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Change of Control Clauses in High Yield: What You Need to Know

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Most high yield indentures contain a "Change of Control" clause that relates to changes in the beneficial ownership of the issuer. We provide an overview of the relevant definitions, as well as clauses to consider in relation to a change of control and some options available when faced with a possible change of control.

Background

What is a Change of Control and what happens when a Change of Control is Triggered?

Broadly, high yield indentures define a "Change of Control" as the occurrence of (1) any person (other than "Permitted Holders" (such term varying deal-by-deal and incorporating the initial equity holders in the issuer as well as related parties and management)) becoming the "Beneficial Owner" of more than a specified percentage (usually 50 per cent.) of the voting power of the voting stock of the issuer or (2) the disposition of all or substantially all of the assets of the restricted group other than to a Permitted Holder. In the past the change of control clause in European high yield indentures was also triggered when "continuing directors" ceased to constitute a majority of the board of directors of the issuer, but such provision is not customary nowadays. "Beneficial Owner", in turn, is generally defined by reference to Rule 13(d)-3 ("Rule 13(d)-3") of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). The threshold for beneficial ownership can vary from deal to deal and is sometimes lower than 50 per cent. in transactions involving public companies, typically 20 – 40 per cent. The "beneficial ownership" threshold is, in a minority of high yield deals (and as was historically typical for the loan market), triggered the other way around, where a change of control would occur if Permitted Holders no longer are the beneficial owners of a specified percentage of the voting power of the voting stock of the issuer.

A change of control alters not only the ownership of the business but also potentially the management thereof, which directly affect the way the business operates and its strategy. For this reason, indentures typically include a change of control clause which provides a put option to bondholders by requiring the issuer to make an offer to repurchase the bonds at a price of 101 per cent. of the bonds' principal amount (a "change of control offer"). Bondholders are not obligated to accept the change of control offer, but if they accept, the bondholder "puts" (i.e., sells back) the bonds to the issuer.

In theory, change of control mechanics offer bondholders the option to revaluate their investment decision in the group in light of new ownership. Where an investor may initially have decided to invest in a group under the control of one owner (often a private equity sponsor), the same group under different ownership may represent quite a different investment dynamic for investors. In practice, although investors may base their decision on the identity of incoming and outgoing private equity sponsors, the decision to put the bonds is driven mainly by current trading prices of the bonds. If the bonds are trading above the change of control offer price (101 per cent.) in the open market, bondholders will be unlikely to accept.

Discussion Points

While the change of control mechanics are similar across high yield indentures, two areas are worth considering in detail. Portability is a key discussion point at the outset of any transaction, and if included, the terms can be key in any takeover transaction. In addition, the use of terms from US regulations in the European high yield market is an important point to focus on, as these complex rules and how they have been interpreted can trigger change of control events that may not be apparent from the change of control covenant itself.

Portability

Portability is the ability, subject to specific criteria, to transfer beneficial ownership of a group without triggering a change of control and it is increasingly included in private equity sponsor transactions. The following are the three most common types of portability features in high yield indentures.

Leverage

Portability based on leverage allows for a change of beneficial ownership of the group without triggering a change of control, so long as the leverage of the group is below a certain threshold. Leverage-based portability is heavily negotiated and can depend on many variables including:

(i) Basis of calculation of the leverage ratio (gross or net basis as well as related financial definitions)

(ii) Step down (or tightening) of the threshold after a certain period of time (although these have been less common in the market in 2018)

(iii) One time use or multiple uses

(iv) Other covenants and financial definitions relating to leverage, including timing of testing and certain basket re-sets if portability is utilised

When compared to the ratings-type portability provisions below, leverage portability (while not actually used all that often in practice), when drafted correctly, provides the certainty needed that a given transaction would not trigger a change of control when it otherwise would.

Ratings

Ratings-based portability is less common in the mainstream European high yield bond market than leverage-based portability and is an import from investment grade / emerging markets transactions. If included, this feature requires that a change of control be accompanied or followed by a downgrade of the bonds within a certain time period. Such provisions can also be formulated more stringently to require that even if an issuer’s bonds are downgraded, its change of control offer obligation is not triggered unless (1) the ratings agency(ies) provide in writing that the downgrade resulted specifically from the change of control, and/or (2) that a requisite number of ratings agencies (likely two) downgrade the bonds by one or multiple notches.

This approach often has significant challenges when applied in the acquisition finance context (e.g., it is not typically drafted in a way that provides transaction parties sufficient certainty that a change of control would not be triggered by the transaction such that bridge or backstop financing would not be required) and we often see change of control consents done for companies even with these “ratings”-type portability constructs.

Specific Buyer

Issuers can also avoid the obligation to make change of control offers by transferring ownership to specific buyers. As opposed to leverage-based or ratings-based portability, which looks at the financial situation of the group, this exception is based on the identity of the purchaser of the voting stock. This type of portability has been seen where a bond transaction is executed around the same time a potential takeover transaction may occur. The identity of the new owner may be specified, or based on definitions around the industry and credit rating of such owner. In addition, the definition of “Permitted Holders” may include initial minority equity holders existing on the issue date, or management of the group, and it is important to check such definition to see if a potential change of control will in fact be triggered based on the applicable definitions.

Use of the US Securities Laws Definition of "Beneficial Ownership" and Potential Implications

As mentioned above, the indenture "Change of Control" definition refers to Rule 13(d)-3 of the Exchange Act, which defines a beneficial owner as any person who, directly or indirectly, has or shares voting power and / or investment power over the voting stock of the issuer. Voting power includes the power to vote or to direct the voting and investment power and also includes the power to dispose or to direct the disposition of such voting stock. Rule 13(d)-3 of the Exchange Act also includes an anti-evasion provision, which captures any person (or "group") who, directly or indirectly, creates or uses a contract, agreement or device with the purpose or effect of evading the requirements of the rule.

It is important to note that US courts and the US Securities and Exchange Commission have provided substantial guidance and interpretation of Rule 13(d)-3 of the Exchange Act, including in what circumstances more than one person may share voting / investment power in securities. This can be important, as under the Exchange Act, more than one "person" (or a "group" formed by one or more persons) may hold the relevant rights, and if one of them is not a Permitted Holder under the indenture, it can trigger a change of control even though another person, who is a Permitted Holder, also beneficially owns the bonds.

In *Wilmington Savings Fund Society v. Foresight Energy LLC ("Foresight")*, the Delaware Court of Chancery found that the corporation was the beneficial owner of shares of a third party (and thus went above the relevant change of control threshold in the applicable indenture) under the relevant rules and based on the de facto position of the parties under their various agreements. This was due to, among other things, (i) the corporation's veto right over the parent company's ability to transfer its voting units and (ii) certain governance rights which allowed it to veto (and hence control) certain non-ordinary course transactions. The court noted that in certain circumstances, a power to veto a vote would be a shared power to vote. The above features are important to assess when found in investment and / or shareholder arrangements between shareholders who, as above, may be a mix of Permitted Holders and other parties. This in turn can cause the formation of a new "group", which may not be a Permitted Holder for indenture purposes, and can trigger the relevant change of control thresholds in some cases.

The above is particularly important when structuring a minority investment in a high yield bond issuer to ensure that a change of control is not inadvertently triggered. In *Foresight*, the Court held that, despite the parties' efforts to structure the transaction as a minority investment in order not to trigger the change of control provision of the indenture, the anti-evasion provision of Rule 13(d)-3(b) of the Exchange Act required the court to look beyond the voting and investment power purchased by the buyer on the face of the transaction. The Court ruled in favour of the bondholders that a change of beneficial ownership had indeed occurred because the buyer had de facto acquired control of the company notwithstanding that it did not trigger the change of control provision on its face.

Options on a Change of Control

If a change of control would be triggered by a transaction, issuers have certain options to deal with the required change of control offer. The merits of each option must be carefully considered in light of the overall dynamics of any given high yield transaction.

Obtain Consent from Holders of the Bonds

One option when facing a potential change of control is to amend the indenture in such a way that a given event or transaction would not trigger a change of control. This method can take the form of a waiver or amendment to the change of control clause, or to the definition of Permitted Holders, either of which must be approved by the holders of a majority (50 per cent. + 1) of the bonds. When this option is used, a fee is usually required in exchange for the bondholders' consent. In certain circumstances, the consent process may be run concurrently with the M&A process and closing of the M&A transaction may be made conditional upon receiving the required consent.

Make a Change of Control Offer (and make financing arrangements)

If an issuer is unable to obtain consent from a majority of the bondholders in connection with a transaction that would lead to a change of control, it will be required to make the change of control offer. Upon the change of control event, the issuer will be required to deliver a notice typically stating that a change of control has occurred, the date on which the bonds will be repurchased by the issuer (*provided that* the bondholders put their bonds to the issuer) and the instructions for bondholders to have their bonds repurchased. The repurchase date will typically be no earlier than 30 days and no later than 60 days from the date such notice is mailed, thereby leaving the change of control offer open for a period of at least 30 days. The likelihood of bondholders selling their bonds back to the issuer will be highly influenced by the price at which the bonds are trading. Therefore, when the bonds are trading at a price above 101 per cent., bondholders may be less likely to resell their bonds to the issuer.

However, given that bond prices can fluctuate, a bond issuer must be sure to have appropriate financing in place prior to making the repurchase offer. This typically takes one of two forms: (i) bridge financing or (ii) a backstop. In a bridge financing, a bank will agree to lend a bridge loan to the issuer so it can repurchase any tendered bonds, with amounts drawn under such loan then refinanced with a bond transaction. In a backstop, a bank will agree to repurchase any tendered bonds, with a view to then re-selling these on the market. Such resale will often require the cooperation of the bond issuer, such as producing updated marketing materials.

If a change of control offer is required, it is worth noting that more recently, indentures have increasingly included a mandatory call in favour of the issuer at 101 per cent. if holders of at least 90 per cent. of the aggregate principal amount in a series of bonds tender their bonds to the issuer in a change of control offer. This “clean up” or “squeeze-out” call allows the issuer to sweep up remaining bonds and to thereby avoid becoming stuck with a small tranche with what may be different covenants to any new debt. There is also some benefit to holders, as while it may sweep some holders who held onto the bonds purposefully, it may be that some holders miss a change of control offer, and the use of the mandatory call takes them out of what is likely a very illiquid bond.

Refinance the Bond

A final option is to refinance the existing bond in full. Whether this option is taken may depend on the then-existing redemption price of the bond and whether it makes economic sense to take out the bond in full. A full refinancing is likely to take the form of a bridge loan to be refinanced after the refinancing of the bond (or at least a bridge loan with a subsequent bond into escrow to fund the take out of the bridge loan). Change of control provisions provide that if a redemption notice for all existing bonds is made in the change of control offer period, then a change of control offer at 101 per cent. does not also have to be made.

Conclusion

While a change of control clause on its face provides a mechanism for a bondholder to take a second look at a bond issuer in the event of a takeover, the clause and related provisions must be carefully considered on each particular transaction to assess whether a change of control offer is indeed required. As discussed above, a change of control offer may even be triggered in certain minority investment transactions, and so it is important to properly assess each transaction under the applicable rules. In the event a change of control offer is required to be made, an issuer can then assess the options open to it, either to seek an amendment / waiver of the high yield indenture pursuant to a consent solicitation, or to potentially finance the change of control offer, or to execute a broader refinancing, depending on the transaction economics and the current trading price of the bonds.

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