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Secured Bonds: What You Need to Know Now

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The issuance of secured bonds has surged recently, accounting for over half of the high-yield bond volume in the first quarter of 2019 according to *Debtwire*, up from 34% last year. This trend may continue as investors seek out secured fixed rate debt exposure in the current economic and rate environment. This discussion briefly outlines topics sponsors, issuers and underwriters should consider when evaluating pursuing a secured bond transaction in lieu of, for example, a term loan or unsecured bonds.

Issue Secured Bonds in a "144A For Life" Offering Whenever Possible. Secured bonds issued pursuant to a registration statement declared effective by the Securities and Exchange Commission or in a Rule 144A offering with registration rights (i.e., in an offering other than a 144A for life offering) triggers two important legal provisions with potentially costly and onerous implications.

- TIA: An SEC registered offering of debt securities in general requires the indenture to be qualified under the Trust Indenture Act of 1939. The TIA provides for rigid procedural requirements when releasing collateral, including furnishing the indenture trustee with a certificate or opinion as to the fair value of the property being released from collateral. In particular, if the property being released in any calendar year is 10% or more of the aggregate principal amount of the bonds outstanding, the certificate or opinion must come from an independent engineer, appraiser or other expert. These requirements can be managed in a second-lien secured bond offering, with proper structuring, but can be particularly challenging in a first-lien secured bond offering. In addition, the TIA also requires an opinion of counsel every year regarding maintaining the lien on the collateral.
- Rule 3-16: Rule 3-16 of Regulation S-X requires separate financial statements for affiliates of the issuer whose securities constitute a substantial portion of the collateral. This provision can often be implicated in secured bond transactions because the collateral package often includes stock of subsidiaries, which can constitute a substantial portion of the collateral. To mitigate this concern, sponsors, issuers and underwriters may consider the advisability of including a "collateral cut-back" provision, which in short provides that the stock of a subsidiary does not constitute collateral to the extent doing so would require separate financial statements of the subsidiary pursuant to Rule 3-16, although that is often a suboptimal solution. In 2018, the SEC proposed rules relaxing the requirements of Rule 3-16 in certain respects, but these proposed new rules have not yet been adopted.

Each of these implications can be costly and time consuming. However, a 144A for life offering (i.e., an offering of secured bonds that is never registered with the SEC) does not require the indenture be qualified under the TIA (and as a result does not necessarily require the certificate or opinions mentioned above), and does not need to follow Rule 3-16 (and as a result does not necessarily require separate financial statements of subsidiaries that form a substantial portion of the collateral). While not historically the case, 144A for life offerings currently do not typically result in a material pricing impact to the sponsor or issuer. As a result, many sponsors, issuers and underwriters elect a 144A for life offering for secured bond transactions. Finally, as a practice point reminder, issuers should not voluntarily incorporate provisions of the TIA in a 144A for life offering for secured bonds to avoid being subject to the above TIA obligations.

Anticipate the Need for an Intercreditor Arrangement. Typically secured bonds are not the only secured debt in the issuer's capital structure and, as a result, will require entering into an intercreditor agreement. Intercreditor agreements govern, among other things, the waterfall for proceeds from collateral, as well as standstill periods (e.g., 180 days) during which the secured bonds collateral agent is prohibited from exercising remedies. Secured bonds may be secured pari passu with the term loans, or be secured on a junior/second-lien basis. When pari passu with a term loan, the intercreditor agreement generally will contemplate that the collateral agent under the term loans will control the process. This arrangement with the term loan collateral agent may not be the case when the secured bonds are second-lien or junior to the term loans (which can make the standstill period more significant to the secured bondholders). In addition, while acting as collateral agent is standard in connection with a loan, the collateral agent role is not as frequent in connection with bonds, so thoughtful selection of a collateral agent is advisable. Unlike issuing unsecured bonds which simply either are or are not permitted to be incurred by the existing debt agreements, secured bonds with an intercreditor agreement often require the active involvement of existing secured debt investors to negotiate an intercreditor agreement. If secured bonds may be on the horizon, one way to alleviate a protracted or contentious negotiation is to anticipate the potential of additional secured debt and pre-negotiate the form of intercreditor agreement when the original secured debt is put in place.

Structure the Security and Collateral Provisions Anticipating that Amendments and Waivers are More Onerous with Bondholders. Companies frequently approach lenders for amendments or waivers under credit agreements, including with respect to the security provisions and collateral. Sponsors and issuers should understand prior to issuing secured bonds that amendments and waivers typically are a more involved and infrequent process with bondholders when compared to lenders. As a result, sponsors and issuers should try to structure the security and collateral provisions to avoid potential amendments or waivers that may be necessary in the future operation of the issuer to the extent possible.

Use Careful Drafting When Weaving the Security Provisions into the Terms of the Bonds. Security provisions are still more customarily associated with loans than bonds and mistakes can be made when weaving the security and collateral provisions into the terms of bonds. For example, proceeds from asset sales of collateral often should be used to repay secured debt holders "pro rata". However, the method of repaying debt holders differs between loans and bonds and determining what pro rata means can often be difficult between the two instruments if not carefully drafted. While the borrower affirmatively repays the lenders for loans without any decision or action by the lenders, an issuer is typically required to make an offer to repay bonds and some bondholders may elect not to accept the offer. As a result, the standard terms of pro rata repayment in loans can sometimes yield confusion when migrated to secured bonds. Engaging thoughtful and experienced counsel can help in this regard.

Anticipate and Plan for the Additional Expense Associated with Secured Bonds. As you might suspect, issuer and underwriters' counsel must perform additional work for secured bonds when compared to unsecured bonds. Perfecting security interests in certain types of collateral, and in certain jurisdictions, can be quite involved. Secured bonds are most efficient in terms of collateral work when there is a concurrent secured loan transaction so that security work for the bonds can piggyback off of the collateral work for the loans. In addition, while the expense of underwriters' counsel is often borne by the underwriters for U.S. offerings of bonds, the incremental expense associated with collateral work performed by underwriters' counsel for secured bonds may be negotiated to be borne by the issuer. Sponsors, issuers and underwriters should plan at the outset the division of labor and who will bear what expenses associated with the collateral work.

Conclusion

As investors continue to find secured bonds attractive in the current environment, sponsors, issuers and underwriters should be looking around the corner to anticipate the hurdles that secured bonds present so that the optimal and most efficient execution can be achieved.

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