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When An Offering Funds a Debt Repayment: Practical and Legal Considerations

Utilities often have very large amounts of outstanding debt. And many utilities frequently access the capital markets to refinance such debt. We thought it might be helpful to review some of the legal and practical considerations involved when the proceeds of an offering fund the redemption or repayment of the issuer's outstanding debt.

Regulation FD and Fifth Third

One question the lawyers are often asked on a go/no go call for a deal is "Are the banks good to announce or do we need to wait [for the preliminary prospectus to show up on the SEC's EDGAR website]." Although there are a number of reasons for this question, a primary concern is Regulation FD. Regulation FD provides that when an issuer discloses material nonpublic information to certain individuals or entities—generally, securities market professionals, such as stock analysts, or holders of the issuer's securities who may well trade on the basis of the information—the issuer must also make immediate public disclosure of that information. The goal is "full and fair disclosure".

So, back to the "go/no go" call. While there are any number of material nonpublic pieces of information that may happen to be included in the preliminary prospectus to be filed with the SEC, a particularly common item is the announcement that the issuer intends to use the proceeds in order to redeem certain outstanding securities. While there is an exception in Regulation FD for communications in connection with an offering of securities registered under the Securities Act of 1933 (1933 Act), most issuers are well advised to consider the need for public disclosure of a redemption despite the exception provided in Regulation FD.[1] This is especially true in cases where the market is not expecting the redemption (unlike, for example, the case of a repayment at maturity).

[1] There is no such exemption from Regulation FD in Rule 144A or Reg. S transactions.

In a seminal SEC proceeding on Regulation FD from November 2011, the SEC instituted a cease-and-desist order against Fifth Third Bancorp in connection with Fifth Third's redemption of trust preferred securities (TruPS) in May 2011. The SEC charged that, by publishing the redemption notice solely through DTC, Fifth Third "selectively disclosed," in violation of Regulation FD, that it would redeem a class of its TruPS for about $25 per share. The TruPS were trading at about $26.50 per share at the time. The SEC stated Fifth Third did not issue a Form 8-K or other public notice of the redemption (other than through DTC) until it became aware of unusual trading activity in the TruPS. Specifically, investors who appeared to have learned of the redemption had been selling the securities (above par) to buyers who appeared to be unaware of the upcoming redemption (to be made at par). Fifth Third compensated harmed investors and agreed to adoption and implementation of various additional policies and procedures. Further, Fifth Third settled the SEC's enforcement action without admitting or denying the allegations.

So, the lesson is relatively clear. Where the redemption has not been announced publicly (and, based on the Fifth Third proceedings, the SEC did not deem the notice of redemption sent to DTC to be "public"), an issuer subject to Regulation FD must ensure that the announcement of the redemption complies with Regulation FD.

What to Disclose Regarding Debt to be Redeemed

Regulation S-K details much of what must be included in the prospectus related to an offering. Specifically, Regulation S-K Item 504 "Use of Proceeds" requires the issuer to state the principal purposes for which the net proceeds to the registrant from the securities to be offered are intended to be used and the approximate amount intended to be used for each such purpose.

Instruction 4 of S-K Item 504 clarifies that, "If any material part of the proceeds is to be used to discharge indebtedness, set forth the interest rate and maturity of such indebtedness. If the indebtedness to be discharged was incurred within one year, describe the use of the proceeds of such indebtedness other than short-term borrowings used for working capital."

Listed Securities and the Exchanges

Issuers also need to be mindful of the requirements of any relevant securities exchange. Both the NYSE (See Section 2. "Disclosure and Reporting Material Information" in the NYSE's Listed Company Manual.) and the NASDAQ Exchange (See, e.g., IM-5250-1 "Disclosure of Material Information" of the NASDAQ Rulebook) have disclosure requirements with respect to material information.

More specifically, Section 311.01 of the NYSE Listed Company Manual, "Publicity and Notice to the Exchange of Redemption" requires that prompt publicity be given and prompt notice be sent to the NYSE of corporate action (or any action of which the company has knowledge) which will result in, or which looks toward, either the partial or full call for redemption of a ***listed*** security.

A Further Twist: A Conditional Notice of Redemption

Some issuers may want to explore the possibility of a "conditional" notice of redemption. A conditional notice of redemption allows an issuer to revoke its previously announced notice of redemption if certain conditions are not met. For instance, a common conditional notice provision will allow an issuer to opt out of the previously-announced redemption if the issuer is unable to deliver the redemption price to the trustee on the redemption date.

Issuers will initially need to determine whether the indenture (or other base document) which established the debt permits "conditional" notices of redemption. If permitted by the indenture, the issuer will next need to determine the timing/sequencing of the issuance of the conditional notice of redemption. And the timing/sequencing of the notice will be informed by the other discussions above, including the considerations with respect to Regulation FD.

The issuer will also need to determine the exact scope of the condition built into the notice of redemption (including whether there are any limitations on the nature of the condition that is permitted by the indenture). For example, does the indenture permit any "conditional" notice of redemption. Or alternatively, are the "conditional" redemption notices allowed by the indenture more circumscribed (e.g., conditional upon the issuer having sufficient proceeds on hand at the time of the redemption, etc.).

In addition to the legal analysis, issuers are well advised to consider the market implications of issuing a conditional redemption notice. Markets abhor uncertainty. Certain investors may not look favorably upon these provisions due to the uncertainty injected into the redemption process. To the extent a redemption notice is ultimately revoked due to the conditionality provision, investor reaction may be more extreme.

Conflicts of Interest

Given that some portion of the proceeds of the offering is to be used to pay down outstanding debt, the working group will also have to pay particular attention to FINRA Rule 5121, "Public Offerings of Securities With Conflicts of Interest." While there are a number of scenarios which can give rise to a "conflict of interest" of a FINRA member under the FINRA rules, for purposes of this article, the applicable provision is Rule 5121(f)(5)(C):

> (C) at least five percent of the net offering proceeds, not including underwriting compensation, are intended to be:
>
> > (i) used to reduce or retire the balance of a loan or credit facility extended by the member, its affiliates and its associated persons, in the aggregate; or
> >
> > (ii) otherwise directed to the member, its affiliates and associated persons, in the aggregate.

Note that, when determining whether a "conflict of interest" exists, it's irrelevant whether the debt to be redeemed is being repaid at maturity or redeemed earlier than the debt's original maturity. The question, for Rule 5121 purposes, is whether the offering proceeds are being directed to a FINRA member (i.e. the underwriter of the offering) or its affiliates and associated persons. In the instance where the test is tripped and a "conflict of interest" is deemed to exist, the remedy, under most circumstances, is relatively mild. In addition to the disclosures described in the Rule with respect to the prospectus table of contents, summary section and plan of distribution, the Rule mandates that "No member that has a conflict of interest may sell to a discretionary account any security with respect to which the conflict exists, unless the member has received specific written approval of the transaction from the account holder and retains documentation of the approval in its records."

Many times the determination of whether a conflict exists under Rule 5121 is nuanced. One example is when the proceeds are to be used to pay down commercial paper holdings of the issuer. While the fact that an underwriter is also a "dealer" on the issuer's commercial paper program seems unimportant for Rule 5121 purposes, the underwriters will have to determine whether such underwriters (or affiliates), in fact, hold any of the issuer's commercial paper which will be paid down with the proceeds of the offering.

Finally, if a "conflict of interest" is deemed to exist, then unless one of a number of exclusions exist ((1) the member(s) primarily responsible for managing the public offering does not have a conflict of interest, is not an affiliate of any member that does have a conflict of interest, and meets certain additional requirements; (2) the securities offered have a bona fide public market; or (3) the securities offered are investment grade rated or are securities in the same series that have equal rights and obligations as investment grade rated securities) then a "qualified independent underwriter" must participate in the preparation of the registration statement.

Conclusion

Utilities have always been very capital intensive enterprises. And when the purpose of a capital markets transaction is to "manage the balance the sheet", the timing of any associated redemption or repayment should be well choreographed so as to avoid any unnecessary heartburn (or worse) for the working group.

Open Market and Negotiated Purchases of Debt Securities; Avoiding a Creeping Tender Offer

An issuer wishing to repurchase some portion of its debt will need to engage in some preliminary diligence to make sure the purchase is both (1) authorized and (2) permitted.[1] Whether board approval of a debt repurchase is required depends on a number of factors. The issuer and counsel will need to review management's existing authority to enter into repurchases as well as the overall size of the potential upcoming repurchase. The issuer will also need to review the indenture or, alternatively, the note purchase agreement (if such debt has been privately placed) governing the series of debt as well as any outstanding bank debt or credit agreement in order to determine whether limitations exist on the issuer's ability to repurchase the debt.

For an issuer wishing to repurchase some of its debt, the two principal manners in which a company can repurchase debt are (1) open market and privately negotiated repurchases and (2) an issuer tender offer. A tender offer is an offer to purchase a security directly from its holders, conditioned upon the occurrence, or non-occurrence, of certain events. And tender offers are regulated by the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934, as amended (1934 Act).

For nonconvertible debt, tender offers are regulated by Regulation 14E under the 1934 Act, and the rules adopted pursuant to that regulation. Those rules prohibit fraudulent and manipulative activity, require that the offer be kept open for at least 20 business days and an additional ten business days from notice of certain changes in the terms of the offer. On January 23, 2015, the SEC staff issued a no-action letter which permits abbreviated tender offers of five business days.[2] But the requirements under the no-action letter are lengthy and, as a result, many tender offers for nonconvertible debt are still governed by the 20 business day timeline.

Because the 1934 Act and the SEC have not provided a definition of tender offer, courts have stepped in to provide guidance on what constitutes a tender offer, with the Southern District of New York in 1979 providing the most famous test. In *Wellman v. Dickinson*, the court laid out what has become known as the *Wellman* test. The *Wellman* test

established eight factors to determine the existence of a tender offer. If, as a result of such determination, the offer is deemed a tender offer, it would therefore be subject to the 1934 Act tender offer rules. Those eight factors are:

i. an active and widespread solicitation of public security holders for the securities of an issuer;

ii. a solicitation made for a substantial percentage of the issuer's securities;

iii. an offer to purchase at a premium over the prevailing market prices;

iv. the terms of the offer being firm and not negotiable;

v. the offer being contingent on the tender of a fixed number of securities;

vi. the offer being open only for a limited period of time;

vii. the offeree being subject to pressure to sell the relevant securities; and

viii. rapid accumulation of a large amount of target securities, preceded or accompanied by a public announcement concerning the purchase of such securities.

[1] Note that this article does not treat the disclosure considerations with respect to debt repurchases (e.g., Rule 10b-5, Regulation FD and the European Union's Market Abuse Regulation). Nor does this article cover the tax consequences with respect to repurchases of an issuer's debt.

[2] https://www.sec.gov/divisions/corpfin/cf-noaction/2015/abbreviated-offers-debt-securities012315-sec14.pdf

Under the *Wellman* test, the factors are applied as broad guidelines, "weighted and not simply counted numerically."[3] Accordingly, the *Wellman* test is not a bright line test whereby all eight factors must be met. An application of the *Wellman* test is a nuanced and subjective examination which does not always lead to a clear conclusion.

The Ninth Circuit applied the *Wellman* test in *S.E.C. v. Carter Hawley Sale Stores, Inc.*, finding that the repurchase of the company's stock was not a tender offer because a number (but not all) of the *Wellman* factors were not present. Specifically, there was no widespread solicitation, shares were purchased at market prices without any premium, the timing of the purchases were attributable to market forces and the company did not pressure shareholders to sell shares.

In *Hanson Trust PLC v. SCM Corp.*, the court addressed the totality of the circumstances and found that a combination of privately negotiated and open market repurchases of equity securities totaling less than 25% of the total outstanding securities did not constitute a tender offer. The *Hanson* court also noted that, unless the tender offer rules are followed, there will be substantial risk that offerees will lack information needed to make an educated investment decision.[4]

It is important to note that an accumulation through open market or negotiated purchases can be deemed a de facto tender offer. Such an accumulation is referred to as a "creeping" tender offer and is therefore subject to the 1934 Act tender offer rules.

To avoid being subject to tender offer rules, issuers are advised to ensure that:

i. negotiation and pricing of each purchase should remain independent of others;

ii. direct offers should be made to a limited number of potential sellers;

iii. open market repurchases should be made over an extended period without a firm deadline for completion;

iv. potential sellers should be sophisticated institutional investors;

v. issuer negotiations with potential sellers should not impose the same terms on all sellers or impose a fixed deadline for negotiations;

vi. negotiations with different sellers should be at different prices and on different terms, preferably negotiated individually with each seller; and

vii. negotiations with potential sellers should not be conditioned on the repurchase of a specific amount of the debt.

Furthermore, certain practitioners have taken the position that, in most circumstances, negotiations with ten or fewer purchasers leading to the purchase of 80% or less of an outstanding series of debt would likely not trip the "creeping" tender offer guidance.

With proper planning and consultation with counsel, an issuer can get comfortable that the upcoming debt repurchases are (1) authorized, (2) permitted, and (3) comply with the relevant 1934 Act rules with respect to issuer tender offers for nonconvertible debt.

[3] Thomas Lee Hazen, Treatise on the Law of Securities Regulation, §11.4, 5th Ed. 2005.

[4] The court, in dicta, noted that "in the case of privately negotiated transactions or solicitations for private purchases of stock many of the conditions leading to the enactment of § 14(d) for the most part do not exist." *Hanson Trust*, 774 F.2d at 56.

Utility Securitizations: Recent Developments

In 2021 and continuing into 2022, there has been a dramatic uptick in utility securitizations to recover a wider variety of costs from their customers. With each new securitization, utilities are expanding what is possible and how to efficiently and effectively recover these costs. There have been several novel securitizations done recently and this article will focus on: (1) DTE Electric Company (DTE) closing the first securitization that securitized two substantially different securitization costs with different customer classes, all with one series of bonds; (2) both Southern California Edison Company (SCE) and Pacific Gas and Electric Company (PG&E) completing multiple securitization offerings, with each using the same respective SPE and (3) the Electric Reliability Council of Texas, Inc. (ERCOT) completing a securitization offering as an independent system operator where the customers were not the obligors. These securitizations provide innovative ways of tailoring securitization offerings to suit a utility's unique needs. These new structures also demonstrate that the field of utility securitization has room to expand to meet the varying needs of utilities.

DTE Electric Co.'s Multiple Securitizations

Earlier this year, DTE completed the first bond issuance that securitized two different types of securitization costs in one offering. DTE desired to securitize the decommissioning of its River Rouge Generation Plant as well as costs associated with its tree trim surge program. These two securitization costs had a separate set of customers and different time periods for their recovery. As a result, the financing order for the deal set forth different periods for how long securitization charges could be imposed for securitization bonds issued to recover each cost. However, DTE was still able to issue one set of bonds.

The registration statement was carefully drafted to make clear that the "tree trim" securitization charges and the "River Rouge" securitization charges were separate. It indicated that there would be no cross-collateralization so the charges would only cover the respective bonds associated with tree trim or River Rouge costs. The first tranche was covered by both charges and specifically indicated the amounts from each charge on each payment date, which was broken down in the Expected Principal Contribution Obligation Balance Schedule. The maturity of the first tranche was also timed to coincide with the termination of the tree trim securitization charge, after which debt service for the second tranche was payable entirely from the River Rouge securitization charge. Another key feature was the Instruction for Distribution of Funds (Instruction) in the Account in the Servicing Agreement. The Instruction provides how the payments would be divided between the securitization charges and the specific account that the money will flow through. The use of the structure allowed for recovery of a couple smaller amounts through a larger bond offering that was deemed to be more desirable to investors.

California Utilities Issue $9.2 Billion of Bonds in 17 Months

Since February 2021, over $9 billion of utility securitization bonds were issued in California alone. PG&E issued approximately $8.3 billion in three deals while SCE issued approximately $800 million across two deals. The bonds were issued to recover costs related to recent wildfires and to harden utility assets against future wildfires.

PG&E issued $7.5 billion of Recovery Bonds pursuant to a financing order issued in connection with its emergence from bankruptcy. The transaction was required by California law to be "rate neutral". So, in parallel with the bond issuances, a separate trust was established and funded by PG&E to provide a customer credit, designed to equal the securitization charge imposed on customers.

PG&E's other transaction, completed in November 2021, was a more traditional offering in which PG&E issued Recovery Bonds to recover costs incurred protecting and hardening PG&E's infrastructure against future wildfires. The November offering was the first of three potential transactions over the life of the program.

SCE has issued two series of bonds to recover wildfire hardening costs. Although issued pursuant to separate financing orders from the CPUC, the deals were similar and ultimately the programmatic nature of the two deals allowed for significant savings in issuance costs for the second deal.

ERCOT's Non-Customer Securitization

In February 2021, Winter Storm Uri resulted in power outages and dramatic increases in the prices in the wholesale electricity market. A number of market participants defaulted on their payment obligations under ERCOT Protocols, resulting in ERCOT owing money to certain wholesale market participants. To address this problem, the Texas Legislature passed Subchapter N to Chapter 39 of the Texas Public Utility Regulatory Act. In addition, the Texas Legislature allowed market participants to opt out of the securitization structure to allow such participants to pay ERCOT in another manner.

In Texas, there are multiple entities between ERCOT who buys the electricity and the ultimate end-use customers. These entities include Qualified Scheduling Entities (QSEs) who deal directly with ERCOT and load servicing entities (LSEs)(which includes municipally owned utilities, electric cooperatives and retail electric providers). For the ERCOT securitization, the charge is assessed to the QSEs which, in turn, collect it from the obligated LSEs. The LSEs passed through the cost to their end-use customers. In addition, the QSEs are cross-collateralized among all QSEs responsible for paying the charge to ensure stability in the markets and ensure the bonds are repaid and were able to receive a AAA rating. This structure allowed for an independent system operator like ERCOT to use securitization to recoup costs over an extended period of time at a lower cost to the Texas electric customers.

Each of these innovative transactions should serve as helpful precedent for future utility securitizations.

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