GIBSON DUNN Five Things to Know About Convertible Notes

February 23, 2023

GIBSON DUNN

AGENDA

OVERVIEW OF CONVERTIBLE NOTES

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What is a Convertible Note?

A fixed rate debt instrument that provides the holder the right to convert the principal into shares of common stock of the issuer

Right to convert may be contingent on certain triggers

Downside protection

The issuer is obligated to repay at least money invested ("par") plus accrued interest

Upside potential

If stock price rises, conversion option becomes valuable or "in-the-money." This embedded option has value to investors

Contemporaneous transactions

A convertible note offering may be done in conjunction with derivative transactions (such as a call spread or capped call) or a stock repurchase

Customary Terms for "Plain Vanilla" Convertible Bond?

Maturity – Often 5 or 7 years

Seniority – Generally senior unsecured

Interest – Generally payable biannually

Redemption – Issuer may have right to redeem bonds

Often after a non-call period

Often has a price test – share price must be 130-150% of conversion price in order to redeem (so bonds significantly "in-the-money" when called)

Generally with a "Make-Whole"

In practice, "forces conversion"

Fundamental Change

Typically events that result in investors not owning type of company they originally invested in (e.g. change of control (unless substantially all consideration consists of shares of a listed company)) or delisting event

Generally triggers two events:

- Additional value (Make-Whole) upon conversion
- Investor put right (generally cash equal to par value)

Make-Whole

Increase in conversion rate upon specified events, based on stock price at time of event and timing of event (additional conversion value decreases over time and as value of shares increases)

Compensates investors for lost option value

Advantages of Convertible Notes

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Advantages of Convertible Notes

Lower Interest Rate

Given embedded option, investors accept a lower interest rate.

Potential Equitization of Obligation

If the issuer’s common stock rises, holders will convert rather than hold to maturity, and notes will be converted instead of repaid as a debt obligation (often giving the issuer choice of settling in cash, shares or a combination).

Minimal Covenants/Generally Unsecured

Most converts ordinarily have minimal operating or financial covenants, other than around treatment in a fundamental change. For issuers without an investment grade debt rating, this can be a significant benefit compared to high-yield bonds, which typically have significant covenants

Most converts are unsecured and do not have subsidiary guarantees

Debt Ratings

Generally not required or obtained

Disadvantages of Convertible Notes (aka “Living with Converts”)

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Disadvantages of Convertible Notes

Dilution/Pressure on Stock Price

Conversion of convertible notes can be significantly dilutive

Hedging strategies of investors may put downward pressure on stock price, especially in near term

Operational Complications

Fundamental change provisions may complicate M&A transactions

Merger covenant and conversion price adjustment provisions may complicate spinoff transactions

Long notice/observation/settlement period

Accounting may be complicated, and may result in changes between long-term to current liability status from period to period

While unusual, debt limitation/limitation on lien covenants limit future financing flexibility

Difficult to obtain consent to amend (many key provisions require 100% approval)

Early Redemption/Refinancing Difficult

Convertible notes are generally redeemable only if they are in the money, so may be difficult to unwind prior to maturity

In the absence of an effective redemption right, any restructuring must be on the basis of a negotiated transaction or open market purchase

Because converts are an “equity security” restructuring through tender or exchange offer more complicated than straight debt

Call Spread/Capped Call can make early repurchase/exchange transaction more complicated

Coordination with other credit instruments may be complicated

Process Points for Issuing Convertible Notes

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Process Points Issuing Convertible Notes

Rule 144A/Registered Offering

Convertible notes are generally Rule 144A eligible, and many are done as a Rule 144A offering. They may also be done as an offering registered under the Securities Act

Resale registration is generally not required for 144A offerings – instead there is a legend removal process once Rule 144 resale becomes available (one year after issuance)

Offering can generally be effected within 2-4 weeks of process kickoff, subject to MNPI considerations

Documentation/Process Items

Business/Legal/Accounting due diligence

Accounting/tax review

Offering Memorandum/Prospectus

Investor presentation

Purchase/Underwriting Agreement

Comfort Letter/Opinions

Other closing documentation

Documentation for hedging/share repurchase transaction

Potential Third Party Approvals

NYSE/Nasdaq Shareholder Approval Requirements (20%/Related Party tests)

Authorized Shares

Other Debt Agreements

Key Economic/Negotiation Points

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Key Economic Points /Points of Negotiation Issuing Convertible Notes

Key Economic Terms

Conversion Price – % premium over common share price at pricing

Conversion terms – convertible at any time versus contingent conversion

Settlement method – physical, cash, or combination

Observation period

Redemption/conversion at issuer's option

Covenants/Other Terms

Specific exceptions/ adaptions to conversion price adjustment provisions

Terms of any individualized covenants

Cross default terms

Investor "blocker" provisions

Terms of Related Derivative Transactions

Pricing of call spread or capped call transactions often highly negotiated and competitively bid

PIPE Terms More Variable

Convertible notes issued in a non-144A private placement to one or two investors may have many more variable terms

Tax Considerations

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Tax Considerations Convertible Notes

1. Conversion is generally not a taxable event.
2. Certain adjustments to the conversion ratio that have the effect of increasing a convertible note holder's proportionate interest in the issuer can result in a deemed distribution to the convertible note holder even though no cash is actually distributed.
3. A deemed distribution to a non-U.S. holder can be subject to 30% withholding.
4. Any issuer of convertible notes that adjusts the conversion ratio should discuss with its tax advisors whether IRS Form 8937 should be posted.
5. If the issuer is not a U.S. company, then a "passive foreign investment company" (PFIC) analysis will need to be done – holding stock of a PFIC can result in adverse tax consequences.

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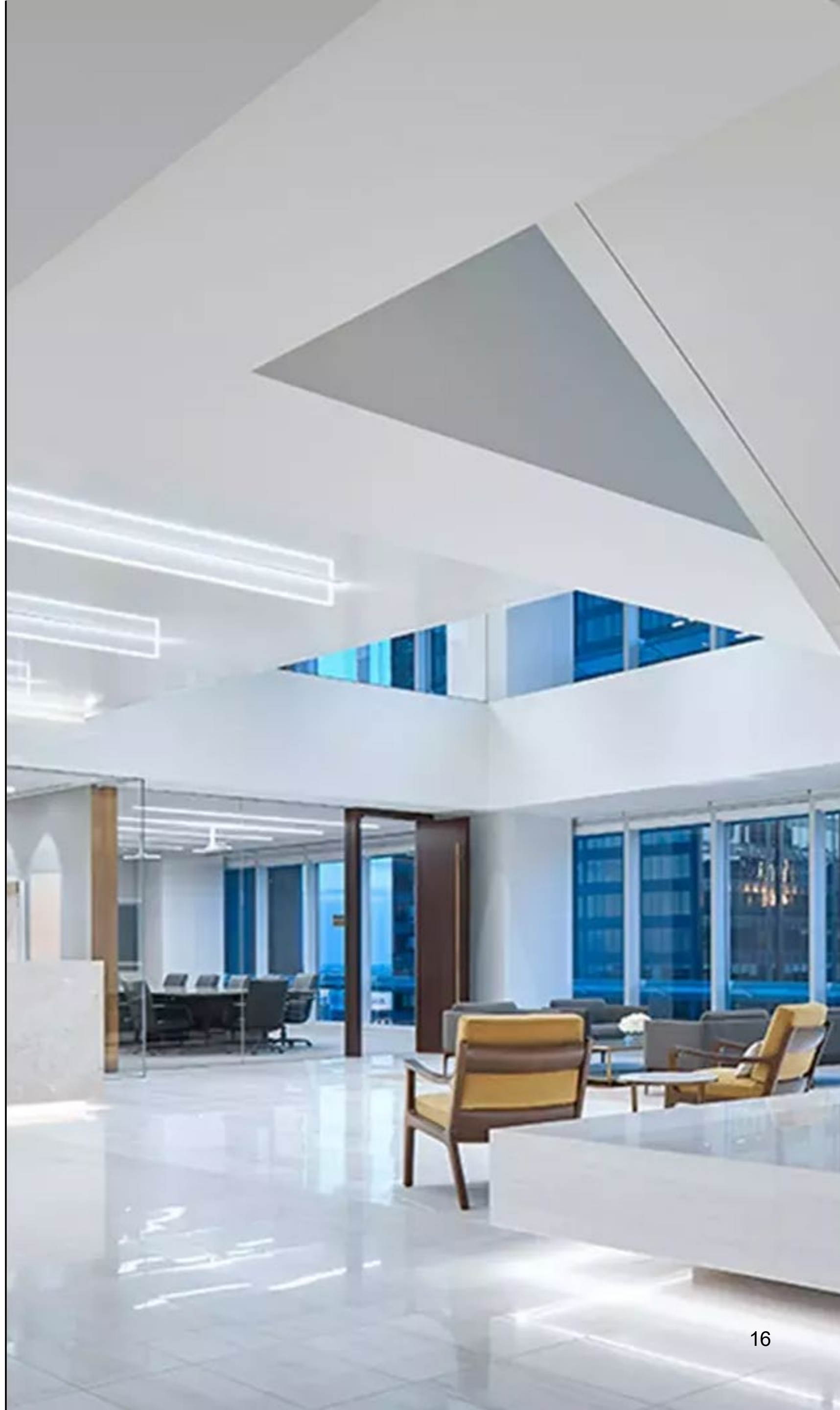

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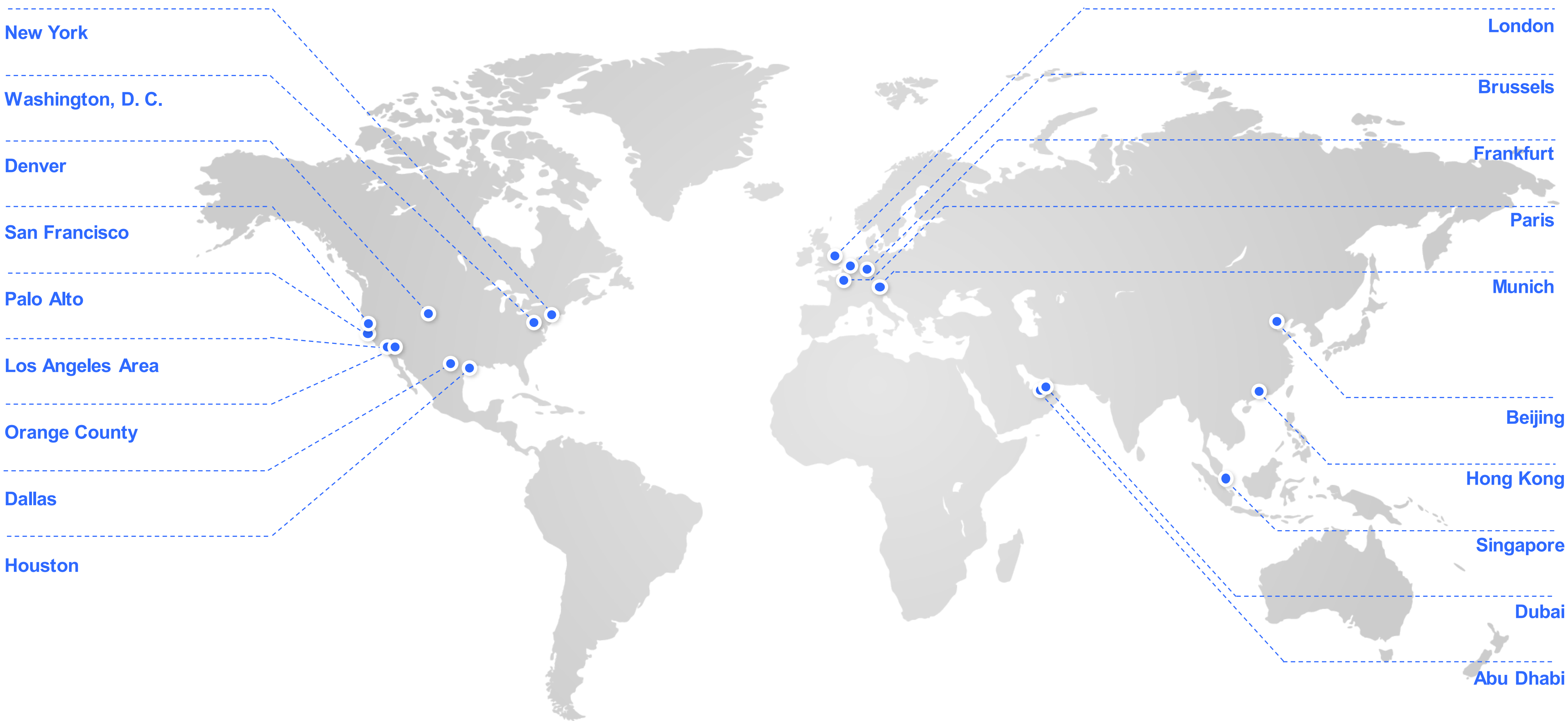
- Real Estate

Our Global Footprint



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Ms. McDowell's practice involves the representation of business organizations as to capital markets transactions, mergers and acquisitions, SEC reporting, corporate governance and general corporate matters. She has significant experience representing both underwriters and issuers in a broad range of both debt and equity securities offerings. She also represents both buyers and sellers in connection with U.S. and cross-border mergers, acquisitions and strategic investments.

Ms. McDowell received her law degree from the University of Virginia School of Law in 1995 and her Bachelor of Arts degree from Princeton University in 1991.

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Mr. Scarazzo's practice covers both the conduct of securities offerings and service as clients' outside corporate counsel. He advises in a wide range of areas, such as capital raising transactions, reporting obligations under the Exchange Act (including significant advisory work with respect to acquisition reporting), prospective and remedial stock exchange compliance, and beneficial ownership reporting matters (particularly complex Section 13 and 16 disclosure matters). As day-to-day outside counsel he also assists clients in communicating with investors and the U.S. stock markets, and ensuring that they fulfill their disclosure obligations with the Securities and Exchange Commission, including the preparation of annual and quarterly reports.

Mr. Scarazzo counsels extensively on financial reporting and accounting matters, particularly in connection with acquisition financings and post-acquisition reporting. He has advised on complex acquisition reporting for numerous transactions, such as the Amazon acquisition of Whole Foods, the Marriott acquisition of Starwood, the Johnson Controls acquisition of Tyco International, the Sequential Brands acquisition of Martha Stewart and the Tenet Healthcare acquisition of United Surgical Partners. The broad range of clients that Mr. Scarazzo represents includes issuers and underwriters, public, private, and private equity portfolio companies, and businesses from development-stage to blue chip. Clients span the geographic spectrum from U.S.-based to foreign and multinational.

Mr. Scarazzo received his Juris Doctor, with a concentration in Corporate Law, in 2005 from the University of California, Los Angeles. He earned a master's degree in Accounting, with a concentration in Tax Consulting, in 2000, and a Bachelor of Science degree in Finance, Economics and Accounting in 1999, from the University of Virginia.

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