Corporate Debt Securities in U.S. Capital Markets

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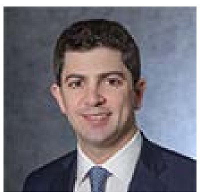

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The U.S. debt capital markets are an important source of capital for companies that borrow money to finance their businesses. Companies borrow money for a variety of reasons, from financing day-to-day operations and managing seasonal fluctuations in working capital, to funding acquisitions or paying dividends. Most companies obtain debt through loans from banks and other institutional lenders market or by issuing debt securities in the capital markets. This practice note provides a high-level introduction to debt securities commonly issued by companies in the U.S. debt capital markets and discusses the offering process and key characteristics of different types of transactions. Counsel should be aware that there are a significant number of other legal terms and issues relevant to issuers, underwriters, and investors that are outside the scope of this note. In addition, different transactions may give rise to different issues based on the facts and circumstances at hand.

For additional information on various types of debt transactions, see Market Trends 2017/18: Investment Grade Debt Offerings, Market Trends 2017/18: High Yield Debt Offerings, Market Trends 2017/18: Convertible Bond Offerings, Market Trends 2017/18: Medium-Term Note Programs, Market Trends 2017/18: Sovereign Bonds, Top 10 Practice Tips: Investment Grade Debt Offerings, Top 10 Practice Tips: High Yield Debt Offerings, and Top 10 Practice Tips: Convertible Note Offerings.

What Is a Debt Security?

A debt security is a tradable instrument evidencing the obligations of one party (the issuer) to repay money to the holders of the security. U.S. corporate debt securities are often referred to as notes or bonds. Key characteristics of debt securities include the following:

- **Principal amount.** The amount the issuer must repay at maturity and on which interest is calculated.
- **Maturity.** The time at which any outstanding amounts still owed under a debt security must be repaid is known as the maturity. The length of the period from the date of issuance of a debt security to its maturity date is sometimes referred to as the term or tenor. Maturities vary significantly depending on the nature of the offering and the issuer.
- **Ranking.** Notes may either be senior obligations or subordinated obligations. Senior obligations rank equally in right of payment with general unsecured claims against the issuer and ahead of subordinated claims, whereas subordinated debt may not be paid until all senior claims to which the debt has been subordinated have been repaid in full.
- **Interest.** Noteholders are typically entitled to be paid interest on the outstanding principal amount of their notes. The interest rate may be a fixed rate or a floating rate based on a benchmark rate. Interest is typically paid in cash at regular intervals during the term of the debt security. In the case of paid-in-kind or PIK notes, the issuer is permitted to pay interest in kind by adding the amount of interest owed to the

outstanding principal amount in lieu of a cash payment. Zero coupon notes are notes that do not pay interest; instead, the notes are issued to investors at a discount to their face amount and then repaid at face value at maturity.

- **Redemption.** Corporate debt securities often include restrictions on the issuer's right to redeem (or repay) the securities before maturity or require the issuer to pay an additional premium to do so. Call protection is attractive to debt investors because it helps protect against the risk that the issuer will refinance the bonds at a lower interest rate as soon as business or market conditions improve, in which case investors may be unable to reinvest their capital at the same rate. This is important as most debt securities are fixed rate. The notes may also include mandatory redemption provisions requiring the issuer to redeem the notes before maturity if certain events occur (such as asset sales and change of control).
- **Credit ratings.** Many issuers of debt securities in the U.S. are rated by one or more credit ratings agencies, the most prominent of which are S&P, Fitch, and Moody's. The ratings reflect the agencies' assessment of an issuer's ability to repay the particular debt security. Issuers also have corporate credit ratings which speak to the issuer's credit more broadly. Often, different securities issued by the same company will have different credit ratings depending on their terms. For example, a secured note with a 5-year maturity may have a higher rating than a 10-year unsecured note. Highly rated investment grade securities typically have terms that differ significantly from non-investment grade (or high yield) securities, as discussed below.
- **Transferability.** Debt securities are usually easily transferable between investors, facilitating trading, and providing liquidity to investors.
- **Guarantees.** Debt securities may be guaranteed by the issuer's parent holding company (if any) or all or certain of its operating subsidiaries. Whether guarantees are provided and the scope of the guarantees are primarily determined by the credit ratings of the debt securities, market conditions, and negotiations between the issuer and underwriters.
- **Collateral.** Debt securities may be either unsecured or secured by certain assets of the issuer and any guarantors.
- **Covenants.** The documentation governing debt securities usually include covenants that the issuer must comply with as long as the securities remain outstanding, with the nature of the covenants varying depending on the nature of the security, the credit worthiness of the issuer, and market conditions.
- **Registration.** Debt securities are subject to the U.S. securities laws. Accordingly, transactions in debt securities must either be registered with the Securities and Exchange Commission or qualify for an exemption from registration.

For further information on debt securities, see Debt Finance: Syndicated Loans, Debt Securities, and Mezzanine Loans. For information on international debt transactions, see Debt Capital Markets in International Jurisdictions.

The Offering Process

Engaging the Underwriters and Initial Purchasers

Issuers typically engage one or more banks early in the process to act as underwriters for the offering and to advise on pricing and other aspects of the offering. In an unregistered offering, the lead banks are referred to as initial purchasers in marketing documentation, rather than as underwriters. The underwriters are closely involved in most aspects of the offering, including the strategy for marketing the debt, the preparation of the disclosure documents and other marketing materials, conducting due diligence, organizing road shows, and negotiating the legal documentation. In selecting the lead bank, issuers take into account several factors including:

- Indicative terms proposed by each underwriter for the financing, including the underwriting fees
- The underwriter's experience in arranging similar debt financings for companies in the same industry
- The issuer's relationship with the underwriter and the underwriter's familiarity with its business

In cases where multiple underwriters are engaged, the underwriter with primary responsibility for the offering is often referred to as the left lead, after the customary practice in which the lead underwriter's name is listed on the left-hand side of marketing materials for the offering.

Registered vs. Unregistered Offerings

The steps involved in conducting an offering of debt securities differ depending on whether the transaction is being done on a registered basis or on an unregistered basis in reliance on an exemption from the securities laws.

In a registered offering, as is the case for equity offerings, the issuer must draft and file a registration statement and prospectus for the offering with the SEC, which must be declared effective (or be deemed effective pursuant to SEC rules) before the offering can be consummated. The registration statement includes disclosures regarding the issuer's business as well as a detailed description of the terms of the debt securities being offered.

In an unregistered offering, the issuer typically prepares an offering memorandum to be shared with potential investors. Although unregistered offerings are not subject to many of the specific disclosure requirements contained in the Securities Act applicable to registered deals, the anti-fraud provisions set forth in Rule 10b-5 under the Securities Exchange Act apply to all offerings of securities, whether registered or unregistered. Rule 10b-5 forbids issuers and underwriters from making any untrue statement of a material fact or omitting to state a material fact necessary in order to make statements made not misleading in light of the circumstances in which they were made in connection with the purchase or sale of any security. In light of this broad requirement and to protect against potential liability arising from potential lawsuits by noteholders, offering memoranda in unregistered offerings often look to SEC disclosure requirements for registered offerings as a guide post, and include disclosures similar in scope to what would be required for a registered offering. That said, the appropriate scope of disclosure in an unregistered offering requires careful legal analysis and consideration of the circumstances of the offering, including the nature of the issuer's business, the terms of the securities and the number of the investors and their degree of financial sophistication.

In some unregistered offerings, investors receive registration rights with respect to the debt securities, pursuant to which the issuer agrees to register resales of the debt securities by the holders within a certain time period after issuance or if particular conditions are met or, alternatively, to exchange the initial securities with new securities issued in a registered offering with otherwise identical terms (referred to as an A/B exchange offer). Other offerings are marketed on a 144A-for-life basis and are never registered.

From an issuer's perspective, the decision whether to conduct an offering on a registered or unregistered basis depends on several factors, including:

- **Nature of target investors.** Unregistered offerings usually must be limited to investors that satisfy size or sophistication criteria set forth in the relevant exemption or safe harbor, such as qualified institutional buyers in Rule 144A offerings, whereas registered offerings may be marketed to all investors.
- **After-market liquidity.** Securities issued in a registered offering are generally more liquid.
- **Whether the issuer is already an SEC reporting company.** Issuing securities in a registered offering may cause the issuer to become subject to ongoing SEC reporting requirements to the extent the issuer is not already a reporting company. This makes registered offerings unattractive to most privately held companies that are not otherwise subject to SEC reporting requirements.
- **Other reporting burdens.** If the securities will be guaranteed by the issuer's subsidiaries or secured by pledge of equity interests in such subsidiaries, consideration must also be given to SEC Rule 3-10, which may require delivery of additional financial information or separate financial statements with respect to certain guarantors in a registered offering. Though, we note the SEC has recently announced proposed changes to make these rules less burdensome on issuers.

For additional information, see Underwriting Registered Securities Offerings, Registered Offerings: Applicable Laws, Rules, and Regulations, and Private Offering Management.

Documentation

Most notes are issued pursuant to an indenture which sets forth the key terms governing the notes, including payment terms, redemption provisions, covenants, and events of default. Individual noteholders are not party to the indenture and can only exercise their rights with respect to the notes collectively through the trustee, a financial institution appointed to act on behalf of the noteholders. These notes themselves are generally issued in registered form (as opposed to bearer form) as global notes and are generally cleared and settled using book-entry clearing systems, most commonly the Depository Trust Company (DTC).

Offering Types

Investment Grade vs. High-Yield Securities

High-yield bonds are debt securities with non-investment grade ratings, that is, ratings below BBB- / Baa3. There are several important differences between high-yield and investment grade bonds arising from the lower risk of default by investment grade issuers, though the covenant package and terms vary as an issuer moves up and down the credit spectrum. These include:

- High-yield bonds typically have a higher interest rate since they carry a greater risk of default.
- High-yield bonds are often guaranteed by the issuer's subsidiaries, and are more likely to be secured by the assets of the issuer and its subsidiaries.
- Covenants in high-yield bonds are typically more re-

strictive and apply to a wider scope of activities than in investment grade debt. For example, high-yield bonds typically include closely negotiated limits on the amount of secured and unsecured debt that can be incurred, investments that can be made, and dividends that can be paid, whereas investment grade bonds typically only restrict liens (i.e., secured debt).

- Investment grade bonds are often subject to more restrictive call protection provisions than high-yield debt. High-yield bonds can typically be redeemed halfway to maturity at a redemption premium equal to half of the coupon, which declines to zero over the remaining term of the notes. Investment grade bonds, in contrast, are often only callable at a make-whole premium (which is calculated based on the discounted present value of all remaining interest payments) for their entire term, making them significantly more expensive to refinance prior to maturity.
- Investment grade notes are more likely to be registered with the SEC since they are frequently issued by large creditworthy companies that are likely to be SEC reporting companies, whereas high-yield notes are often unregistered and typically marketed in a Rule 144A offering.
- Because high-yield issuers tend to be more highly levered and hence more vulnerable to shocks in their business or to markets more generally, the high-yield bond market tends to be more strongly impacted by market volatility.

For further information, see Market Trends 2017/18: Investment Grade Debt Offerings, Market Trends 2017/18: High Yield Debt Offerings, Top 10 Practice Tips: Investment Grade Debt Offerings, and Top 10 Practice Tips: High Yield Debt Offerings.

Medium Term Notes

Medium term note programs (MTN programs) are a form of debt financing used by large companies with an ongoing need to raise additional capital in the debt capital markets.

To establish an MTN program, issuers file a shelf registration statement with the SEC to permit delayed and continuous registered offerings. They also enter into master legal documents governing the program, including agreements with one or more banks to act as selling agents or dealers under the program. The master documents provide for flexibility to issue a wide variety of debt securities with different terms.

Once an MTN program has been established initially, issuers can complete offerings with minimal new documentation, usually limited to a prospectus supplement indicating the issue price, interest rate, amount, maturity, and other terms specific to the offering. This significantly reduces the amount of time and expense required to launch and complete a new offering and enables issuers to react more quickly to favorable market conditions.

Most MTNs have a maturity of two to five years, though there is no legal requirement that the notes have medium terms, and it is not uncommon for issuers to issue short or long-term notes under MTN programs. MTNs usually carry an investment grade rating.

For more information on medium term notes, see Medium-Term Note (MTN) Programs and Market Trends 2017/18: Medium-Term Note Programs.

Convertible Bonds

A convertible bond is a hybrid debt security that provides the holder, and sometimes the company, with the option to convert the debt security into another security of the issuer—typically common equity shares—after a fixed date or upon certain conditions being met at a specified conversion price. Until converted, a convertible bond behaves like a typical debt security.

Convertible bonds usually include anti-dilution provisions, pursuant to which the conversion price is automatically adjusted in order to preserve the value of the conversion option in the event of new equity issuances, stock splits, mergers, or other transactions affecting the equity of the issuer.

Convertible bonds can be an attractive financing tool for emerging companies or companies with high growth potential, because they allow them to obtain debt financing at a lower interest rate than would otherwise be available (due to the imbedded value of the option) while delaying the dilutive effect on the issuer's common equity. Technology and biotechnology companies are frequent convertible bond issuers.

However, the hybrid debt/equity nature of convertible bonds introduces additional legal, tax, and accounting complexity. In addition, many convertible bonds issued in recent years can only be called by the issuer if certain market price conditions are satisfied, which can create difficulties in structuring a sale or merger involving the issuer.

For additional information on convertible bonds, see Convertible Debt Securities, Market Trends 2017/18: Convertible Bond Offerings, and Top 10 Practice Tips: Convertible Note Offerings.

Commercial Paper

Commercial paper is a short-term, unsecured debt instrument used by large highly rated investment grade issuers. Commercial paper has a maturity ranging from 2 days to 270 days, with most maturing between 5 and 45 days.

At maturity, issuers typically either pay the commercial paper from cash on hand or roll the paper by issuing new commercial paper and using the proceeds to repay the paper that has come due. Due to its short maturity, commercial paper is only a viable financing tool for highly creditworthy companies that are confident of being able to sell commercial paper at attractive rates on a continuous basis. These qualities make commercial paper an attractive and relatively low-risk investment for certain institutional investors, such as money market mutual funds, and as a result commercial paper tends to be less expensive than other forms of debt financing, such as a bank credit facility. These investors typically hold commercial paper for its entire term.

Commercial paper is almost always issued on an unregistered basis pursuant to an exemption from registration. The most commonly relied upon exemptions are Section 3(a)(3) of the Securities Act and Section 4(a)(2). Section 3(a)(3) of the Securities Act provides an exemption from registration for debt securities with a maturity of nine months or less, the proceeds of which are used to finance current transactions. Issuers must take steps to ensure that the proceeds from commercial paper sold under this exemption are only used to finance working capital and other current transactions, such as paying operating expenses. SEC guidance has established other requirements for commercial paper issued pursuant to this exemption, including that the paper must be of prime quality and may not be of type ordinarily purchased by the public. In addition, the commercial paper must be eligible for discounting by the Federal Reserve Banks.

Companies typically issue commercial paper through one or more banks referred to as dealers. Similar to the role of an underwriter in a registered securities transaction, dealers purchase the commercial paper from issuers and immediately resell it to investors. The issuer also typically appoints a third-party financial institution, usually a trust company or bank, to act as issuing and paying agent, which performs functions similar to those of a trustee under a bond indenture, including processing payments and coordinating clearing and settlement with DTC.

Like MTNs, commercial paper is typically issued on an ongoing basis pursuant to a pre-established program. The documentation for a commercial paper program is typically negotiated by the issuer and the lead dealer, and include an offering circular, one or more dealer agreements and an issuing and paying agent agreement. Given the high credit quality and short maturity of commercial paper, terms are relatively standardized compared to other corporate debt securities and are not heavily negotiated. For more information, see Commercial Paper Programs.

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Ari Blaut is a partner in the firm's leveraged finance, restructuring and capital markets groups. Ari maintains a broad corporate practice advising clients on a wide range of financing transactions, including bank financings, high yield bond issuances, "PIPE" transactions, debt restructurings, liability management, creditor representations and joint ventures. Ari has particular expertise in leveraged finance, acquisition finance and strategic credit transactions. Ari regularly acts for clients in connection with arranging committed debt financing (both bank and bond) for mergers and acquisitions.

Some of Ari's significant representations in the past year include, among others, advising (i) AT&T on its $40 billion debt financing for its pending acquisition of Time Warner, (ii) Tesoro on its $4.1 billion debt financing for its pending acquisition of Western Refining, (iii) Eastman Kodak in connection with its "PIPE" transaction with Southeastern Asset Management and (iv) the ad hoc committee of Key Energy's unsecured note holders in connection with financing matters related to the acquisition of Key Energy through its prepackaged Chapter 11.

RECENT RANKINGS AND RECOGNITIONS

IFLR1000 – Recognized as Rising Star (2017)

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