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Dentons Quick Guide to Change of Control Put Options

Practical summaries of interesting topics in Debt Capital Markets (DCM)

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In the current economic environment of higher interest rates and depressed secondary market bond prices for bonds issued prior to the recent rates rises, businesses considering acquiring companies that have issued bonds with a change of control (**CoC**) put option (**CoC Put Option**) are likely to find that the bonds are trading below the CoC put price (Put Price) in the secondary market, and investors given the option to put (i.e. sell back) their bonds at the Put Price are very likely to do so.

This Quick Guide provides a summary of CoC Put Options and common variations to their triggers in the context of bonds issued in the European market, offered to professional investors and under an exemption to the registration requirements of the US Securities Act of 1933 (as amended), on either a Regulation S or a Rule 144A/Regulation S basis.

Why do many bonds include a CoC Put Option?

Before purchasing bonds, potential investors consider possible risks, including the issuer's creditworthiness, being, on the most fundamental level, the issuer's ability to:

- make interest payments until the bonds mature; and
- repay the principal amount on maturity.

Potential investors will have assessed the issuer's business, its strategy and the direction set by its senior management team, and will not usually have priced in a change in ownership, which is likely to be accompanied by at least some of the following:

- a change in senior management;
- a change in business strategy and prospects;
- a change in the leverage in the business (perhaps resulting from the cost of the acquisition itself); and/or
- a potential change in the credit ratings assigned to the bonds.

A CoC Put Option protects bond investors against the possibility of a reduction in an issuer's creditworthiness as a result of a CoC by allowing them to exit the bond if they so wish at the Put Price (usually at the principal amount plus accrued interest in investment grade bonds or, in high yield bonds[1] , usually at 101% of the principal amount plus accrued interest). Without a CoC Put Option, investors bear the risk of the consequences of a CoC upon the issuer's creditworthiness. Certain institutional investors will also have an investment mandate which prohibits or restricts investment in sub-investment grade bonds.

Although CoC Put Options are common, they are not included in all terms and conditions. They are fairly standard in high yield bonds and are included by negotiation on a case-by-case basis in investment grade bonds.

How is a CoC defined in terms and conditions?

Before the CoC Put Option is triggered, there must first be a CoC. Bonds may define a CoC in positive or negative terms.

A CoC defined in positive terms is most common. This is where any person or persons acting together gain "control" of the issuer. Control is often defined to mean:

- more than 50% of the ordinary shares of the issuer;
- the right, directly or indirectly, to appoint a majority of the directors of the issuer; or
- any other ability to control the affairs of the issuer.

Alternatively, where an existing owner, majority shareholder or the senior management team are key to an issuer's creditworthiness or business strategy, it might be more appropriate to define a CoC in negative terms as a ceasing to have "control". In this situation, a CoC is usually expressed to be the existing controller of the issuer ceasing to have:

- a certain minimum percentage of the ordinary shares of the issuer;
- the right, directly or indirectly, to appoint a majority of the directors of the issuer; or
- any other ability to control the affairs of the issuer.

A properly drafted definition of "control" will also cover situations where persons or entities acting together acquire "control", as there will usually be a concept of persons "acting in concert" and acting, directly or indirectly, to achieve control. In a UK context, "topco" schemes of arrangement used otherwise than in a takeover context are typically carved out given that there is no economic change in control of the issuer or its business.

In some expanded definitions of "control" asset sales (i.e. a sale of the business that the issuer conducts) and similar transactions are caught in addition to sales of shares in the corporate entity (i.e. a sale of the issuer itself).

Finally, in a bond where the issuer is a subsidiary of a parent guarantor, the CoC definition will usually be applied to the parent guarantor and, in addition, the definition will customarily require that the issuer remains (directly or indirectly) a 100% subsidiary of the parent guarantor. A purely internal group restructuring, where the issuer is transferred within the parent guarantor's group, but the parent guarantor retains its 100% interest (directly or indirectly) in the issuer, should not, based on the usual definitions, be a CoC.

Please do speak with any of the Dentons contacts in a situation where a group restructuring involves additional complexity, such as external parties acquiring ownership/control interests as part of the restructuring, or where a CoC of the guarantor or the guarantor ceasing to hold, directly or indirectly, its 100% interest in the issuer, may arise.

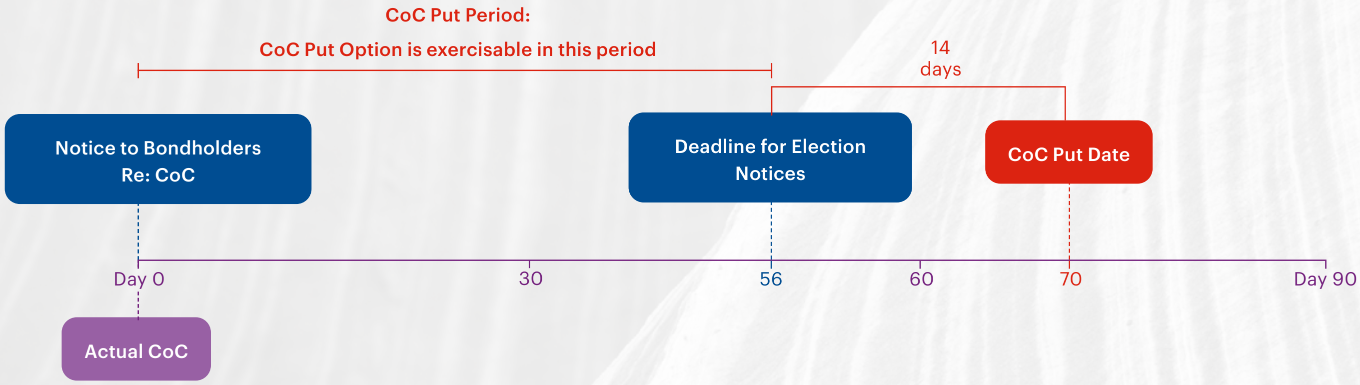
1 When referring to "high yield" bonds, we mean bonds assigned no rating or a sub-investment grade credit rating of BB+, Ba1 or BB+ or lower by Fitch, Moody's or Standard and Poor's, respectively. High yield bonds issued in a leveraged finance context may contain further highly negotiated variations to change of control provisions, beyond the scope of this article.

When does a CoC trigger a CoC Put Option and how does a CoC Put Option work?

The trigger for a CoC Put Option (the **Trigger Event**) and the mechanism of an investor's resulting put right depends on the drafting in the terms and conditions, which vary from transaction to transaction.

Figure 1 below is a diagrammatic example of a very simply drafted CoC Put Option.

Figure 1



In Figure 1, the Trigger Event is the occurrence of the CoC. Upon this, the issuer is required to promptly publish a notice to bondholders via the ICSDs (a **Notice**), specifying that a Trigger Event has occurred and the date the bonds will be redeemed (the **Put Date**). We have assumed that the terms and conditions specified that:

- the Put Date must be a business day not less than 60 and not more than 90 days after the Notice, and the issuer chose the 70th day; and
- the deadline for exercising the CoC Put Option must be a business day seven to 14 days prior to the Put Date, and the issuer chose 14 days prior (i.e. day 56).

The period in which the bondholders may exercise the CoC Put Option is referred to in this article as the **CoC Put Period**. In Figure 1, the CoC Put Period is the period between publication of the Notice and that deadline.

A CoC Put Option gives each individual bondholder the right, but not the obligation, during the CoC Put Period to put their bonds at the Put Price specified in the terms and conditions on the Put Date.

Bondholders that have exercised their CoC Put Option during the CoC Put Period will be paid the Put Price on the Put Date. Issuers cannot compel a bondholder to exercise their put right. Each bondholder's decision will be driven by their own expectations and preferences but will be influenced heavily by the then prevailing market price of the bonds on the secondary market.

> A "put" gives the holder of the option the right to sell the underlying asset at a specific price. In practice, when a bondholder exercises their put right in the context of a CoC, they are requiring the issuer to redeem or purchase the relevant bonds at the Put Price on the Put Date.

To put their bonds, bondholders will follow the redemption requirements set out in the Notice and the terms and conditions. It is customary for these requirements to oblige a bondholder to submit an irrevocable election notice together with evidence that they are the holder of the relevant bonds during the CoC Put Period. Depending on the requirements of the relevant clearing systems, the bonds will then be irrevocably blocked (i.e. incapable of being transferred to another investor) until the Put Date or will be transferred to a paying agent to hold until repayment and cancellation on the Put Date.

Can bondholders exercise their put right in relation to a CoC Put Option if the issuer has already exercised a call right?

Not every set of terms and conditions will specify this explicitly but, subject to wording to the contrary, the first option exercised should generally prevail if only because of the timing of expiry of the relevant notice period. The exercise of either option will usually be irrevocable and will bind the issuer to redeem the relevant bonds in accordance with the corresponding put or call redemption requirements set out in the terms and conditions. In order to put the point beyond doubt, the terms and conditions may also explicitly state that the CoC Put Option cannot be exercised by a bondholder in respect of bonds in relation to which the issuer has given an earlier notice to exercise a call right.

Common variations to CoC Put Options

Put Price

For investment grade bonds with a CoC Put Option, the Put Price is usually set at par (i.e. face value or 100% of the principal amount of the bonds) plus interest accrued on the principal amount to (but excluding) the Put Date. However, for high yield bonds, the Put Price is usually set at 101% of the principal amount plus accrued interest. This is because the issuer of a high yield bond may be more likely to be subject to a CoC, and investors generally expect a higher Put Price as compensation for the early redemption of a high yield bond.

In the current macroeconomic climate, with rising interest rates, businesses considering acquiring companies that have issued bonds with a CoC Put Option should monitor the current trading price of the bond. If a bond is trading below the Put Price, investors are very likely to take the opportunity to exercise their put right, which may, in effect, act as a disincentive to a potential acquisition and would certainly need to be factored in as a cost of the deal.

Permission for specific acquirers

If an issuer is considering issuing bonds in anticipation of a potential CoC or in the knowledge of a corporate reorganisation transaction, it is possible to carve out a specific acquirer, or class of acquirer, from the definition of CoC to avoid triggering a CoC Put Option.

CoC plus a negative rating assessment are both required to cause a Trigger Event

A very commonly seen variation to a CoC Put Option is to make the occurrence of the Trigger Event dependent on there being both (i) a CoC and (ii) a downgrade by one or more notches (or, in the case of an investment grade bond, a downgrade to below investment grade), withdrawal or cessation of a solicited credit rating assigned to the bonds by a rating agency during a specified period (the **CoC Period**). Thus, the CoC Put Period only begins if both the CoC and the rating elements of the Trigger Event are met. This feature is often seen in CoC Put Options in investment grade bonds that are rated only one or two notches above a non-investment grade rating, with the rating condition effectively set to preserve the investment grade rating.

To avoid rating action that is unconnected with the CoC from triggering a CoC Put Option, it is customary for the drafting to provide that the downgrade, withdrawal or cessation is expressed by the relevant rating agency to be due, in whole or in part, to the CoC (a **Negative Rating Assessment**).

See Figure 2(b) below for an illustrative example.

Practical tips for analysing a CoC Put Option with a CoC plus a Negative Rating Assessment trigger:

- Check the definition of "rating agency" to see which rating agencies could trigger the CoC Put Option by giving a Negative Rating Assessment. From the issuer's perspective, these should be the same agencies as those that assigned a credit rating to the bonds at the invitation of the issuer when issued, and the Negative Rating Assessment should therefore apply in relation to solicited credit ratings only.
- Check the drafting to see whether the rating element of the Trigger Event is met by a Negative Rating Assessment by one rating agency acting individually, or whether it requires a second rating agency to also give a Negative Rating Assessment. This will generally be influenced by how many ratings the issuer solicited on the bond at issuance.
- Remember that a well-drafted CoC Put Option will contemplate that a rating agency could act and give a Negative Rating Assessment after news of a potential CoC becomes public (a **Potential CoC Announcement**) but before the CoC actually takes place.[2] We would expect the CoC Period, during which a Negative Rating Assessment could trigger the CoC Put Option, to begin on the date of the Potential CoC Announcement and end a set period (e.g. 90 days) after the actual CoC. Therefore, a Negative Rating Assessment that occurs prior to the actual CoC may be relevant when assessing whether a Trigger Event has occurred. See Figure 2(a) for an illustrative example.

CoC plus a Negative Rating Assessment are both required to cause a Trigger Event, but a rating reinstatement ends the CoC Put Option exercise period

A more issuer-friendly approach to the inclusion of a Negative Rating Assessment requirement is to add the concept of a "reinstatement" by the relevant rating agency. This feature means that if the relevant rating agency subsequently upgrades (in the case of a downgrade) or reinstates (in the case of a withdrawal or cessation) the credit rating to its earlier credit rating or better (a **Reinstatement**) during the CoC Period, the CoC Put Period comes to an early end. For the avoidance of doubt, this should not affect any bondholders that have exercised their CoC Put Option prior to the Reinstatement (as the exercise of a CoC Put Option is irrevocable), and the relevant bonds will still be redeemed by the issuer on the Put Date.

See Figure 3 below for an illustrative example.

CoC plus a Negative Rating Assessment are both required to cause a Trigger Event, but the CoC Put Option can only be exercised after the CoC Period

The most issuer-friendly approach to the inclusion of a Negative Rating Assessment requirement is not only to add the concept of a Reinstatement by the relevant rating agency, but also to provide that the CoC Put Period only commences at the end of the CoC Period. This feature means that the Trigger Event is only assessed at the end of the CoC Period. Thus, if, following a CoC and a Negative Rating Assessment, there is a Reinstatement during the CoC Period, the rating element of the Trigger Event is not met, the CoC Put Period does not commence and no bondholders will be able to exercise a CoC Put Option.

The longer period prior to the CoC Put Option becoming live may give the issuer (and/or the entity that will be acquiring control of the issuer) time to demonstrate to the relevant rating agencies that the change in rating (or the extent of the notching) is not justified. It may also provide the issuer (potentially acting in coordination with the entity that will be acquiring control of the issuer) with time to launch a consent solicitation or exchange offer or for the issuer or acquiring entity to negotiate to refinance the put bonds via a banking syndicate. Investors who wish to exit prior to the Put Date may still be able to find a willing third-party purchaser who would pay a purchase price reflecting the likely redemption at the Put Price.

See Figure 4 below for an illustrative example.

2 For example, the definition may refer to a Potential CoC Announcement as a public announcement by the issuer or potential acquirer of a potential CoC where, within 180 days of that announcement, an actual CoC occurs.

Illustrative Examples

Figures 2(a), 2(b), 3 and 4 below provide illustrative examples of CoC Put Options with:

- a dual CoC plus Negative Rating Assessment trigger (Figure 2);
- a dual CoC plus Negative Rating Assessment trigger where the CoC Put Period comes to an early end on a Reinstatement (Figure 3); and
- a dual CoC plus Negative Rating Assessment trigger where the CoC Put Period only commences at the end of the CoC Period (Figure 4).

The examples assume that the bonds carry an investment grade credit rating, and are subsequently downgraded to a non-investment grade credit rating as a result of the CoC. They assume that the terms and conditions specify that a CoC and Negative Rating Assessment by any one of the issuer's solicited credit rating providers is a Trigger Event.

Figure 2(a)

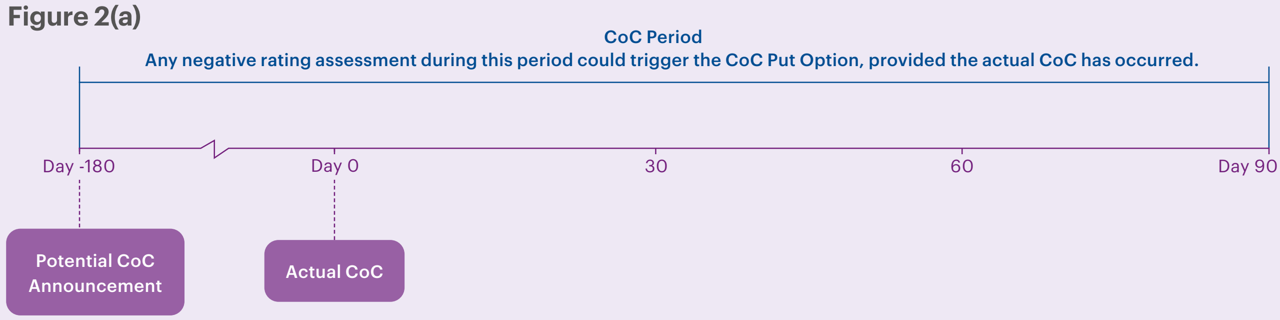
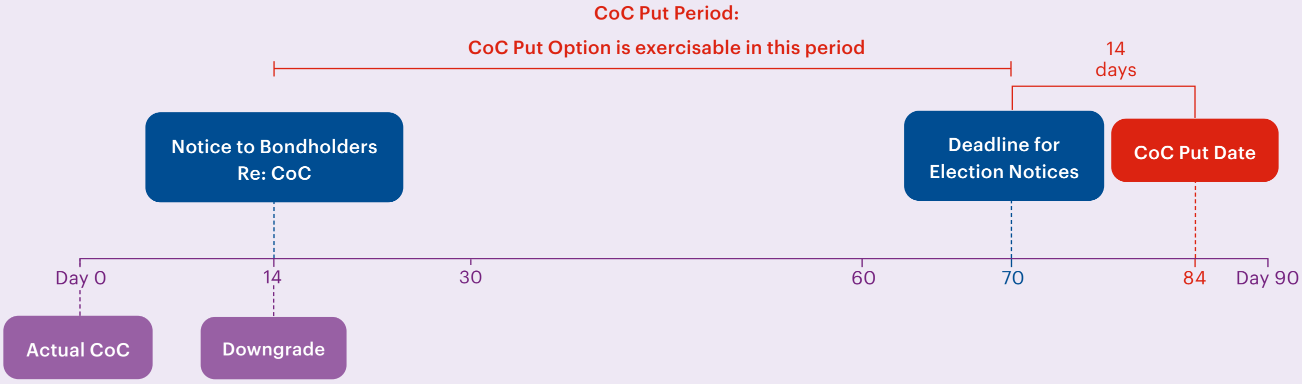


Figure 2(a) illustrates a CoC Period.

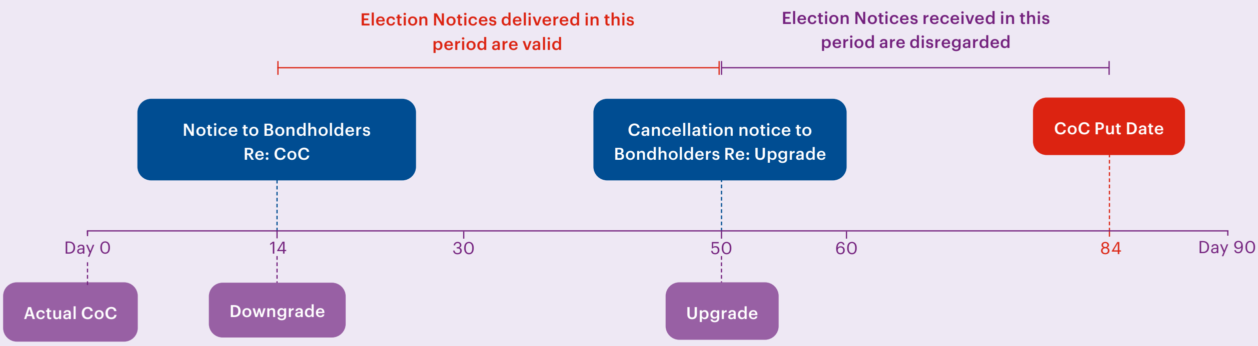
Figure 2(b)



In Figure 2(b), the Trigger Event occurs once both the CoC has taken place and the issuer has been downgraded by a solicited credit rating provider to non-investment grade on day 14. Upon this, the issuer promptly publishes a Notice, specifying that a Trigger Event has occurred and the Put Date. We have assumed that the terms and conditions specified that:

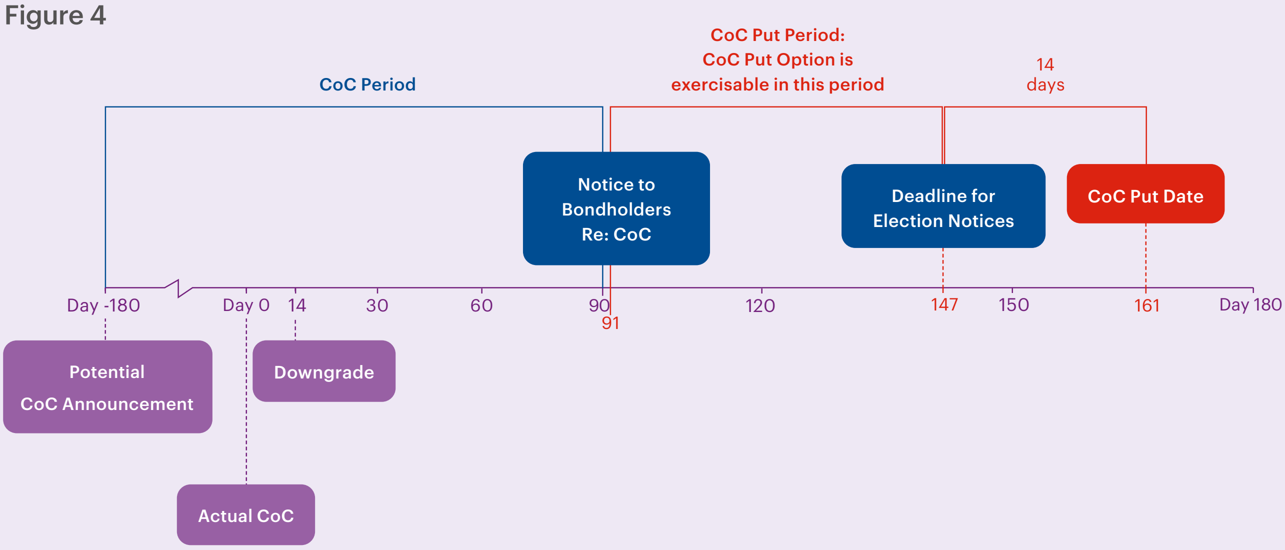
- the Put Date must be a business day not less than 60 and not more than 90 days after the Notice, and the issuer chose the Put Date to fall on the 70th day (i.e. day 84); and
- the deadline for exercising the CoC Put Option (i.e. the end of the CoC Put Period) must be a business day seven to 14 days prior to the Put Date, and the issuer chose 14 days prior (i.e. day 70).

Figure 3



In Figure 3, the Trigger Event is the same. However, there is a Reinstatement by the relevant credit rating agency on day 50. We have assumed that, in addition to the above, the terms and conditions require the issuer to promptly publish a cancellation notice to bondholders, specifying that a Reinstatement has occurred and that this ends the CoC Put Period. Although the Put Date is unaffected, the issuer may disregard any election notices received on or after the date of the cancellation notice.

Figure 4



In Figure 4, the Trigger Event is assessed at the end of the CoC Period. The bonds are downgraded by one of the issuer's solicited credit ratings providers and there is no Reinstatement by the end of the CoC Period on day 90. We have assumed that the terms and conditions:

- require the issuer to promptly publish a Notice on the business day immediately following the end of the CoC Period (i.e. day 91), specifying that a Trigger Event has occurred and the Put Date; and
- specified that:
  - o the Put Date must be a business day not less than 60 and not more than 90 days after the Notice, and the issuer chose the Put Date to fall on the 70th day (i.e. day 161); and
  - o the CoC Put Period begins on publication of the Notice and ends on a business day between seven and 14 days prior to the Put Date, and the issuer chose 14 days prior to the Put Date (i.e. day 147) as the end of the CoC Put Period.

Every transaction is different...

The Figures above are examples only and it is not possible to discuss in this article every variation that may be included in a CoC Put Option. Every transaction will need to be considered on a case-by-case basis. If you are a business considering acquiring a company that has issued bonds, an issuer considering an offer from an external party, or a member of an issuer-group considering an intra-group reorganisation and would like to discuss the matters raised in this article further, please get in touch with the Dentons DCM team.

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