

FUNDING INVESTMENTS

FINANCE 238/738, Spring 2008, Prof. Musto

Class 7 – Corporate Bond Contracts

Bonds are defined by legal contracts, called *indentures*, which spell out the rights and responsibilities of both sides. We will explore this contracting by reading the prospectus of a recent offering and analyzing its salient features, and by discussing contract features that arise elsewhere.

On January 17th, Target issued 3 bonds, totaling \$4BB: a 5-year, a 10-year and a 30-year. Here's a description of the 5 year:

1		Corp	DES
SECURITY DESCRIPTION		Page 1/ 1	
TARGET CORP	TGT5 1/8 01/15/13	104.496/104.496	(4.11/4.11) TRAC
ISSUER INFORMATION		IDENTIFIERS	
Name TARGET CORP	Type Retail-Discount	Market of Issue Global	CUSIP 87612EAT3 ISIN US87612EAT38 BB Number EH1640539
SECURITY INFORMATION		RATINGS	
Country US	Currency USD	Collateral Type Sr Unsecured	Moody's A2 S&P A+ Fitch A DBRS AH *-
Calc Typ(1)STREET CONVENTION	Maturity 1/15/2013 Series	MAKE WHOLE	ISSUE SIZE
Coupon 5 1/8 Fixed	S/A 30/360	Announcement Dt 1/14/08	Amt Issued/Outstanding
Int. Accrual Dt 1/17/08	1st Settle Date 1/17/08	1st Coupon Date 7/15/08	USD 500,000.00 (M) USD 500,000.00 (M)
Iss Pr 99.67400	SPR @ ISS 215.00 vs T 3 5/8 12/12	HAVE PROSPECTUS DTC	Min Piece/Increment 100,000.00/ 1,000.00
			Par Amount 1,000.00
			BOOK RUNNER/EXCHANGE
			BAS,CITI,LEH TRACE
			1) Additional Sec Info 2) ALLQ 3) TRACE Trade Recap 4) Corporate Actions 5) Cds Spreads/RED Info 6) Ratings 7) Custom Notes 8) Covenant/Default 9) Identifiers 10) Prospectus 11) Sec. Specific News 12) Involved Parties 13) Issuer Information 14) Pricing Sources 15) Related Securities 16) Issuer Web Page 65) Old DES 66) Send as Attachment
POISON PUT @ 101%. PUT @ 101% IF RATINGS BELOW INVESTMENT GRADE.			
SHORT 1ST CPN. CALL @ MAKE-WHOLE T +30BP.			
Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000 Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2008 Bloomberg Finance L.P. H191-335-0 28-Jan-08 10:32:24			

In the prospectus, we see

	Public offering price	Underwriting discount	Proceeds, before expenses, to Target Corporation
Per 2013 note	99.674%	0.350%	\$ 496,620,000
Per 2018 note	99.194%	0.450%	\$ 1,234,300,000
Per 2038 note	99.318%	0.875%	\$ 2,214,967,500
Total			\$ 3,945,887,500

So the underwriters get 35bp, 45bp and 87.5bp on the 5, 10 and 30 years.

The easiest place to start reading a prospectus is at the Summary, or “Description of Notes,” which gives the big picture:

- Coupon rate, payment dates and maturity
- Call or other option features, if any
- Seniority
- Issue size
- Trustee
- Use of proceeds

In this bond’s summary we see the same material from the Bloomberg, and also

- There is some sort of optional redemption
- There are “Events of Default”
- There is a requirement to make a “Change of Control Offer” upon a “Change of Control Triggering Event”

First, let’s look at this optional redemption. On page S-3, we get this:

Optional Redemption

We may redeem the notes, at our option, in whole or in part, as described under “Description of Debt Securities—Redemption and Repayment of Debt Securities—Optional Redemption By Us” and “—Optional Make-Whole Redemption of Debt Securities” in the accompanying prospectus at a redemption price equal to the greater of the following amounts, plus, in each case, accrued and unpaid interest thereon to the redemption date:

- 100% of the principal amount of the notes to be redeemed; and
- the sum of the present values of the remaining scheduled payments, such payments to be discounted to the redemption date on a semi-annual basis (assuming a 360-day year consisting of twelve 30-day months) using a discount rate equal to the treasury rate applicable to the 2013 notes, the 2018 notes or the 2038 notes, as the case may be, plus 30 basis points in the case of the 2013 notes, plus 35 basis points in the case of the 2018 notes and plus 40 basis points in the case of the 2038 notes.

Is this like the other calls we’ve seen? Target can buy the bond back for the *maximum* of (i) par, and (ii) the present value of the future payments on the note, discounted at the Treasury rate plus 30, 35 or 40bp, depending on the maturity. To see what this means, note that

- The present value, discounted at the Treasury rate plus 0 basis points, is what the note would sell for *if it were totally riskless*
 - Because, *by construction*, that’s what a Treasury note with the same payments would sell for

So if we discount at the Treasury rate *plus 30bp*, we get a slightly lower number

- What the note would sell for if it traded 30bp over Treasuries
- The 5-year was issued 215bp above Treasuries, so 30bp would be a much higher price, corresponding to much higher creditworthiness
 - Even a AAA-rated issuer would not generally expect to trade within 50bp of the Treasury yield
- The 5-year was issued at a yield of 5.20, implying a price of 99.67. If the yield were 185bp lower, at 3.35, that would imply a price of 108.11

So, putting this together, the option is to buy the bond back for more than it is worth. Why bother writing this option into the contract? We'll see at the end of class, it is there to help the bondholder get out of the contract, should this become necessary.

Much of the rest of the prospectus is boilerplate and standard disclosure

- Currency & location of payments; tax consequences; registration; listing
- Dire warnings about risks facing the issuer
- Financials related to interest coverage

The key moments in the prospectus, looking ahead to a distress situation, are

- Covenants, positive and negative
- Rights of creditors if the issuer defaults
- How the contract can be changed by a vote

Covenants

An indenture will have a section on covenants, which are actions the issuer either commits to do (positive covenants) or *not* do (negative covenants). The bulkpack article “*On Financial Contracting: An Analysis of Bond Covenants*” lists many of the covenants one is likely to see, and considers why they are used. How do they add value?

- If management always maximizes expected value, there is no positive role for covenants. They can only reduce expected value by constraining management
 - A covenant might make debt sell for more, but if it doesn’t increase total value then it must simultaneously make equity worth *less*, so the net effect to equity from selling the debt is negative

So covenants must be there to defend against management’s bad incentives, particularly its willingness to take negative NPV actions that move value from debt to equity

The Target bond lists three covenants:

Restrictions on Secured Funded Debt

The indenture limits the amount of secured funded debt that we and our restricted subsidiaries may incur or otherwise create, including by guarantee. Neither we nor our restricted subsidiaries may incur or otherwise create any new secured funded debt unless immediately after the incurrence or creation:

- the sum of
 - the aggregate principal amount of all of our outstanding secured funded debt and that of our restricted subsidiaries (other than certain categories of secured funded debt discussed below), plus
 - the aggregate amount of our attributable debt and that of our restricted subsidiaries relating to sale and lease-back transactions,
- does not exceed 15% of our consolidated net tangible assets.

This limitation does not apply if the outstanding debt securities are secured equally and ratably with or prior to the new secured funded debt.

This sort of covenant is called a *Negative Pledge* – the issuer is saying it won’t pledge its existing assets to *other* debt, unless it lets *this* bond at least share (i.e. be “secured equally and ratably with or prior to”)

- However, there’s a *Carve Out* – the issuer carves out 15% of consolidated net tangible assets against which it can secure senior borrowing (and see the prospectus for other caveats and details)

Restrictions on Sale and Lease-Back Transactions

The indenture provides that neither we nor any of our restricted subsidiaries may enter into any sale and lease-back transaction involving any operating property more than 120 days after its acquisition or the completion of its construction and commencement of its full operation, unless either:

- we or the restricted subsidiary could (1) create secured funded debt on the property equal to the attributable debt with respect to the sale and lease-back transaction and (2) still be in compliance with the restrictions on secured funded debt (see "Restrictions on Secured Funded Debt" above); or
- we apply an amount, subject to credits for certain voluntary retirements of debt securities and/or funded debt, equal to the greater of
 - the fair value of the property, or
 - the net proceeds of the sale,
- within 120 days, to the retirement of secured funded debt.

This restriction will not apply to any sale and lease-back transaction

- between us and one of our restricted subsidiaries,
- between any of our restricted subsidiaries, or
- involving a lease for a period, including renewals, of three years or less.

A sale-and-leaseback transaction is almost equivalent, economically, to secured borrowing

- Firm sells an asset to another firm (e.g. GE Capital) and simultaneously enters a long-term contract to lease the same asset
- If the firm defaults on the contract, the owner can take back the asset

If the lease term covers the economic life of the asset, this is very, very close to secured borrowing (note that the owner gets to keep the asset after the lease expires, but its economic life is over)

So this is similar to the negative pledge clause. However, it is not possible to pledge some of the value of the sold asset to the bondholders, so what this restriction says instead is that sale-and-leaseback is OK as long as the sale proceeds are spent on retiring secured debt.

Consolidation, Merger or Sale

The indenture generally permits a consolidation or merger between us and another corporation. It also permits the sale or transfer by us of all or substantially all of our property and assets and the purchase by us of all or substantially all of the property and assets of another corporation. These transactions are permitted if:

- the resulting or acquiring corporation, if other than us, assumes all of our responsibilities and liabilities under the indenture, including the payment of all amounts due on the debt securities and performance of the covenants in the indenture;
- immediately after the transaction, no event of default exists; and
- except in the case of a consolidation or merger of a restricted subsidiary with or into us, either:
 - we have obtained the consent of the holders of a majority in aggregate principal amount of the outstanding debt securities (as defined in the indenture) of each series, or
 - immediately after the transaction, the resulting or acquiring corporation could incur additional secured funded debt and still be in compliance with the restrictions on secured funded debt (see "Restrictions on Secured Funded Debt" above). (Section 801)

Even though the indenture contains the provisions described above, we are not required by the indenture to comply with those provisions if we sell all of our property and assets to another corporation if, immediately after the sale:

- that corporation is one of our wholly-owned restricted subsidiaries; and
- we could incur additional secured funded debt and still be in compliance with the restrictions on secured funded debt.

Generally, the bondholders must approve a merger that would put the firm out of compliance with the restrictions on secured debt.

There is one more restriction on a change of control:

Change of Control Offer

If a **change of control triggering event** occurs with respect to the 2013 notes, the 2018 notes or the 2038 notes, unless we have exercised our option to redeem such notes as described above, **we will be required to make an offer (a "change of control offer") to each holder of the series of notes** with respect to which such change of control triggering event has occurred to repurchase all or any part (equal to \$100,000 or an integral multiple of \$1,000 in excess thereof) of that holder's notes on the terms set forth in such notes. In a change of control offer, **we will be required to offer payment in cash equal to 101% of the aggregate principal amount of notes** repurchased, plus accrued and unpaid interest, if any, on the notes repurchased to the date of repurchase (a "change of control payment"). Within 30 days following any change of control triggering event or, at our option, prior to any change of control, but after public announcement of the transaction that constitutes or may constitute the change of control, a notice will be mailed to holders of the 2013 notes, the holders of the 2018 notes and/or to the holders of the 2038 notes, as the case may be, describing the transaction that constitutes or may constitute the change of control triggering event and offering to repurchase such notes on the date specified in the applicable notice, which date will be no earlier than 30 days and no later than 60 days from the date such notice is mailed (a "change of control payment date"). The notice will, if mailed prior to the date of consummation of the change of control, state that the change of control offer is conditioned on the change of control triggering event occurring on or prior to the applicable change of control payment date.

On each change of control payment date, we will, to the extent lawful:

- accept for payment all notes or portions of notes properly tendered pursuant to the applicable change of control offer;
- deposit with the paying agent an amount equal to the change of control payment in respect of all notes or portions of notes properly tendered; and
- deliver or cause to be delivered to the trustee the notes properly accepted together with an officers' certificate stating the aggregate principal amount of notes or portions of notes being repurchased.

We will not be required to make a change of control offer upon the occurrence of a change of control triggering event if a third party makes such an offer in the manner, at the times and otherwise in compliance with the requirements for an offer made by us and the third party repurchases all notes properly tendered and not withdrawn under its offer. In addition, we will not repurchase any notes if there has occurred and is continuing on the change of control payment date an event of default under the indenture, other than a default in the payment of the change of control payment upon a change of control triggering event.

We will comply with the requirements of Rule 14e-1 under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and any other securities laws and regulations thereunder to the extent those laws and regulations are applicable in connection with the repurchase of the notes as a result of a change of control triggering event. To the extent that the provisions of any such securities laws or regulations conflict with the change of control offer provisions of the notes, we will comply with those securities laws and regulations and will not be deemed to have breached our obligations under the change of control offer provisions of the notes by virtue of any such conflict.

For purposes of the change of control offer provisions of the notes, the following terms will be applicable:

"Change of control" means the occurrence of any of the following: (1) the direct or indirect sale, lease, transfer, conveyance or other disposition (other than by way of merger or consolidation), in one or more series of related transactions, of all or substantially all of our assets and the assets of our subsidiaries, taken as a whole, to any person, other than our company or one of our subsidiaries; (2) the consummation of any transaction (including, without limitation, any merger or consolidation) the result of which is that any person becomes the beneficial owner (as defined in Rules 13d-3 and 13d-5 under the Exchange Act), directly or indirectly, of more than 50% of our outstanding voting stock or other voting stock into which our voting stock is reclassified, consolidated, exchanged or changed, measured by voting power rather than number of shares; (3) we consolidate with, or merge with or into, any person, or any person consolidates with, or merges with or into, us, in any such event pursuant to a transaction in which any of our outstanding voting stock or the voting stock of such other person is converted into or exchanged for cash, securities or other property, other than any such transaction where the shares of our voting stock outstanding immediately prior to such transaction constitute, or are converted into or exchanged for, a majority of the voting stock of the surviving person or any direct or indirect parent company of the surviving person immediately after giving effect to such transaction; (4) the first day on which a majority of the members of our Board of Directors are not continuing directors; or (5) the adoption of a plan relating to our liquidation or dissolution. Notwithstanding the foregoing, a transaction will not be deemed to involve a change of control under clause (2) above if (i) we become a direct or indirect wholly-owned subsidiary of a holding company and (ii) (A) the direct or indirect holders of the voting stock of such holding company immediately following that transaction are substantially the same as the holders of our voting stock immediately prior to that transaction or (B) immediately following that transaction no person (other than a holding company satisfying the requirements of this sentence) is the beneficial owner, directly or indirectly, of more than 50% of the voting stock of such holding company. The term "person," as used in this definition, has the meaning given thereto in Section 13(d)(3) of the Exchange Act.

"Change of control triggering event" means the occurrence of both a change of control and a rating event.

"Continuing directors" means, as of any date of determination, any member of our Board of Directors who (1) was a member of such Board of Directors on the date the notes were issued or (2) was nominated for election, elected or appointed to such Board of Directors with the approval of a majority of the continuing directors who were members of such Board of Directors at the time of such nomination, election or appointment (either by a specific vote or by approval of our proxy statement in which such member was named as a nominee for election as a director, without objection to such nomination).

"Fitch" means Fitch Inc., and its successors.

"Investment grade rating" means a rating equal to or higher than BBB- (or the equivalent) by Fitch, Baa3 (or the equivalent) by Moody's and BBB- (or the equivalent) by S&P, and the equivalent investment grade credit rating from any replacement rating agency or rating agencies selected by us.

"Moody's" means Moody's Investors Service, Inc., and its successors.

"Rating agencies" means (1) each of Fitch, Moody's and S&P; and (2) if any of Fitch, Moody's or S&P ceases to rate the notes or fails to make a rating of the notes publicly available for reasons outside of our control, a "nationally recognized statistical rating organization" within the meaning of Rule 15c3-1(c)(2)(vi)(F) under the Exchange Act selected by us (as certified by a resolution of our Board of Directors) as a replacement agency for Fitch, Moody's or S&P, or all of them, as the case may be.

"Rating event" means (A) with respect to the 2013 notes, the rating on the 2013 notes is lowered by at least two of the three rating agencies and the 2013 notes are rated below an investment grade rating by at least two of the three rating agencies, (B) with respect to the 2018 notes, the rating on the 2018 notes is lowered by at least two of the three rating agencies and the 2018 notes are rated below an investment grade rating by at least two of the three rating agencies, and (C) with respect to the 2038 notes, the rating on the 2038 notes is lowered by at least two of the three rating agencies and the 2038 notes are rated below an investment grade rating by at least two of the three rating agencies, in any case on any day during the period (which period will be extended so long as the rating of the applicable notes is under publicly announced consideration for a possible downgrade by any of the rating agencies) commencing 60 days prior to the first public notice of the occurrence of a change of control or our intention to effect a change of control and ending 60 days following consummation of such change of control.

In English, *if* there is a change of control *and* the bonds are downgraded to junk, *then* the bondholders must be given the right to sell their bonds back to the issuer at 101 cents on the dollar. Since this is a right to sell, it is a put, and since it penalizes a takeover that harms the bonds, it is called a *poison put*. This rating-based structure means that, to some extent, the put does not punish takeovers that *do not* harm the bonds.

The bulkpack article describes some other common covenants, such as

- Dividend and share-repurchase restrictions
- Asset-sale restrictions
- Requirements to maintain and/or insure assets

With any covenant, the key questions are

- What bad incentives does it address?
- What good actions does it interfere with?
- Does the benefit of the first outweigh the costs of the second?

Rights of creditors upon default

Following the covenants, the indenture defines default:

Events of Default

Unless otherwise specified in the applicable prospectus supplement, an "event of default" means, when used in the indenture with respect to any series of debt securities, any of the following:

- failure to pay interest on any debt security of that series for 30 days after the payment is due;
- failure to pay the principal of or any premium on any debt security of that series when due;
- failure to deposit any sinking fund payment on debt securities of that series when due;
- failure to perform any other covenant in the indenture that applies to debt securities of that series for 90 days after we have received written notice of the failure to perform in the manner specified in the indenture;
- default under any indebtedness for borrowed money, including other series of debt securities, or under any mortgage, lien or other similar encumbrance, indenture or instrument, including the indenture, which secures any indebtedness for borrowed money, and which results in acceleration of the maturity of an outstanding principal amount of indebtedness greater than \$20 million, unless the acceleration is rescinded, or the indebtedness is discharged, within 10 days after we have received written notice of the default in the manner specified in the indenture;
- certain events in bankruptcy, insolvency or reorganization; or
- any other event of default that may be specified for the debt securities of that series when that series is created.

So events of default is what one would think – a failure to pay a coupon (after a 30-day grace period) or principal, a covenant violation (after a 90-day grace period), bankruptcy and similar events.

- Note the fifth bullet – this is the *cross default* clause: enough *other* debt being in default is an event of default for *this* bond

An example from December: *Tekni-Plex*

December 19, 2007 Wednesday 11:55 AM PST

HEADLINE: S&P: **Tekni-Plex Credit Rating Lowered To 'D' After Missed Payment On Subordinated Notes Dec. 18, 2007**

Standard & Poor's Ratings Services said that it lowered its rating on Tekni-Plex Inc.'s \$315 million 12 3/4% senior subordinated notes due 2010 to 'D' from 'C' and its corporate credit rating to 'D' from 'CCC-'. We lowered the ratings on the \$150 million 10 7/8% first-lien senior secured notes due 2012 to 'CC' from 'CCC-'. We placed the ratings on the senior secured notes due 2012 and the \$275 million second-lien senior secured notes due 2013 on CreditWatch with negative implications. At Sept. 28, 2007, Tekni-Plex had total debt outstanding of about \$866 million. "The rating actions follow the company's announcement that it did not make its \$20.5 million interest payment due on Dec. 17, 2007, on its 12 3/4% senior subordinated notes due 2010," said Standard & Poor's credit analyst Liley Mehta. If Tekni-Plex does not make the interest payment by the end of a 30-day grace period on Jan. 17, 2008, then the company will be in default under the subordinated notes indenture, which will allow the noteholders to accelerate the maturity on the notes. Acceleration of the subordinated notes would also result in an event of default under the company's 10 7/8% senior secured notes due 2012 and 8 3/4% senior secured notes due 2013.

And *Tropicana*

December 17, 2007 Monday 5:46 AM GMT

HEADLINE: **Tropicana Entertainment corporate family rating cut to 'Caa1' from 'B2'- Moody's**

Moody's Investors Service said it has downgraded US-based gaming company Tropicana Entertainment LLC's corporate family rating (CFR) to 'Caa1' from 'B2' reflecting the decision by New Jersey Casino Control Commission to deny the company's gaming license renewal application.

As a result of this decision, Tropicana may have to sell its Atlantic City property, Moody's said.

Unless the commission's decision is stayed or reversed, an event of default will result under the company's senior credit facilities. If such an event occurs and the lenders accelerate, it will cause an event of default under the company's senior subordinated bond indenture, Moody's added.

The agency also lowered Tropicana Las Vegas Resort & Casino LLC's corporate family rating to 'B3' from 'B2' because if an event occurs under the senior credit facilities and the lenders accelerate, it will also cause an event of default under the Trop Las Vegas term loan.

A crucial point about an “event of default” is that it does not automatically trigger legal action. Instead,

If an event of default for any series of debt securities occurs and continues, the trustee or the holders of at least 25% in aggregate principal amount of the outstanding debt securities of the series may declare the entire principal of all the debt securities of that series to be due and payable immediately. If a declaration occurs, the holders of a majority of the aggregate principal amount of the outstanding debt securities of that series can, subject to certain conditions, rescind the declaration. (Sections 502, 513)

The prospectus supplement relating to each series of debt securities which are original issue discount securities will describe the particular provisions that relate to the acceleration of maturity of a portion of the principal amount of that series when an event of default occurs and continues.

An event of default for a particular series of debt securities does not necessarily constitute an event of default for any other series of debt securities issued under the indenture. The indenture requires us to file an officers' certificate with the trustee each year that states that certain defaults do not exist under the terms of the indenture. (Section 1011) The trustee may withhold notice to the holders of debt securities of any default, except defaults in the payment of principal, premium, interest or any sinking fund installment, if it considers the withholding of notice to be in the best interests of the holders. (Section 602)

Other than its duties in the case of a default, a trustee is not obligated to exercise any of its rights or powers under the indenture at the request, order or direction of any holders, unless the holders offer the trustee reasonable indemnification. (Sections 601, 603) If reasonable indemnification is provided, then, subject to certain other rights of the trustee, the holders of a majority in principal amount of the outstanding debt securities of any series may, with respect to the debt securities of that series, direct the time, method and place of:

- conducting any proceeding for any remedy available to the trustee; or
- exercising any trust or power conferred upon the trustee. (Sections 512, 603)

The holder of a debt security of any series will have the right to begin any proceeding with respect to the indenture or for any remedy only if:

- the holder has previously given the trustee written notice of a continuing event of default with respect to that series;
- the holders of at least 25% in aggregate principal amount of the outstanding debt securities of that series have made a written request of, and offered reasonable indemnification to, the trustee to begin the proceeding;
- the trustee has not started the proceeding within 60 days after receiving the request; and
- the trustee has not received directions inconsistent with the request from the holders of a majority in aggregate principal amount of the outstanding debt securities of that series during those 60 days. (Section 507)

However, the holder of any debt security will have an absolute right to receive payment of principal of and any premium and interest on the debt security when due and to institute suit to enforce the payment. (Section 508)

We can condense the legalese to the following:

If the default is a failure to pay this bond on time, then every creditor has the individual right to take legal action to force payment (the part highlighted in green). This sort of default is called a *financial default*

- The Federal Trust Indenture Act mandates that bondholders have this individual right

But if the default is on anything else, i.e. a *covenant default*, then the trustee has the right to take action, but individual creditors *do not*. Instead, we see that

- A majority (by value) of bondholders can tell the trustee what to do
- A quarter of bondholders can take action, *provided that* a majority does not oppose them

So while it might seem that a bondholder can pursue any failure on an indenture, in fact his rights are more limited than that.

How the Contract can be Changed by a Vote

Modification and Waiver

Under the indenture, we and the trustee can modify or amend the indenture with the consent of the holders of a majority in aggregate principal amount of the outstanding debt securities of each series of debt securities affected by the modification or amendment. However, we may not, without the consent of the holder of each debt security affected:

- change the stated maturity date of any payment of principal or interest;
- reduce certain payments due on the debt securities;
- change the place of payment or currency in which any payment on the debt securities is payable;
- limit a holder's right to sue us for the enforcement of certain payments due on the debt securities;
- reduce the percentage of outstanding debt securities required to consent to a modification or amendment of the indenture;
- limit a holder's right, if any, to repayment of debt securities at the holder's option; or
- modify any of the foregoing requirements or a reduction in the percentage of outstanding debt securities required to waive compliance with certain provisions of the indenture or to waive certain defaults under the indenture. (Section 902)

Under the indenture, the holders of a majority in aggregate principal amount of the outstanding debt securities of any series of debt securities may, on behalf of all holders of that series:

- waive compliance by us with certain restrictive covenants of the indenture; and
- waive any past default under the indenture, **except**:
 - a default in the payment of the principal of or any premium or interest on any debt securities of that series; or
 - a default under any provision of the indenture which itself cannot be modified or amended without the consent of the holders of each outstanding debt security of that series. (Sections 1012, 513)

What this says is, the issuer can change *almost anything in the indenture* if a majority of the bond agrees (the text in green). What they *can't* change, due to the Trust Indenture Act, is anything having to do with timely payment of principal and interest (the text in red). That can be amended only with a *unanimous* vote.

Holding a vote to remove covenants and other contract features turns out to be a useful tactic for distressed firms, which we will cover in detail. For now, notice that one could seriously damage the value of a bond without changing its principal, interest or maturity

- For example, with this bond, one could remove the part of the indenture that says the bond is senior, and instead make it junior

Example from Last Year of a Vote regarding a Covenant Violation: *IMAX*

April 3, 2007 Tuesday 2:40 PM EST

HEADLINE: Commences Consent Solicitation from holders of its Senior Notes and Announces Two thirds of Required Consents Have Already Been Obtained

IMAX CORP ("IMX-T") - IMAX Corporation announced that it is soliciting consents (the "Consent Solicitation") from the holders of its \$160 million aggregate principal amount of outstanding 9 5/8% Senior Notes due 2010 (the "Senior Notes") to extend the deadline to file its Annual Report on Form 10-K for the year ended December 31, 2006 and all other reports required to be filed by it under the Securities Exchange Act of 1934, until May 31, 2007 or at its election until June 30, 2007.

The consent of a majority of the holders of the principal amount of the outstanding Senior Notes is required to extend the filing deadline, and approximately 67% of the required consents have already been obtained. The consent will constitute a waiver of any defaults or event of defaults arising from the Company's failing to file its 10-K prior to its deadline, including pursuant to a notice of default it will receive from the Trustee under the Indenture.

Holders of the Senior Notes are referred to the Company's Consent Solicitation Statement dated April 3, 2007 and the related Consent Form, which are being mailed to holders, for the detailed terms and conditions of the Consent Solicitation. The record date for determining the holders who are entitled to consent was 5:30 p.m., New York City time, on March 28, 2007. The Consent Solicitation will expire at 5:01 p.m., New York City time, on April 12, 2007, unless extended.

The Company is offering holders a consent fee of \$10.00 in cash for each \$1,000 in principal amount of Senior Notes for their consent to the extension of the filing deadline until May 31, 2007 (plus applicable cure period), with the option by the Company to extend the filing deadline until June 30, 2007 (plus applicable cure period), all subject to the terms of the Consent Solicitation. If the Company elects to extend the filing deadline until June 30, 2007, shortly after notice of such election, it will pay holders an additional consent fee of \$5.00 in cash for each \$1,000 in principal amount of Senior Notes.

As previously disclosed, the Company has not yet filed with the SEC its Annual Report on Form 10-K for the year ended December 31, 2006 in order to allow additional time to complete a previously announced restatement due to certain accounting errors, and to allow an internal review of its accounting relating in particular to its revenue recognition policies.

Imax got its waiver but a big creditor tried to sue anyhow:

Hollywoodreporter.com

October 13, 2007 Saturday

HEADLINE: Imax financials target of suit in Ontario

BYLINE: Etan Vlessing

TORONTO -- Turning up the heat on Imax, Catalyst Fund said that it will go ahead with a lawsuit in an Ontario court over recent delays in the giant-screen exhibitor filing its financial statements.

Toronto-based equity investor Catalyst Fund, which holds senior notes and stock in Imax, said Friday that it has gone to the Ontario Superior Court to seek redress for the Canadian exhibitor's "continuing misrepresentations, inaccurate financial reporting, and its defaults under the indenture that governs the senior notes."

Catalyst Fund also disputed Imax's reporting Thursday that the equity fund has withdrawn a New York state lawsuit over waivers Imax received in April from certain bondholders granting more time to file its annual financial results (HR 10/12).

Catalyst Fund said it was not "giving up its challenge to Imax's conduct," and instead dropped the New York action because it can potentially secure additional remedies in the Ontario courts not available in New York.

The Canadian equity fund is attempting to invalidate a waiver Imax secured in April from most holders of \$160 million in senior notes to extend the deadline for filing its annual report.

The legal action comes as Imax continues to clean up its balance sheet amid ongoing probes into its financial books by the U.S. Securities and Exchange Commission and the Ontario Securities Commission.

In July, Imax restated faulty financial results for fiscal 2002 through 2005. Then, last week, Imax said it planned yet again to restate its earnings for fiscal 2006 and the first two quarters of 2007 after it uncovered another accounting error (HR 10/5).

Catalyst Fund said Imax wrongly insisted in July that it had completed restating its financial results after it recently admitted to a further accounting error and "confirmed that its financial reports should not be relied upon."

Imax executives were not readily available for comment.

As of January, this dispute still wasn't resolved.

Why limit bondholders' rights this way? Suppose you didn't, and instead let any bondholder demand immediate repayment after any infraction

- May not be best for bondholders, particularly if they are junior
- A bondholder may not realize this, or may have a conflict of interest
- Trustee is charged with taking the prudent action
 - Of course, the trustee might misjudge or have conflicts of its own, which is why there is the override provision

Why does this limitation apply to covenant defaults but not to financial defaults?

- *Legal Answer:* This is required by the Federal Trust Indenture Act
 - Mandates that each bondholder has the inalienable right to get his principal and interest on time
- *Economic Answer:* Bondholders can actually benefit when it is hard for the firm to negotiate with them. More on this later.

The law does not mandate that covenants be changeable by majority vote. An indenture could require a $\frac{3}{4}$ vote or some other supermajority, and it could also require a unanimous vote.

Defeasance

Essentially all corporate bonds allow for *defeasance and discharge*:

Defeasance

Defeasance and Discharge. At the time that we establish a series of debt securities under the indenture, we may provide that the debt securities of that series are subject to the defeasance and discharge provisions of the indenture. Unless otherwise specified in the applicable prospectus supplement, the debt securities offered thereby will be subject to the defeasance and discharge provisions of the indenture, and we will be discharged from our obligations on the debt securities of that series if we deposit with the trustee, in trust, sufficient money or government obligations to pay the principal, interest, any premium and any other sums due on the debt securities of that series, such as sinking fund payments, on the dates the payments are due under the indenture and the terms of the debt securities. (Section 403) As used above, "government obligations" means:

- securities of the same government which issued the currency in which the series of debt securities are denominated and in which interest is payable; or
 - securities of government agencies backed by the full faith and credit of that government. (Section 101)
- In the event that we deposit funds in trust and discharge our obligations under a series of debt securities as described above, then:
- the indenture will no longer apply to the debt securities of that series (except for obligations to compensate, reimburse and indemnify the trustee, to register the transfer and exchange of debt securities, to replace lost, stolen or mutilated debt securities and to maintain paying agencies and the trust funds); and
 - holders of debt securities of that series can only look to the trust fund for payment of principal, any premium and interest on the debt securities of that series. (Section 403)

Defeasance of Certain Covenants and Certain Events of Default. At the time that we establish a series of debt securities under the indenture, we can provide that the debt securities of that series are subject to the covenant defeasance provisions of the indenture. Unless otherwise specified in the applicable prospectus supplement, the debt securities offered thereby will be subject to the covenant defeasance provisions of the indenture, and if we make the deposit described in this section under the heading "—Defeasance and Discharge" above:

- we will not have to comply with the following restrictive covenants contained in the indenture:
 - Consolidation, Merger or Sale (Sections 801, 803);
 - Restrictions on Secured Funded Debt (Section 1008);
 - Restrictions on Sale and Lease-Back Transactions (Section 1009);

- Classification of Restricted and Unrestricted Subsidiaries (Section 1010); and
 - any other covenant we designate when we establish the series of debt securities; and
- we will not have to treat the events described in the fourth bullet point under the heading "—Events of Default" as they relate to the covenants listed above that have been defeased and no longer are in effect and the events described in the fifth, sixth and seventh bullet points under the heading "—Events of Default" as events of default under the indenture in connection with that series.

In the event of a defeasance, our obligations under the indenture and the debt securities, other than with respect to the covenants and the events of default specifically referred to above, will remain in effect. (Section 1501)

If we exercise our option not to comply with the certain covenants listed above and the debt securities of that series become immediately due and payable because an event of default has occurred, other than as a result of an event of default specifically referred to above, the amount of money and/or government obligations on deposit with the trustee will be sufficient to pay the principal, interest, any premium and any other sums, due on the debt securities of that series (such as sinking fund payments) on the date the payments are due under the indenture and the terms of the debt securities, but may not be sufficient to pay amounts due at the time of acceleration. However, we would remain liable for the balance of the payments. (Section 1501)

In other words, the issuer can get out of, i.e. be *discharged* of, the covenants it committed to in the indenture by arranging for the bond to be paid by a trust containing sufficient securities, i.e. to be *defeased*.

So the firm will

- Assemble a portfolio of government bonds whose scheduled payments will pay off the bond
- On or before each coupon or principal repayment date of the bond, the portfolio pays at least as much as the scheduled payment
- Place this portfolio in an irrevocable trust which is directed to use the portfolio's payments to make the remaining payments on the bond
- The investors in a defeased bond would regard it as riskless, and it would trade at something very close to the Treasury yield
- By the same token, the cost of the portfolio of Treasuries is the present value of the bond's future payments, discounted at the Treasury rate

If the bond's indenture gives the issuer the right to defease the bond, then the issuer is no longer bound by the covenants after defeasance

Connection between defeasance and make-whole call options:

If Target were to exercise its make-whole call option, it would pay bondholders the present value of its bond's future payments, discounted at the Treasury rate plus 30bp

- If Target were to defease the bond, it would buy the portfolio of Treasury bonds. The cost is the present value of its bond's future payments, discounted at the Treasury rate. By construction, this is a somewhat higher cost

The net effect of exercising the make-whole option is the same as the net effect of defeasing the bond

- After exercising the make-whole option, the bond is gone
- After defeasing the bond, it is effectively gone – the payments to bondholders will come from the trust, not from Target, and the covenants are no longer in effect

From the bondholders' point of view, the two strategies are very similar

- With the make-whole call, they get an amount slightly less than the present value of the future payments discounted at the Treasury rate
- With the defeasance, they get a bond that is now as safe as a Treasury bond, but isn't a Treasury bond. It is still a Target note, and is probably somewhat illiquid

Which do they prefer? They might actually prefer the make-whole call, depending on how close the defeased bond trades to the Treasury rate. In any case, they are very similar.

V. Why is Bank Debt Senior?

In the typical capital structure, a firm's bank creditors are senior to its bondholders, and secured by specific collateral.

- In bankruptcy, they would get paid first
- Relatively insensitive to small decreases in firm value

At first glance, this seems counterintuitive, since banks are in a much better position to monitor borrowers than are bondholders:

- Have a direct relationship with the borrower
- Can observe various aspects of the firm's financial situation

It would seem that the efficient arrangement is to have the bank debt *junior* to the bond debt, since

- If the bank protects its claim, it is automatically protecting all claims *senior* to its own
 - i.e. if bank is paid off, then senior claims are paid off too
- Monitoring is the bank's comparative advantage, and this allows the bank's monitoring to pay off for everybody

Here's the problem: bankruptcy is costly, which makes junior claimants reluctant to force bankruptcy. To illustrate, in a bare-bones sense, suppose there's a company that is currently worth 100, but would be worth 50 in bankruptcy. And suppose it has two classes of debt, totaling 80

- Senior bonds, face value 40
- Junior bank loan, face value 40

Now suppose the banker observes the company embarking on some high-risk activity, to take advantage of bondholders. The banker could threaten to pull the loan, i.e. demand immediate repayment, but if that would force the company into bankruptcy, then the company could say

- With 40 senior to the bank, you'd get only 10 in bankruptcy
- You do better than that *outside* of bankruptcy, so you'll never do it

A banker's leverage against a misbehaving debtor is to call the loan. If the bank does better financially by *not* calling the loan, then the company will know it can get away with misbehavior.

- No credible threat
- Without a credible threat, no point in monitoring in the first place
 - If you discover something bad, what are you going to do?
- So it doesn't work to have the monitoring done by a junior claimant

The result is, banks are almost always senior and secured. Everybody wants seniority and security, but the efficient allocation is to the bank because otherwise its comparative advantage at monitoring is wasted.

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SECTION: FINANCE; Pg. 23
HEADLINE: An expensive catch to late filing;
FUNDS;
MARKETPLACE by Bloomberg

BYLINE: Caroline Salas

DATELINE: NEW YORK

As soon as Vitesse Semiconductor said it was under investigation for securities law violations that might delay routine regulatory filings, the company, which makes computer chips and is based Camarillo, California, also learned it was about to be held for ransom in the bond market.

Vitesse bonds and the debt of dozens of companies are being exploited by hedge funds, which are using provisions that allow creditors to demand immediate payment of principal when earnings reports are delayed.

At stake is as much as \$36 billion worth of bonds that may be retired if the funds have their way, according to data compiled by Bloomberg. While no one expects that amount to be redeemed early, almost \$200 million in premature payments may be made, according to the law firm Latham & Watkins in New York. The Securities and Exchange Commission is investigating more than 100 companies for defrauding shareholders by backdating stock option grants, forcing borrowers like UnitedHealth Group and Amkor Technology to postpone filings.

"There are more people looking beneath the hood to see if somebody has technically defaulted on something," said David Darst, the author of "The Complete Bond Book: A Guide to All Types of Fixed-Income Securities." "One of the great things about hedge funds and it's been very chic and fashionable to criticize them is that they spend hours and hours poring over these documents."

Company executives would rather delay filings than risk violating the Sarbanes-Oxley Act of 2002, which says that chief executives must certify the accuracy of financial statements. For hedge funds, or private partnerships for wealthy individuals and institutions, this is an opportunity.

"You're taking advantage of a loophole in the system," said Frank Johnson, who runs the LaGrange Capital Management hedge fund in New York. "You're trying to send a company to jail for jaywalking. You have this options scandal, and there's incredible pressure on boards and management teams not to file false financials."

Regulators are examining whether options grants have been illegally backdated or manipulated to take advantage of low stock prices, making them more valuable. At least 48 companies have delayed filings because of the inquiries, according to the research firm Glass, Lewis & Co. in San Francisco.

Whitebox Advisors, a hedge fund, bought about a third of Vitesse's \$100 million worth of convertible bonds in the second quarter, when the company announced the SEC investigation, regulatory filings show. Convertibles are debt securities that can be exchanged for stock at a preset price.

Whitebox figured that the investigation might cause Vitesse to violate its borrowing agreements, requiring it to repay debt at 100 cents on the dollar, when it had fallen below 90 cents.

"We're holding managements accountable where accountability has been lacking," said Andrew Redleaf, the founder of Whitebox, which is based in Minneapolis.

Hedge funds are seeking to profit by enforcing rules that protect creditors. Known as covenants, the terms were added to bond prospectuses after railroad defaults of the 19th and early 20th centuries.

The strategy has become so popular that bonds of companies caught up in the investigation often rally. Yields narrowed relative to government debt on three out of four noninvestment-grade bonds that the hedge funds focused on, according to Merrill Lynch. Bonds rated below Baa3 by Moody's Investors Service or BBB- by Standard & Poor's are considered high-yield, high-risk or junk.

Amkor's \$425 million worth of 7.75 percent notes due in 2013 trade at 94 cents, up from 89 cents Aug. 15, according to Trace, the bond-price reporting system of the NASD. That was when Amkor, a packager of semiconductors that is based in West Chester, Pennsylvania, said that it had received a noncompliance notice on \$1.62 billion worth of debt. Medarex, based in Princeton, New Jersey, has had \$150 million worth of convertibles rally to 102 cents from 94 cents in July.

"Companies will take note that somebody is watching this stuff," said Darst, who is also the chief investment strategist at Morgan Stanley Global Wealth Management.

Late filings may mean a borrower has not upheld its obligations outlined in the covenants, not that it is unable to make interest or principal payments.

"We are now living in an era where hedge funds are making more frequent use of technical defaults" to improve returns, said James Tanenbaum, head of global capital markets at Morrison & Foerster, a law firm in New York, which has helped sell bonds for companies like Bank of America. "As we think about covenants to be included in term sheets and indentures and described in prospectuses, we keep these issues top of mind."

Most companies may agree to pay a special fee to appease bondholders and buy time because it would be "a little tough" raising new money to pay off the old bonds without up-to-date financial statements, said Kirk Davenport, co-chairman of the global corporate finance practice at Latham & Watkins.

The fees can range from as little as 10 basis points to as much as 500 basis points, with "the lower end of that" being most common, he said. A 50-basis-point fee on \$36 billion in debt would amount to \$180 million. A basis point is 0.01 percentage point.

Sanmina-SCI, one of the world's largest makers of electronics for other companies, has yet to report second-quarter results because of an investigation into options granted as far back as 1997. The company, based in San Jose, California, agreed last month to pay \$12.5 million to entice investors holding \$1 billion worth of its bonds to give Sanmina until Dec. 14 to file earnings.

A company spokeswoman did not return phone calls seeking comment.

Investigations into the dating of options have spread to companies like Apple Computer and Home Depot, the world's largest home-improvement retailer.

Covenants became standard in the 19th century when as many as 40 percent of railroad bonds ended up in default, Alasdair Nairn wrote in his book "Engines that Move Markets: Technology Investing from Railroads to the Internet." Investors gained more protection with the Trust Indenture Act of 1939, which says that debt securities cannot be sold to the public without a formal agreement.

"If you have a covenant in your indentures, then you're entitled to current financial statements, and if the company can't deliver them that is a default no ifs, ands or buts," said J. Andrew Rahl, an attorney at Anderson Kill & Olick in New York. "This is quite straightforward."

Rahl represented bondholders who pushed the truck maker Navistar International to accelerate payments on its debt after failing to report financial results since September 2005.

Navistar, based in Illinois, said in August that it had bought \$190 million worth of 2.5 percent convertible notes due in 2007 at 101 cents on the dollar, to fix the technical default. The earnings report delay was not related to an options investigation.