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Why Direct Lenders and Issuers May Prefer to Structure Debt Investments in the Form of Notes Rather than Loans and Related Considerations

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I. Overview

Much has been reported on the increased popularity of direct lending and its many advantages to borrowers over traditional syndicated loan and high yield debt financings, particularly in the context of sponsor LBOs. See, e.g., "The Rise of Private Credit & Its Impact on Acquisition Dynamics" here. Although direct lending typically takes the form of a loan with a credit agreement, a direct lending transaction may be effected in the form of a note (i.e., a bond that is a security) and, in fact, there are several reasons why this structure may be required or preferred by direct lenders and issuers.

- **Convertible Structure**: If the debt is convertible into equity, the debt may be considered a security and, therefore, the transaction generally should be documented in the form of a note purchase agreement rather than a credit agreement.
- **Investor Back Leverage**: Investors may seek financing for their investments, and that financing may require the investor to pledge the investments as security for the financing. In these back leverage financings, investors may receive more credit for pledging notes as opposed to loans (in part, due to the typically better liquidity of notes).
- **Transferability**: Unless the parties agree otherwise, notes are typically easier to transfer than loans, particularly if issued in global form through The Depository Trust Company ("DTC"). Trades in the bond market tend to settle more quickly than traditional loan assignments, which usually require borrower consent, and the market for notes placed in direct lending transactions will typically provide more liquidity for investors than the loan market.
- **Regulatory Considerations**: Direct lenders that are subject to the leveraged lending guidelines (e.g., commercial banks) may be limited in the types or amount of leveraged loans that they can fund, and, as a result, they may prefer to structure the investment as a note that is a security.
- **Fund Considerations**: An investor's governing documents, such as its limited partnership agreement, may contain limitations on the aggregate amount of funds that can be invested in the form of loans versus a note that is a security.

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- **Limitations in Existing Debt Agreements**: A company's existing credit facility may contain most-favored nation ("MFN") pricing adjustments that would increase the applicable interest rate upon the incurrence of certain additional indebtedness at a higher rate within certain timeframes. Typical MFN provisions in loan agreements often only apply to incremental indebtedness incurred in the form of a loan and not "incremental equivalent debt" issued in the form of a security (i.e., notes).
- **Securities Law Protection**: An investor acquiring notes is afforded the protection of the U.S. securities laws, which although may be limited in the context of a note sold to sophisticated investors, do not apply to an investment in the form of a loan.
- **Tax Considerations**: Although the distinction between a debt obligation in the form of a note versus in the form of a loan does not have any independent significance for tax purposes, the distinction might be evidence of, or otherwise indirectly impact, the specific tax treatment of the debt obligation as described in more detail below.
- **Local Law Requirements**: Non-U.S. jurisdictions may require the debt obligation to take the form of a note in order for the debtor to grant security to the creditors or to incur the debt in the first place. In addition, creditors may avoid certain licensing requirements as well as potential foreign tax consequences if the debt is provided as note rather than loan.
- **League Table Credit**: Last, but certainly not least, if the investor is a bank or has a broker-dealer affiliate, the investor may prefer to structure the debt in the form of notes to obtain league table credit.

II. Form, Content and Process Considerations

Investors and issuers should consider the following when electing to fund a direct lending transaction in the form of notes instead of loans:

- **Economics and Covenants.** In direct lending transactions, regardless of form, investors and companies are free to include traditional term loan features (such as financial maintenance covenants, a floating interest rate and the ability to prepay the debt at any time) or high-yield bond features (such as incurrence-based covenants, a fixed interest rate and more extensive call protection). As a result, the substantive business arrangement on the economics, covenants and other terms of the investment often will not dictate whether the investment takes the form of loans or notes.
- **Documentation.**
  - *No Offering Memorandum*. In traditional syndicated bond transactions, the issuer is required to prepare an offering memorandum or prospectus that includes extensive disclosure regarding the issuer as well as audited and reviewed financial statements. In addition, the issuer will be required to obtain a comfort letter from its independent auditor and, in some instances, the auditors will need to re-audit or re-review historical periods. Furthermore, in the context of acquisition financing, acquirers will often be required to include the target's financial statements as well as prepare pro forma financial statements and obtain a comfort letter from the target's auditors. None of the foregoing is typically required in a direct lending transaction in the form of a note, as investors do their own due diligence and benefit directly from the representations and warranties in the purchase agreement (see "Other Legal and Tax Considerations—Securities Law Exemptions" below). As a result, the documentation is no more onerous than a loan transaction.

- *Note Purchase Agreement vs. Indenture.* In a traditional syndicated bond transaction, an indenture sets out the terms of the bonds and the underwriting agreement (or purchase agreement) governs terms pursuant to which the underwriters (or initial purchasers) buy the bonds from the issuer, including representations and warranties, the purchase price and closing conditions. In direct lending notes deals, the terms of the bonds can be collapsed into the note purchase agreement itself (similar to a credit agreement). Parties often prefer the collapsed approach as it is more streamlined, particularly if the investors do not anticipate trading the notes in the future. Parties may instead opt for both a note purchase agreement and an indenture for a variety of reasons, particularly if there is a desire to trade the notes through DTC or there are certain terms that the parties do not want to apply in the hands of a subsequent transferee of notes (e.g., a reporting covenant that provides extensive information rights that are intended to benefit only the initial note investors). The parties may alternatively elect to include some of these provisions in a side letter outside of both the note purchase agreement and the indenture.
- *Convertible Debt.* Under the U.S. securities laws, the incurrence of a debt obligation that is convertible into the equity securities of the borrower is generally considered to be a securities offering (particularly if conversion is unconditionally permitted within one year of issuance). If a loan structure is otherwise desired, there are various alternative structures that can be explored (e.g., memorializing the equity component as a detachable warrant or restricting any conversion until one year after incurrence). Nevertheless, the most efficient and effective way to document such convertible debt investments is in the form of notes with a note purchase agreement.
- *Certificated Physical Notes vs. Global Notes in DTC.* Certificated physical notes are preferred if investors do not intend to resell the notes. Certain investors, however, may want the ability to trade the notes through DTC, which will necessitate an indenture, a form of global note and the engagement of a trustee. Even if the investor does not immediately intend to trade the notes, having the ability to do so (easily) in the future has value. Although placing the notes in DTC facilitates trading of the notes, parties should be aware that (i) settling notes in DTC at closing of a direct lending transaction may be more complicated than a syndicated transaction (and the parties should consider engaging an advisor to assist) and (ii) DTC is not be able to monitor or enforce compliance with the note covenants (e.g., voting restrictions or prohibitions on transfers to competitors). In addition, the process for obtaining noteholder consents for global notes held in DTC is more cumbersome than obtaining noteholder consents for certificated physical notes.

- **Transfer Restrictions.** An advantage for a creditor of holding a debt obligation in the form of notes versus a loan is the ability of the creditor to easily transfer the obligation to a third party, subject only to compliance with the U.S. securities laws (see “Other Legal and Tax Considerations—Securities Law Exemptions” below). Debtors and creditors may, however, contractually agree to limit the transferability of a direct note through a side letter, in the note purchase agreement (or indenture) or in the note itself. Issuers often bargain for limits on transferability primarily as a means to maintain control over, and knowledge of, their creditor base, to facilitate amendments and waivers as well as to avoid the notes trading into the hands of aggressive “vulture” hedge funds, competitors or other hostile parties. As a result, there may be a number of different restrictions on transferability, including:
  - *Blanket Restrictions Without Issuer Consent*. The most extensive form of restriction is that a holder cannot transfer the note without the consent of the issuer. While such restrictions are common in loans, they are rare in notes.

- *Transfers in a Default or Event of Default Situation*. In a variation of the blanket restriction above, these provisions otherwise prohibit transfers without the consent of the issuer, except if the issuer has defaulted on the note. This construct allows a holder to trade out of a distressed instrument, but may not protect the issuer from the note ending up in hostile hands.
- *Restrictions on Transfers to Competitors*. Loans and notes issued in direct lending transactions often contain restrictions on transfers to competitors of the issuer, a feature that is not practical in broadly syndicated bond transactions since those bonds are issued in global form through DTC, but can be implemented in notes issued in direct lending transactions.
- *Disqualified Holder Lists*. To avoid the note from trading to a specified list of holders perceived by the issuer as aggressive, issuers may insist on a so-called "DQ list," which will void any transfer to a pre-determined list of investors. A DQ list is very common in loans (in both the direct and syndicated contexts), but not practical in the broadly syndicated high yield bond market given the trading through DTC. Typically, the list will be negotiated at the time of entry into the note, but the issuer may retain the ability to add names to the list in certain circumstances. Holders may negotiate for any such restrictions to fall away in a default scenario.
- *Rights of First Offer or Refusal*. These provisions provide that a holder looking to transfer its note must first offer the note to the issuer for repurchase (or, alternatively, if an investor offers to purchase a note from a holder, the issuer has the right to purchase the note instead).
- *Lock-ups*. These provisions require the holder to hold the note for a specified period of time and may fall away in a default or event of default scenario.

  Holders of a note will generally prefer unfettered transferability; however, such rights may result in less restrictive covenants or more issuer favorable provisions, as issuers will be reluctant to agree to tighter provisions without the assurance that they will "know" their creditors (and, therefore, who can consent to an amendment or waiver) in the future. A compromise solution may be to provide for a different (i.e., less restrictive) set of covenants if the initial holders sell down below a specified threshold (e.g., 50%). In addition, issuers may bargain for certain covenants that only apply for the benefit of the initial holders, such as reporting obligations and periodic access to management.

- **Drafting / Negotiation.** When negotiating a direct lending transaction in the form of a note, often a "lead investor" will negotiate the terms of the note on behalf of the entire investor group with any "co-investors" having minimal ability to comment—similar to the dynamics in direct lending loan transactions. However, in other circumstances, the issuer may be forced to negotiate individually with each investor or with a group of investors to find a common set of terms. An important practical consideration in all private credit transactions, whether in loans or notes, is whether counsel for the company or counsel for the investors prepares first drafts of the documents. There is no market convention, and the answer will depend on a number of factors, including the negotiating leverage of the respective parties, practicality, speed and cost.
- **Administrative Agent vs. Trustee.** In direct lending transactions, whether in the form of a loan or notes, an agent is engaged to help administer the investment. In loans, that agent is typically an administrative agent, which can be one of the investors or a third party, and has some agency to make judgments in administration of the loan. In contrast, syndicated bonds have a trustee, who will mechanically administer the terms of the indenture without employing any discretionary judgment. As a result, obtaining a ministerial waiver or consent with an administrative agent will almost certainly be easier than with a trustee. Private credit transactions in the form of notes can have either an administrative agent or a trustee. Typically, the decision depends on whether the notes will be held at DTC, in which case, a traditional trustee is likely required due to the need for an indenture.

- **Placement Agent.** In certain syndicated private credit transactions, the issuer may engage a placement agent to assist the issuer in identifying potential private credit investors in the transaction. The placement agent will be engaged by the issuer pursuant to a private placement engagement letter, and the issuer will be responsible for the placement agent's fees as well as fees of its counsel (often subject to a cap).

III. Other Legal and Tax Considerations.

- **Securities Law Exemptions.** Often an overlooked (or unexamined) part of the transaction, the specific U.S. securities law exemption used for issuance of the notes can have important implications for the marketing and structure of the transaction. The U.S. securities laws require any issuance of securities to be registered with the Securities and Exchange Commission absent an exemption or exception from such registration requirements. Most notes are issued pursuant to Section 4(a)(2) of the Securities Act, which exempts transactions not involving a "public offering" from the registration requirements of the Securities Act. Among other conditions, Section 4(a)(2) prohibits the issuer from soliciting a significant number of buyers, limits the manner in which such offering may occur, and requires any solicited buyers to be sophisticated investors. In most direct lending transactions, these conditions are easily satisfied; however, the parties should consider other exemptions (such as Rule 506(b) or 506(c) of Regulation D) if there is a desire to market the note to a significant number of investors or to less sophisticated individuals. Regardless of the exemption used, the notes will be "restricted securities" under the U.S. securities laws and, therefore, will require investors to use an available exemption for resales.
- **Securities Law Liability.** Diligence and disclosure are approached similarly in direct lending transactions whether in the form of notes and loans. As noted above, most direct note issuances will utilize Section 4(a)(2) and, therefore, no offering document will be prepared by the issuer and distributed to investors. Instead, the issuer will be required to make representations regarding its business, financial statements and compliance with laws in the note purchase agreement, with any exceptions noted in disclosure schedules. In addition, investors will be asked to provide representations as to their sophistication, their ability to do due diligence on the issuer and their understanding that they may lose all or substantially of their investment—so called "big boy" representations. Courts are generally inclined to enforce "big boy" representations against sophisticated investors unless the issuer or the placement agent (if any) has particular knowledge of an issue that is not disclosed to the investor prior to the investment. As a result, investors will typically not benefit from the same level of protection from the anti-fraud provisions of the U.S. securities laws as enjoyed by investors in registered or broadly syndicated unregistered bond offerings.
- **Volcker Rule Considerations.** The legal analysis of private credit investing under the Volcker Rule is outside the scope of this client alert. However, private credit investing by institutions that may be subject to the Volcker Rule should consider the implications of switching from investing in the form of loans to investing in the form of notes. For example, certain groups within such regulated entities that are primarily engaged in underwriting activities may have to do an analysis to assess whether there is a reasonably expected near-term demand (or RENTD) for the notes.
- **Tax Considerations.** The issuance of a debt obligation as either a loan or a note does not have any direct impact on the tax treatment of the obligation. However, there are situations where the form of the obligation has indirect tax consequences to the parties.

- *U.S. Tax Treatment of Foreign Lenders*. A foreign lender is more likely to reduce its risk of paying U.S. taxes by investing in the note of a U.S. issuer than by entering into a loan with a U.S. borrower. Investing in the debt of a U.S. borrower through a note is more likely to be viewed as a "passive" business and, therefore, less likely to cause the investor to be viewed as engaged in a trade or business in the United States (which would result in the investor having sufficient nexus to the U.S. as to cause it to be subject to U.S. income tax). Note that, unlike lenders to a loan, foreign noteholders are typically not entitled to a "gross-up" with respect to an increase in withholding taxes resulting from a post-issuance change in law; however, the liquidity of the notes should allow for a holder to easily sell the note in the event of such a change in law.
- *Treatment as a Security.* Classification of a note as a security for tax purposes may allow the lender to exchange its position in the note for certain new debt or equity of the issuer without paying tax on any gain the lender may have in the note. Although it is not a prerequisite for tax purposes, the treatment of a note as a security for securities law purposes increases the likelihood of treatment as a security for tax purposes.

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