

## Private Entity Access To Capital Markets Through Rule 144A For Life Offerings

Many privately or family owned entities may believe access to U.S. capital markets is foreclosed due to burdensome and cost prohibitive regulatory requirements. With interest rates at historical lows and a robust supply of dollars available to borrow, many privately owned entities are selling so-called high yield notes in Rule 144A<sup>1</sup> for life offerings. These notes are sold in underwritten private offerings only to qualified institutional buyers<sup>2</sup> (“QIBs”) with no covenant made by the issuer to exchange them in a future exchange offer for notes registered under the Securities Act of 1933, as amended (the “1933 Act”). Rule 144A for life offerings allow private entities to enjoy many of the benefits that accrue to publicly listed entities by borrowing funds through U.S. capital market offerings without subjecting the private entity to making periodic filings with the U.S. Securities and Exchange Commission (“SEC”) or having its top executive officers attest quarterly to the adequacy of disclosure controls or financial statement internal controls.<sup>3</sup>

The table below sets forth a summary of the substantive differences between indebtedness incurred in a Rule 144A for life offering and in a traditional bank term loan.

<u>Term Loan Indebtedness</u>	<u>Rule 144A For Life Indebtedness</u>
Secured	Unsecured
Periodic Financial Maintenance Covenants	No Financial Maintenance Covenants
Probably Not Rated	Rated
No Offering Memorandum	Offering Memorandum
Low Execution Risk	Moderate Execution Risk
Amortization	No Amortization
Future Audited Annual Financial Statements	Future Audited Annual Financial Statements plus Management’s Discussion and Analysis of Financial Condition and Results of Operations <sup>4</sup>
Shorter Tenor (up to five years)	Longer Tenor (five to ten years)

### ***Transaction Players***

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<sup>1</sup> Rule 144A promulgated under the 1933 Act.

<sup>2</sup> Rule 144A(a)(1).

<sup>3</sup> See Sarbanes-Oxley Act of 2002.

<sup>4</sup> Item 303 of Regulation S-K promulgated under the 1933 Act (“Reg. S-K”).

In traditional term loans, the borrower and borrower's counsel work with the lender, or the administrative agent for a group of lenders, and its counsel to negotiate and draft the term loan or credit agreement and ancillary documents used to effect the transaction. In a Rule 144A for life offering, the borrower and borrower's counsel work with the initial purchasers and the lead initial purchaser's counsel to prepare an offering memorandum and negotiate and draft the indenture, purchase agreement and other documents used to complete the note offering. In connection with the preparation of the offering memorandum, the borrower's auditor will also be engaged to prepare a comfort letter addressed to the initial purchasers regarding the financial information in the offering memorandum.

### ***Security***

Although instances can be found where traditional term loans are unsecured and Rule 144A notes are secured, most traditional term loans are secured by the assets of the borrower and most Rule 144A notes are not. If Rule 144A notes were secured by the assets of the borrower, the Trust Indenture Act of 1939 imposes administratively burdensome requirements on both the trustee and the borrower if the items of collateral change or if changes to the terms of the security arrangements are made. Because of this, borrowers tend to avoid Rule 144A note offerings and prefer traditional term loans if borrowings must be secured.

### ***Financial Maintenance Covenants***

Traditional term loans generally impose on borrowers periodic financial maintenance covenants, which are not imposed in Rule 144A for life notes. These covenants could include annual or quarterly fixed charge coverage ratio tests, tangible net worth tests and debt to equity (or leverage ratio) tests.<sup>5</sup> While Rule 144A for life notes do not contain periodic financial maintenance covenants, both types of indebtedness would impose on borrowers standard covenants. Standard covenants generally limit (i) the incurrence by the borrower of indebtedness, (ii) effecting affiliated party transactions by the borrower, (iii) making restricted payments to the borrower's equity holders, (iv) effecting sales of the borrowers assets and (v) granting liens on the borrower's assets.

### ***Ratings***

Rule 144A for life notes sold in underwritten offerings are rated by at least two ratings agencies. The rating process usually takes at least one month and involves

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<sup>5</sup> A fixed charge coverage ratio test is calculated by dividing total fixed charges into the net income or earnings before interest and taxes of the borrower. A tangible net worth test is calculated by comparing an agreed upon amount to stated net worth less the sum of accounts receivable from the borrower's affiliates, goodwill and other intangible assets. A leverage ratio is calculated by dividing indebtedness by tangible net worth.

drafting a rating agency presentation and conducting meetings with the rating agencies. Traditional term loans may have a rating requirement but many do not.

### ***Offering Memorandum***

Traditional term loans are effected through the negotiation and signing of a term loan or credit agreement with the lender or the administrative agent representing a group of lenders. Rule 144A for life notes are issued through the negotiation with the initial purchasers of a description of notes included in an offering memorandum, which description then forms the basis for the creation of an indenture setting forth the rights of the note holders and trustee for the notes. The offering memorandum also sets forth a full description of (i) the business and management of the borrower,<sup>6</sup> (ii) risk factors (both relating to the borrower's business and to the notes),<sup>7</sup> (iii) the use of proceeds,<sup>8</sup> (iv) management's discussion and analysis of financial condition and results of operations<sup>9</sup> ("MD&A"), (v) related party transactions<sup>10</sup> and (vi) principal shareholders<sup>11</sup>. Preparation of the offering memorandum is rigorous and time consuming, and it is disseminated to a wider audience than the due diligence information provided to a traditional term loan lender. Many privately owned entities, however, ultimately appreciate the final product and follow the process used to create it as a template in the preparation of other documents describing the borrower's business.

### ***Execution Risk***

Traditional term loans are negotiated by the borrower and the lender or the administrative agent for a group of lenders. Rule 144A for life offerings involve a negotiation by the borrower and the initial purchaser of a description of the notes and a purchase agreement, and also a marketing process, or road show, conducted by the borrower and the initial purchasers with prospective purchasers that are QIBs. At the beginning of the road show, the borrower does not know the specific interest rate or tenor for the notes to be sold, and these items are ultimately determined through indications of interest provided by the prospective QIB purchasers. Because of the additional increment of time (up to two weeks) necessary to complete a Rule 144A for life offering, there is an increased risk that interest rates may increase. Because of this, the borrower may determine at the conclusion of the road show that the interest rate or tenor for the notes may not be favorable enough to complete the offering.

### ***Amortization***

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<sup>6</sup> Similar to what is required by Items 101 through 103 and Item 401 of Reg. S-K.

<sup>7</sup> Similar to what is required by Item 503(c) of Reg. S-K.

<sup>8</sup> Similar to what is required by Item 504 of Reg. S-K.

<sup>9</sup> Similar to what is required by Item 303 of Reg. S-K.

<sup>10</sup> Similar to what is required by Item 404 of Reg. S-K.

<sup>11</sup> Similar to what is required by Item 403 of Reg. S-K.

Traditional term loans generally require that repayment of the principal be amortized over the life of the term loan, although the amount of amortization may be as low as one percent of the principal per annum. Rule 144A for life loans require repayment of the total principal amount at maturity with no amortization.

### ***Periodic Reporting***

Traditional term loans usually require the borrower to provide to the lender annual audited financial statements and quarterly unaudited financial statements. The quarterly unaudited financial statements are not required to be reviewed by the borrower's auditor pursuant to Statement on Auditing Standard 100 ("SAS 100"), as occurs for publicly reporting entities.

The volume and timing of reporting to be provided to the trustee and holders of Rule 144A for life notes varies from offering to offering. The least burdensome reporting covenants require the same financial statements that would be provided to a traditional term loan lender plus quarterly and annual MD&A. Some reporting covenants require the quarterly financial statements to be reviewed pursuant to SAS 100 but others do not. If the reporting covenant does not have this requirement, the borrower will nevertheless need to have its quarterly financial statements reviewed under SAS 100 for purposes of including them in any offering memorandum for a subsequent offering of additional notes so that the auditor may provide the comfort letter desired by the initial purchasers.

Other more burdensome reporting covenants also require the periodic reporting of many of the events contemplated by the SEC's current report on Form 8-K.<sup>12</sup> In addition, some reporting covenants require annual reports setting forth updates to

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<sup>12</sup> Usually Items 1.01 (Entry into a Material Definitive Agreement), 1.02 (Termination of a Material Definitive Agreement), 1.03 (Bankruptcy or Receivership), 2.01 (Completion of Acquisition or Disposition of Assets), 2.02 (Results of Operations and Financial Condition), 2.03 (Creation of a Direct Financial Obligation or an Obligation under an Off-Balance Sheet Arrangement of a Registrant), 2.04 (Triggering Events That Accelerate or Increase a Direct Financial Obligation or an Obligation under an Off-Balance Sheet Arrangement), 2.05 (Costs Associated with Exit or Disposal Activities), 2.06 (Material Impairments), 4.01 (Changes in Registrant's Certifying Accountant), 4.02 (Non-Reliance on Previously Issued Financial Statements or a Related Audit Report or Completed Interim Review), 5.01 (Changes in Control of Registrant), 5.02 (Departure of Directors or Certain Officers; Election of Directors; Appointment of Certain Officers; Compensatory Arrangements of Certain Officers) excluding the portions relating to compensation, 5.03 (Amendments to Articles of Incorporation or Bylaws; Change in Fiscal Year), 5.05 (Amendments to the Registrant's Code of Ethics, or Waiver of a Provision of the Code of Ethics), 7.01 (Regulation FD Disclosure), 8.01 (Other Events) and 9.01 (Financial Statements and Exhibits) excluding the portions relating to exhibits.

the business description, risk factors and related party transactions information included in the initial offering memorandum.

None of the reporting covenants in connection with Rule 144A for life notes require the privately owned entities (i) to comply with Section 302 (officer certifications) or Section 404 (reports concerning the scope and adequacy of the internal control structure and procedures for financial reporting) of the Sarbanes-Oxley Act of 2002 or related Items 307 and 308 of Reg. S-K promulgated by the SEC or Item 601 of Reg. S-K (with respect to exhibits), or (ii) to set forth in reports the separate financial footnote for guarantors and non-guarantor subsidiaries contemplated by Rule 3-10 or Rule 3-16 of Regulation S-X promulgated by the SEC (except summary financial information with respect to non-guarantor subsidiaries to the extent included in the initial offering memorandum).

### ***Tenor***

Generally, Rule 144A for life notes have a tenor of seven to 10 years. Traditional term loans generally have a maturity date no later than the fifth anniversary of the initial funding date.

### ***Considerations***

Many privately owned entities find that having unsecured and longer term Rule 144A for life notes, with no amortization or annual or interim financial maintenance covenants, to be an attractive balance sheet fit. The attendant increased reporting to note holders, while not initially routine, imposes beneficial discipline on the privately owned entity that will yield dividends in future financings or other extraordinary transactions. The slightly longer execution process and need to obtain debt ratings seem to be small annoyances when compared to these benefits.