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To Buy or Not to Buy: Dealing with a Target's Bonds

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When acquiring a Canadian public company, there is no one-size-fits-all approach to dealing with its outstanding bonds. Generally speaking, the decision whether to repurchase the target's bonds is not entirely within an acquirer's control. Corporate bonds – whether Canadian or U.S. – typically carry a change of control put. When triggered, this put obligates the issuer to offer to repurchase its bonds at a premium of 101% of their principal amount. However, this change of control premium may pale in comparison to the premium necessary to redeem or repurchase the bonds in their entirety. An acquirer may conclude that it is not economical to pay this additional premium to pre-emptively call in all of the target's bonds.

An acquirer has many factors to consider before making a call on how to deal with a target's bonds. Beyond the obvious economic considerations, an acquirer must assess whether viable means are available to call in all of the target's bonds, whether it could live with the bonds if such means are not available and what other costs are associated with leaving the bonds outstanding.

Assessing the Purchase Alternatives

An acquirer must consider the bond indenture, the nature and number of bondholders and applicable law to assess the ways in which it might repurchase all of a target's bonds.

Bonds invariably have optional redemption features allowing an issuer to call in all of its outstanding bonds. For investment-grade bonds, this option is typically limited to a make-whole. High-yield bonds may also provide for a fixed call schedule. While optional redemption ensures all the bonds are called in, the redemption premium can be expensive. An alternative is to offer to purchase the bonds at a price that, while below the redemption premium, is sufficiently attractive to cause holders to tender. Key to this is picking the right price because, unlike a redemption, it is up to the bondholder to decide whether to participate in a tender offer. Typically, these tender offers are coupled with an "exit" consent and provide for an early tender premium to induce participation. Still, 100% participation can be an impractical target. When more than 90% participation is achieved, some bonds afford their issuer a right to redeem the outstanding balance at the tender price. Nevertheless, even 90% participation is a high target and may be challenging if the bonds are widely held, particularly if there are a significant number of retail holders.

While bond tenders are typically subject to few restrictions under the governing indenture, they can be subject to securities regulation. There are no Canadian regulations that specifically govern tenders for debt securities that are not convertible. However, U.S. tender regulations can apply to a tender for debt securities of a Canadian issuer.

Identifying Potential Issues

Aside from economic factors, restrictive covenants or other terms of the outstanding target bonds may compel an acquirer to redeem or repurchase the bonds in their entirety. Restrictive covenants in the target bonds can conflict with the acquirer's plans. Target bonds may also conflict with an acquirer's existing or future financing arrangements. These financing arrangements may not allow for the target bonds or, where applicable, any liens securing them. Conversely, target bonds may not accommodate an acquirer's financing arrangements.

Liens are one potential source of conflict. Although a target's bonds may be unsecured, the negative pledge covenant typically included in unsecured bonds may require that they be secured upon effecting the acquisition if the acquirer has secured debt. A negative pledge will also require intercreditor arrangements to ensure that the target bonds rank equally with the acquirer's most senior debt with respect to any common collateral. Typically, this will not allow for a standstill in favour of the acquirer's senior lenders or any other restrictions on the

target bondholder's ability to enforce independent remedies against the common collateral. Extracting these arrangements out of the acquirer's financing sources may be challenging because senior lenders are generally reluctant to share collateral on an equal basis and, where they do, they usually demand the right to call the shots in respect of that common collateral. For existing financing arrangements, these types of accommodations may not be authorized absent lender or bondholder consent.

Assessing Other Costs

Beyond scheduled payments of principal and interest, there can be other significant ongoing costs when a target's bonds are left outstanding. The most significant is the continued cost of public reporting. Canadian securities laws provide that a Canadian reporting issuer must continue to report as a public company as long as there are more than 50 beneficial owners of its securities (including debt securities) worldwide or 15 or more beneficial owners in any province or territory of Canada. It is impractical for most issuers to get under these thresholds by way of a tender offer for its bonds. Redeeming the bonds is often the only option for a debt issuer to cease reporting. Acquirers must also be mindful of whether the bond indenture's reporting covenant requires the issuer to provide financial or other reporting without regard to securities law obligations. However, if problematic, this reporting covenant can typically be removed through exit consents obtained in connection with a pre-emptive tender.

Following delisting of its shares, an acquired Canadian reporting issuer with outstanding debt securities becomes a "venture issuer" under Canadian continuous disclosure requirements. Despite this venture status, the issuer remains subject to most of the same disclosure obligations to which a listed issuer is subject. However, it is permitted more time to file its annual and interim financial statements and associated MD&A. Canadian securities regulators are unwilling to give further relief for these so-called debt-only issuers. A debt-only issuer may, however, satisfy substantially all of its Canadian continuous disclosure obligations through the continuous disclosure documents filed by its parent if that parent is reporting in either Canada or the United States and fully and unconditionally guarantees the issuer's debt securities. The debt issuer need only file certain summary financial information (that deconsolidates its parent's consolidated financial information) and separately report all material changes that are not also material changes in respect of its parent.

Another potentially significant cost is the negative carry associated with any pre-financing of the required change of control offer for the bonds. Some bonds may permit a change of control offer to be made in advance of the acquisition; however, this is not always the case. There may also be expensive ongoing indenture obligations. Some of these may be managed through pre-emptive exit consents – for example, a covenant that the issuer maintain (and pay for) a rating on the bonds. However, certain fundamental obligations may not be so managed, such as the requirement to maintain and pay a trustee and paying agent for the bonds.

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