of covenant coverage

Covenants only apply to loan parties

Another means by which some companies have retained flexibility to create synthetic unrestricted subsidiaries is to limit the scope of the covenants, particularly the negative covenants. One method of doing this is to limit the covenants to the loan parties (e.g., the borrower and the guarantors). With this, any non-loan party subsidiary is a synthetic unrestricted subsidiary. An example of this can be seen in the Open Text Corporation’s credit agreement (the “Open Text Credit Agreement”).¹ The affirmative and negative covenants only apply to Loan Parties². “Loan Parties” is defined to only include the borrower and the guarantors³. Notably excluded from the guarantor group are any “Excluded Subsidiaries.” The definition of “Excluded Subsidiary” is mostly customary for the broadly syndicated loan market, including exceptions for non-wholly owned subsidiaries, immaterial subsidiaries, and entities located outside of the US and Canada (subject to a minimum guarantor coverage test)⁴. As a result of the limited scope of the covenants, Open Text Corporation has flexibility to create synthetic unrestricted subsidiaries by forming Excluded Subsidiaries, including entities

¹ See the Open Text Credit Agreement [here](#). Although the Open Text Credit Agreement is governed by Ontario law, it is otherwise very similar to a U.S.-style credit agreement that would be governed by New York law.

² See Sections 6.01 and 6.02 of the Open Text Credit Agreement.

³ See the definition of “Loan Parties” in Section 1.01 of the Open Text Credit Agreement.

⁴ See the definitions of “Domestic Guarantor,” “Excluded Subsidiary,” “Foreign Guarantor,” and “Loan Parties” in Section 1.01 of the Open Text Credit Agreement.

outside of the US and Canada (subject to the minimum coverage test).

The case of the Open Text Credit Agreement is of particular note because it does not permit the company to designate unrestricted subsidiaries. Lenders may have thought that they had successfully negotiated the concept out of the Open Text Credit Agreement while being unaware that they left the back door open through synthetic unrestricted subsidiaries.

Other limitations of covenant coverage

There are other means companies can use to have flexibility to create synthetic unrestricted subsidiaries. In a transaction seen recently in the market, the covenants only applied to material subsidiaries. As a result, any immaterial subsidiary would be a synthetic unrestricted subsidiary. This may not sound too bad, but the credit agreement also allowed for immaterial foreign subsidiaries to collectively account for up to 20% of revenue (there was also a per-entity cap set at a lower level). Creative lawyers may be able to come up with ways to utilize that type of flexibility in an LMT.

Other potential sources of synthetic unrestricted subsidiary capacity may be hiding in plain sight. One example can be found in Delek U.S. Holdings, Inc.'s Third Amended and Restated Credit Agreement (the "Delek Credit Agreement").⁵ The Delek Credit Agreement includes the ability to designate unrestricted subsidiaries⁶. The covenants generally apply to the loan parties and their restricted subsidiaries⁷. However, there is an unusual feature. The definition of "Restricted Subsidiary" expressly excludes any "MLP Subsidiary" in addition to any unrestricted subsidiary⁸. As a result, any MLP Subsidiary is also a synthetic unrestricted subsidiary. The amount of flexibility this creates may be limited as the definition of "MLP Subsidiary" is very specific and MLP Subsidiaries are themselves subject to certain restrictions⁹.

The Delek Credit Agreement shows one additional downside of synthetic unrestricted subsidiaries from a lender perspective. Section 6.19 includes specified parameters on when the company may designate unrestricted subsidiaries. However, these do not apply to MLP Subsidiaries. Because synthetic unrestricted subsidiaries are not unrestricted subsidiaries, restrictions applicable to unrestricted subsidiaries do not generally apply to synthetic unrestricted subsidiaries (flexibility that Xerox took advantage of with respect to its J. Crew blocker). Lenders may think that they have negotiated protections on unrestricted subsidiaries that will not apply to synthetic unrestricted subsidiaries, potentially making synthetic unrestricted subsidiaries more dangerous to lenders than actual unrestricted subsidiaries. Of course, the MLP component of the Delek Credit Agreement is arguably a bespoke feature of the credit (not many BSL issuers have MLPs in their capital structure). However, conceptually, the approach taken in the Delek Credit Agreement—i.e., the creation of *additional* categories of subsidiaries outside of the covenant coverage beyond simple unrestricted subsidiaries—could easily be replicated in other transactions without an MLP affiliate.

Conclusion

There are sometimes tricky provisions in U.S. loan documents that permit the creation of synthetic unrestricted subsidiaries. Investors should therefore have a broader appreciation for exactly *what* being unrestricted means

⁵ See the Delek Credit Agreement [here](#).

⁶ See Section 6.19 of the Delek Credit Agreement.

⁷ See Sections 5 and 6 of the Delek Credit Agreement.

⁸ See the definition of "Restricted Subsidiary" in Section 1.01 of the Delek Credit Agreement.

⁹ See the definition of "MLP Subsidiary" in Section 1.01 of the Delek Credit Agreement as well as Sections 6.20 and 6.21 of the Delek Credit Agreement.

(i.e., that unrestricted entities are not subject to covenant limitations). Moreover, they should understand that unrestricted subsidiaries are not necessarily the *only* unrestricted entities possible in the capital structure. Companies may increasingly seek these provisions as appetite for LMT flexibility continues to drive the broadly syndicated loan market. Covenant Review will continue to assess this situation as it develops.

— *Covenant Review*

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