Unsecured Debenture Financing

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I. *Introductory*

At the outset, it should be said that an unsecured debenture is basically just an ordinary debt—nothing more, nothing less. Its high-sounding name "debenture" may incline one to think that it has some sort of superior right to repayment, but it ranks for repayment on the same level as all ordinary debts, such as trade accounts payable and promissory notes. To be more specific, an unsecured debenture ranks junior to (a) all secured debts (in so far as the assets securing such debts are concerned) and (b) certain unsecured debts (see section 95 of the Bankruptcy Act[1]), the most important of which are claims of the Crown, including all claims for income, excess profits and other taxes. It ranks equally and rateably with all other debts.

There are many types of unsecured debentures, depending upon what relative position they are intended to have in the capital structure of the particular borrower. Some may be intended as nothing more than the most junior type of long-term debt; this type will not contain any restriction on the creation of secured long-term debt, although it probably will contain some restriction on the creation of unsecured long-term debt or on long-term debt generally. Examples of this type are to be found in the debentures of most of the finance or acceptance companies and also in the convertible debenture issues of many so-called growth companies which, because of the attractiveness or supposed attractiveness of the conversion privilege, have been so popular of recent years in spite of their junior nature and comparatively low interest rate. Other types may be intended as the top senior capital obligation of the borrower; such types will prohibit secured long-term debt, or confine it within very narrow limits, and will restrict unsecured

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[1] Statutes of Canada, 1949 (2nd session), c. 7.

long-term debt. Examples of this type are to be found in the debenture issues of many leading industrial companies. Between the most junior type, on the one hand, and the top senior type, on the other, lie the intermediate varieties.

The terms relating to public debenture issues are set forth in an agreement between the borrower, on the one hand, and a trustee, commonly a trust company, on the other. This agreement is usually referred to as the "trust indenture". The function of the trustee under it is to represent the floating mass of debenture holders. The restrictions to be imposed on the borrower, generally referred to as negative covenants, will be contained in it. Debenture issues may be either of the closed or open-end variety. A closed issue is one which, in addition to whatever restrictions may be imposed on the creation of secured funded debt[2] and otherwise, prohibits the issue of any additional debentures or other unsecured funded debt. An open-end issue is one which does not contain such a prohibition but which permits additional debentures or other unsecured funded debt to be issued, subject in most cases to a fixed over-all dollar limit on the total principal amount thereof to be outstanding from time to time or to compliance with certain tests as to assets and earnings, or to both. Few unsecured debenture issues are of the closed variety since their function is, generally speaking, to provide a medium through which the long-term debt financing requirements of the business may be met subject to reasonable protection for the prior lenders.

Of late years, when income taxes have been high, many companies have found it more advantageous to finance by long-term debt than by preferred shares, because they have considered that the disadvantage involved in the legal obligation to repay the debt with interest (which, of course, is not the case with the preferred share) is more than compensated for by the fact that interest on the debt is deductible[3] by the company for income tax purposes, whereas the preferred dividend is not. With high income taxes a virtual certainty for the foreseeable future, this trend will probably continue, notwithstanding that the dividend tax credit now allowed[4] may, other factors being equal, bring about somewhat higher interest rates.

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[2] "Funded debt" or "funded obligations" as used here means, in contrast to current debt or current borrowings, any indebtedness not payable on demand and maturing more than twelve months after its creation.

[3] Except in the case of an income debenture, being one on which interest is payable only out of profits.

[4] The Income Tax Act now provides, generally speaking, that a tax-

What follows will deal largely with the restrictions considered appropriate for the more senior types of unsecured debentures. Bearing in mind the essential nature of an unsecured debenture, it will be obvious that, for the legitimate protection of the lender in those types of issue designed to be of the senior variety, fairly tight restrictions ought to be imposed on the borrower. Great care must be exercised in settling these restrictions for, if they are too loose, they will not afford proper protection for the lender and, if they are too tight, they will unduly hamper the borrower. Just what these restrictions should be will depend, to a considerable extent, on the historical record and particular circumstances of the borrower (some will need more "confinement" than others; if they need too much, a first mortgage bond issue might be better from the lender's standpoint). For this reason it is not possible to lay down any set of restrictions which will suit every case.

Generally speaking, the senior type of unsecured debenture financing is designed to give the lender a degree of protection approximating that afforded by first mortgage bonds while at the same time relieving the borrower of all the technical red-tape involved, in the first instance, in subjecting the assets to a mortgage and, later on, in obtaining a release of mortgaged assets which the borrower may from time to time desire to sell. Although even the most senior type of unsecured debentures cannot, from their nature, afford the same degree of protection as first mortgage bonds, there is not much practical difference in the case of well-established companies with a long and favourable earnings record and with management of a high order.

II. *Secured Debt*

Probably the most important restriction to be settled relates to the creation of secured debt for, as already mentioned, debt of this sort ranks ahead of the unsecured debenture. The common, and in most cases the best, restriction of this type is to prohibit the creation of secured debt (unless the unsecured debentures are simultaneously secured equally and rateably with it) except for secured current borrowings (the security for which is limited to current assets) made in the ordinary course of business; this exception as to current borrowings is essential if the borrower is to be permitted to give customary banking security. In some cases, however, it may be considered advisable to permit the creation

payer may deduct from his income tax an amount equal to 20% of dividends (but not interest) receivable from taxable Canadian companies.

of secured funded debt but, if it is allowed, the permission should be confined to some reasonable fixed dollar limit and, unless the limit is relatively low, should also be made subject to the fulfilment of certain conditions, for example, that aggregate secured funded debt will not exceed 66⅔% of the cost or fair value, whichever is less, of fixed assets, that the consolidated[5] net tangible assets before deducting total funded debt (both secured and unsecured) will bear some reasonable ratio (say 2½ to 1) to total funded debt and that the consolidated net earnings before deducting interest on the total funded debt will bear some reasonable ratio (say 4 to 1) to the interest requirements on the total funded debt. If at the time of issue of the unsecured debentures the borrower has outstanding a first mortgage bond issue which permits the issue of additional bonds, it may be that the restrictions on issue of the additional bonds will furnish appropriate protection for the unsecured debentures; if such restrictions are to be relied upon, however, they should be incorporated in the debenture trust indenture for, if they are not, they will cease when the bonds are no longer outstanding, or perhaps even before that if they are waived or relaxed by the bondholders.

III. *Unsecured Debt*

The next most important restriction covers the creation of other unsecured debt, which will of course rank equally with the unsecured debentures. Obviously the creation of current unsecured debt incurred in the ordinary course of the borrower's operations, such as accounts payable, ought not to be restricted because to do so would be to interfere with the normal carrying-on of the borrower's operations, which after all is essential to the servicing and liquidation of the unsecured debentures. The usual practice here is to confine this restriction to the creation of unsecured funded debt, although in the United States the tendency is, while permitting ordinary trade accounts payable, to prohibit all borrowings, current or funded. In many cases it may be considered advisable to set a fixed dollar limit which the aggregate unsecured funded debt at any one time outstanding must not exceed; whether or not any such limit is fixed, some requirements ought to be laid

[5] Net tangible assets, as well as net current assets and net earnings, should all be determined, for purposes of the various restrictions, on a consolidated basis, so as to take the financial position and earnings of the borrower's subsidiaries into account. This should be done even when the borrower has no subsidiaries at the outset, because it may form or acquire some as time goes on.

down as conditions precedent to the creation of unsecured funded debt. These requirements are usually (a) that consolidated net tangible assets[6] and consolidated net current assets[7] (in each case including the net proceeds of issue of the then proposed funded debt except to the extent, in the case of net tangibles, that such proceeds are then proposed to be used for acquisition of intangible assets and, in the case of net currents, that such proceeds are then proposed to be used for acquisition of non-current assets) must each be a certain number of times (say 2½ for net tangibles and 1½ for net currents) the aggregate consolidated funded debt (both secured and unsecured) to be outstanding after issue of the then proposed funded debt; and (b) that average annual consolidated net earnings[8] over some specified period preceding issue of the then proposed funded debt (usually the two immediately preceding fiscal years) must be a certain number of times (say 4) the annual interest requirements on aggregate consolidated funded debt (both secured and unsecured) to be outstanding after issue of the then proposed funded debt.

It is advisable to permit unsecured funded debt to be issued (even though the above-mentioned restrictions as to its issue are not met) in lieu of secured funded debt to the extent to which secured funded debt would then be issuable in accordance with the pertinent conditions, but if this is done the draftsman must be careful to work out an appropriate "deduction" from the limits for secured funded debt.

IV. *Subsidiaries*

So far, everything has been quite simple and straightforward. Now we move into that highly confusing realm of "subsidiaries".[9] Re-

[6] Net tangible assets are those of a tangible nature (as distinct from goodwill, patents, copyrights, etc.) valued in accordance with sound accounting practice, less all liabilities other than funded debt.

[7] Net current assets are those of a current nature (cash, trade accounts receivable, inventories, etc.) valued in accordance with sound accounting practice, less all current liabilities, being all liabilities other than funded debt.

[8] Net earnings are gross earnings less all operating expenses and depreciation, but without deduction for interest on funded debt or taxes on income. When computing consolidated net earnings, income taxes of subsidiaries should, in principle, be deducted, but the usual practice is not to deduct them and instead to take their non-deduction into account in fixing the required ratio of consolidated net earnings to annual interest requirements.

[9] "Subsidiary" as used here means any company more than 50% of the voting stock of which is owned by the parent and includes a company standing in like relation to such a subsidiary. "Subsidiary" is sometimes defined as a company all the stock of which is owned by the parent; in

strictions on the borrower alone are of little use unless they extend to existing and future subsidiaries, for otherwise the borrower could completely escape them by the simple expedient of putting money into the equity of the subsidiaries and then permitting the subsidiaries to finance as they see fit. It must be remembered that all obligations of subsidiaries, whether secured or unsecured, are superior, in so far as their assets are concerned, to the unsecured debentures of the parent.

In the first place, all subsidiaries should be prohibited from making current borrowings, whether secured or unsecured, except in the ordinary course of business. Next, all subsidiaries should be prohibited from issuing any funded debt, whether secured or unsecured, except to the borrower or its wholly-owned subsidiaries; and the borrower and its wholly-owned subsidiaries should be prohibited from disposing of funded debt so issued to them except (a) by way of security for funded debt of the borrower, which the borrower is permitted to issue within the restrictions imposed, or (b) to wholly-owned subsidiaries or to the borrower, unless all funded debt of, and all shares in the subsidiary in question held by the borrower or its subsidiaries, or both, are being simultaneously disposed of for their fair value in cash. This prohibition is considered to be sounder than the quite common restriction which, while permitting subsidiaries to issue funded debt, provides that neither the borrower nor any subsidiary will issue funded debt unless the consolidated financial position and past earnings of the borrower and all its subsidiaries meet the required tests, the objection to this restriction being that it fails to put all funded debt on the same level. I also think, although there is much difference of opinion on this point, that the same prohibition should apply to the issue by any subsidiary of preferred shares (that is, any shares ranking as to capital or dividends in priority to the shares in the subsidiary held, directly or indirectly, by the parent) since, although a preferred share of a subsidiary is not an enforceable claim, it is in a real sense superior, in so far as the assets of the subsidiary go, to all debt of the parent.

Because the restrictions mentioned in this part do not in any way apply to non-subsidiary companies it may be advisable, par-

general, such a definition is considered undesirable because companies controlled by the parent and in which it has a very substantial, but not the whole, investment will be completely free of the restrictions. If, however, an appropriate restriction is placed on investment by the borrower and its subsidiaries in non-subsidiary companies (which, as mentioned later, may be desirable, particularly in certain situations), this definition may be perfectly satisfactory.

ticularly where the borrower or those who control the borrower are, or are likely to be, interested in non-subsidiary companies, to restrict the borrower and its subsidiaries from increasing their aggregate present investment in all present and future non-subsidiary companies. This restriction may take the form of some fixed dollar amount (designed to provide an appropriate amount for investment of surplus funds and otherwise to afford some reasonable leeway) and in addition to, or in lieu of, the fixed dollar amount may provide that, after the making of any such investment and without counting it or any other such investment as an asset, the consolidated net tangible assets and consolidated net current assets of the borrower and its subsidiaries must each be at least a certain number of times (say 2 for net tangibles and 1 for net currents) the consolidated funded debt of the borrower and its subsidiaries then outstanding. In certain cases it may also be prudent to extend this restriction to embrace, not only non-subsidiary companies, but also subsidiary companies or ventures deemed to be risky, for example, foreign subsidiaries in countries with unsettled political conditions or foreign exchange difficulties.

In principle, an investment by the borrower in common shares of an existing company (with funded debt or preferred shares outstanding), by which the company becomes a subsidiary, is just as objectionable as issuance by a subsidiary of funded debt or preferred shares. For this reason it is advisable to prohibit the borrower and its subsidiaries from making any investment in any company by which the company would become a subsidiary if it has outstanding any debt or shares it would not have been permitted to issue if it had been a subsidiary. If purchase money mortgages are permitted, such debt or shares may properly be treated, for purposes of this restriction, as purchase money mortgages.

It is also advisable to prohibit the issue of shares by any subsidiary whereby the borrower's interest therein will be diluted and to prohibit the borrower and its subsidiaries from disposing of, except to a wholly-owned subsidiary or to the borrower, any shares in a subsidiary (at least if the dilution or disposal is such that the subsidiary will cease to be a subsidiary), unless all shares in and all funded debt of the subsidiary in question then held by the borrower and its subsidiaries are being simultaneously disposed of.

V. *Exemptions from Restrictions*

For the legitimate protection of the borrower, the restrictions

mentioned in parts II, III and IV should be expressly stated not to apply to:

(1) funded obligations issued par for par to refund funded obligations outstanding at the time of the refunding, provided that the refunding obligation is not better secured than the refunded obligation;

(2) inconsequential and routine matters, such as liens incurred by operation of law and good faith deposits.

Frequently, in fact almost invariably, the borrower puts up a strong fight for exemption of purchase money mortgages from the restrictions mentioned. It is submitted that, in principle, such an exemption is completely unwarranted, but from a practical point of view the fight is probably so persistent that some compromise will be necessary; if so, I suggest that it is advisable for some overall dollar ceiling to be imposed on purchase money mortgages in addition to the customary restriction that the amount of any such mortgage must not exceed 66⅔% of the cost or fair value, whichever is less, of the property being purchased.

VI. *Sinking Fund*

Debenture issues, except perhaps those of the convertible variety, should contain a covenant that the borrower will pay to the trustee annually some specified sum (or a sum sufficient to retire a specified principal amount of debentures) as a sinking fund to be applied by the trustee to the purchase, or redemption by call, of debentures. Such a covenant, in addition to providing for gradual retirement of the debentures, has the further advantage of helping to maintain a market for the debentures.

If, as is commonly the case, the premium at which the debentures are callable out of sinking fund moneys is less than the premium at which they are generally callable, the borrower should not be permitted to pay money into the sinking fund in excess of the mandatory requirement, for otherwise the borrower could effect early retirement of the issue at the lower rate of premium to the detriment of the debenture holders.[10]

[10] A sinking fund, or any other provision by which the debentures are redeemable prior to maturity without the consent of the holders, dilutes the value of the conversion privilege because the privilege attaching to the debentures called for redemption will cease to exist on the date fixed for redemption. It occurs to me to mention, in connection with this matter of dilution, that all convertible debenture issues should contain provisions designed to protect the conversion privilege against dilution by stipulating that the conversion price for common shares (*i.e.*, the price per common share at which the principal amount of debentures are convertible) will

VII. *General*

It is the common, and a sound, practice in debenture issues to provide that:

(1) subsequent issues of debentures or other unsecured funded debt will not be required to be retired (by maturities or sinking fund) at a proportionately faster rate than that provided for retirement of the debentures of the first issue; and

(2) dividends on, or redemptions or other retirements of, capital stock of the borrower will be confined within reasonable limits. This may be done by providing that no such dividends or retirements are to take place if, after giving effect to them, the consolidated net current assets would be less than some appropriate fixed dollar amount (or less than, say, 1½ times the consolidated funded debt then outstanding), or by providing that the aggregate amount afterwards paid out by the borrower by way of such dividends or net retirements (net retirements being the excess of retirements over net proceeds of new issues of shares) will not exceed the aggregate consolidated net profits[11] afterwards earned, or by both.

To complete the picture, although one can never be sure that all holes in the dyke are plugged (in fact one can be pretty sure that they are not), it may be thought prudent, particularly in these days when the practice of selling fixed assets and leasing them back is not uncommon, with the result that fixed rental charges superior to the claim of the unsecured debentures arise, to put some appropriate dollar limit on the aggregate yearly rentals under long-term leases (say, five years and upwards) that may be paid by the borrower and its subsidiaries.

Author to Editor

Probably in estimating the real value of any tinsel which I may put upon my articles, you and I should not materially differ. But it is not by his own taste, but by the taste of the fish, that the angler is determined in his choice of bait. (Letter of T. B. Macaulay to Macvey Napier, Editor of the Edinburgh Review, January 25th, 1830)

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be appropriately adjusted in the event of future issues of common shares at a price below the conversion price.

[11] "Net profits" means net earnings after deducting interest on funded debt and taxes on income.