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So You've Issued Convertible Notes: Now What?

If you have any questions regarding the matters discussed in this memorandum, please contact the attorneys listed on the last page or call your regular Skadden contact.

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The U.S. market for new issuances of convertible notes was very active in 2014, with approximately $51.4 billion of convertible debt issued in 140 transactions. In the first quarter of 2015, approximately $15.5 billion was issued in 26 deals.

Many of these deals involved companies issuing convertible notes for the first time. For a first-time issuer, the provisions in the indenture governing its convertible notes may seem highly technical and unintuitive, even if the company has previously issued non-convertible debt or has outstanding bank debt. The following is a summary of certain provisions that are common in convertible notes (and in certain related derivative transactions) and other considerations that can be traps for the unwary. It is important to remember, though, that these provisions can differ from indenture to indenture.[1]

In addition to the matters described below, issuers should be aware that certain hedging activities by investors in convertible notes and by counterparties to related derivative transactions may affect the price of their common stock. Though outside the scope of this discussion, issuers may wish to consider the nature and magnitude of this impact when structuring convertible note offerings.

Ongoing Reporting and Monitoring Requirements

Convertible note indentures typically do not contain the restrictive covenants or extensive reporting requirements that are often found in high-yield debt indentures. However, issuers should not assume that they do not need to comply with obligations other than making timely interest payments and satisfying conversion obligations. There are a number of ongoing requirements that issuers must consider.

Monitoring Conversion Conditions. Convertible note indentures that require (or permit) the issuer to settle all or a portion of its conversion obligations in cash typically allow holders to convert only in certain specified circumstances. These typically include:

1. if the issuer's stock price is more than a specified percentage above the conversion price for a specified period at the end of a fiscal quarter (known as the "stock price trigger");
2. if the trading price of the notes is less than a specified percentage of the value of the underlying stock for a specified period (known as the "trading price condition");

[1] While many of the following considerations will also be applicable to similar equity-linked instruments, such as equity units and convertible preferred stock, those instruments are generally outside the scope of this discussion.

3. the occurrence of certain significant corporate transactions; and
4. during a predetermined period immediately prior to the maturity of the notes.

In particular, many indentures require the issuer to monitor its stock price to determine if the stock price trigger is met (and to notify holders and the trustee if it has been met). In addition, indentures may require issuers to notify holders if the trading price trigger has been met. Indentures also typically require notice in advance (sometimes well in advance) of the consummation of a corporate transaction that would give holders the right to convert their notes. It is important to keep in mind when contemplating significant corporate transactions (such as mergers, acquisitions or significant distributions) that convertible note holders may have the right to be notified of the transaction prior to consummation. The Depository Trust Company (DTC), through which convertible notes are most often held, also may require that the issuer notify holders if conversion triggers are met and, if they have been met, provide additional information to ensure the notes are eligible for conversion.

Reports to the Trustee. Like most indentures, convertible note indentures typically contain ongoing reporting requirements. In particular, the indentures are likely to require that an issuer certify, at least annually, that no defaults have occurred under the indenture. In the case of a default, an issuer likely would be required to notify the trustee of the occurrence within a specified period of time and of the actions to be taken to cure the default.

Additionally, a convertible note issuer usually is required to deliver to the trustee reports that the issuer is required to file with the SEC, although sometimes the reports are deemed to be delivered when filed with the SEC through the SEC's EDGAR system. Failure to comply with this requirement may result in a default or in the issuer being required to pay additional interest to holders.

SEC Reporting. An issuer of convertible notes also should consider with counsel whether additional reports or changes in the issuer's periodic reporting disclosure may be required in connection with changes to its convertible notes or related derivative transactions. Such changes include the satisfaction of conversion conditions, adjustments to conversion rates, and the issuance of stock upon conversion of notes or, if applicable, the exercise of the warrant portion of call spread transactions, further described below. In addition to the accounting considerations, some of which are described below (and which may change the treatment of convertible notes on an issuer's balance sheet and the related disclosure in the issuer's periodic reports to the SEC), issuers should consider whether any Form 8-K requirements may be triggered as a result of adjustments to the conversion rate or other changes to the convertible notes or call spread transactions, or as a result of the delivery of shares upon conversion or, if applicable, upon exercise of the warrant portion of any call spread transactions.

Legend Removal and Timely Reports

Many convertible notes are sold in reliance on Rule 144A under the Securities Act of 1933. As a result, the convertible notes acquired in these transactions are "restricted securities" within the meaning of Rule 144 and are initially required to bear a restricted securities legend. Rule 144, however, provides an exemption from the registration requirements, subject to certain exceptions, for transactions in such convertible notes (or the underlying common stock) if at least one year has passed from the date the notes were acquired from the issuer or an affiliate of the issuer (or six months if the issuer is a reporting company and has timely filed certain reports required under the Securities Exchange Act of 1934).

Most recent convertible notes offered in reliance on Rule 144A require the issuer to timely file its Exchange Act reports and remove the restricted securities legend after a fixed period of time (typically one year after issuance). If the issuer fails to comply with its obligations to timely file such reports, or if the restricted securities legend is not removed from the notes within a specified period, the issuer likely will be required to pay additional interest to holders for so long as the failure is continuing or until the legend is removed. Because the process of removing the legend can be time-consuming, it is important to begin discussions with the trustee and DTC in advance of the expiration of the one-year period to ensure that all requirements can be met as soon as the period has passed.

Conversion Rate Adjustments

Convertible note indentures typically provide for a number of circumstances that can result in adjustments to the conversion rate. These typically include cash dividends and distributions (above a certain threshold if one is specified in the indenture), as well as rights offerings, stock splits and combinations, tender offers and certain types of other distributions. While many issuers are aware of the obligation to adjust the conversion rate upon the occurrence of these events (and to notify the trustee and holders of the adjustment), it is important to note that many indentures also require notice to holders prior to the occurrence of distributions that could give rise to adjustments to the conversion rate (often prior to the related record date for such distributions). Furthermore, the stock exchange on which the issuer's common stock is listed may require notices of any changes to the conversion rate.

Settlement Method Election

Some indentures give issuers the right to choose whether to deliver to holders cash, stock or a combination thereof upon conversion. There are, however, limitations on how and when these elections can be made. For example, conversions during a fixed period prior to the maturity of convertible notes are typically required to be settled in the same manner, and indentures typically require issuers to notify holders and the trustee of their chosen settlement method prior to the commencement of that period. Failure to do so can result in issuers losing their ability to settle conversions using any method other than the default settlement method set forth in the indenture. Furthermore, issuers that have entered into a "bond hedge" portion of a call spread transaction are generally required to settle those transactions in the same manner as the related convertible notes, and to represent to their bank counterparties that they are not in possession of material nonpublic information with respect to themselves or their shares when making such an election. This requirement may be difficult to satisfy, especially when the relevant period begins during an issuer blackout period. Accordingly, it is important for issuers to plan in advance if they wish to settle conversions using any method other than the default settlement method.

Accounting Considerations

Many of the actions or requirements described above may have accounting implications. For example, the determination that notes are currently convertible may affect the classification of the convertible note indebtedness on the issuer's balance sheet. Similarly, an issuer's settlement method election, and the timing thereof, could have implications on the accounting method used for the convertible notes (and related derivative transactions) and, potentially, on the availability of certain accounting treatment going forward.

Call Spread and Capped Call Transactions Many issuers of convertible notes enter into related derivative transactions, namely call spread or capped call transactions, concurrently with the issuance of convertible notes. These transactions can have the effect, from the issuer's perspective, of effectively increasing the conversion rate of the convertible notes and can, in certain cases, have tax benefits. It is important for issuers to keep in mind that these transactions typically have their own set of reporting requirements, which do not necessarily match the reporting requirements for the convertible notes. For example, an issuer typically must notify its counterparties upon conversions of notes, upon determination of the consideration due to holders following conversions, of the relevant settlement method election and of repurchases by the issuer of shares of its stock in excess of predetermined levels. It is also important to note that counterparties can have significant discretion in adjusting the terms of these transactions upon the occurrence of various events, many of which may not be obvious. Accordingly, it is important for issuers to consider their call spread or capped call transactions before undertaking any activity that could have an impact on these transactions.

Maintaining Ability to Satisfy Conversion Obligations Issuers of convertible notes that will be settled all or in part in shares should remain mindful that they will need to maintain sufficient authorized shares to settle all conversions, especially when considering other equity issuances (including through equity compensation plans). Correspondingly, for convertible notes that require or permit the issuer to settle all or a portion of their conversion obligations in cash, issuers should ensure that they have sufficient cash on hand, and the ability to use that cash, to satisfy their conversion obligations. For example, issuers should note that credit agreements and bond indentures (particularly for high-yield issuances) often have restrictions on the ability of issuers to use cash to pay other indebtedness (including convertible indebtedness). Careful drafting of these agreements is required to ensure they do not limit an issuer's ability to satisfy its conversion obligations in their preferred manner.

Significant Transactions

Issuers that are considering significant transactions, such as mergers and large asset sales, should carefully review their convertible note indentures, as these transactions may give holders the right to "put" their notes back to the issuer and involve various notice requirements, some of which are described above. In particular, it is important to analyze the convertible note indenture definition of a "fundamental change," since it may be broader than simply a change of control. For example, a "fundamental change" often includes delisting from a stock exchange and certain recapitalization transactions. In addition, in order to compensate holders for lost option value, convertible notes typically provide holders with the right to receive "make-whole" protection in the form of additional shares if the notes are converted in connection with certain "fundamental change" transactions. Issuers should be mindful of the "fundamental change" definition when drafting their credit agreements and other indentures to ensure that these agreements will not limit the ability of the issuer to comply with the convertible notes in the event of a "fundamental change." A fundamental change that does not constitute a change of control likely would not otherwise require repayment of the obligations under these other debt agreements, and issuers should take care to avoid a situation in which they need to seek amendments or waivers of, or repay, their other debt obligations simply because they do not permit compliance with the terms of their convertible notes.

Repurchases of Convertible Notes

Issuers may wish to retire previously issued convertible notes before their maturity for a variety of reasons. Once an issuer's convertible notes are in-the-money or when an issuer's stock price has increased, the issuer may wish to retire the notes to avoid further dilution. Other market events and holder-specific circumstances also may create favorable opportunities to repurchase notes. Issuers that are interested in repurchasing their convertible notes have various methods to do so, including through open-market repurchases or tender or exchange offers, or through induced conversions.[2] Issuers seeking to repurchase convertible notes also should keep in mind that many holders likely have short positions in the issuer's stock that the holder will unwind as the holder sells its notes.

Also, in connection with repurchases of their convertible notes, issuers that have entered into call spread transactions may wish to unwind or modify the terms of these transactions. Issuers should keep in mind that they may need to negotiate such a termination with their call spread counterparties. An early termination of a derivative transaction also can have tax, accounting and other implications for an issuer.

[2] See "Convertible Bond Repurchases: Opportunities and Considerations," Skadden, Arps, Slate, Meagher & Flom LLP, Nov. 21, 2008.

Conclusion

While lacking many of the covenants that an issuer might find in a non-convertible note transaction, indentures governing convertible notes contain a number of reporting, monitoring, notice and other requirements that can be easily overlooked. The consequences of failing to comply with these requirements can range from monetary penalties to the occurrence of an event of default. Issuers also should be mindful of their convertible notes when drafting and negotiating credit agreements and other debt agreements to ensure the issuer retains the flexibility to comply with the terms of its convertible notes. Similarly, separate derivative transactions entered into by an issuer in connection with convertible notes issuances may be highly attractive; however, they may present various issues and considerations and add another layer of complexity. Accordingly, it is important that issuers be familiar with their convertible note indentures and keep them in mind when considering both actions in connection with the convertible notes and actions outside of the notes themselves that could have an impact on convertible note holders and their conversion and other rights.

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