**A PRACTICAL USE OF the TRIGGER EMBEDDED INTO A COCO BONDS: Part II**

The concept of the contingent convertible bond embedding a trigger was initially devised for restructuring purposes. However, regarding non-financial corporations, the initial intention seemed to deviate from more classical financial purposes. According to the Liberadzki brothers, the first prototype of CoCos issued by corporations was devised during the early 1990s by a study group at Harvard. The rationale behind it was to provide an instrument for restructuring distressed companies which had issued large quantities of so-called junk bonds[[1]](#endnote-1). This group of Harvard scholars highlighted that an automatic trigger converting junior bonds into a predetermined number of shares could restructure a company without using conventional restructuring tools, which are very expensive[[2]](#endnote-2). The research showed that the mechanism embedded into a CoCo works like a tool for distressed companies. They posed the example of an issuance of 200 million dollars’ worth of CoCos. When the trigger is hit, the bonds will be compulsorily converted into a predetermined number of shares according to a premium conversion. In accounting terms the amount will be counted as 200 million dollars’ worth of debt. Once the trigger is hit the amount will decrease to zero on the right hand side of the balance sheet and an equal amount going from 0 to 200 million dollars will be counted on the left side of the balance sheet as equity[[3]](#endnote-3).

It is important to note in the above example that the hypothetical issuance of CoCos is regarded as a security embedding an automatic trigger converting bonds into shares upon the occurrence of an event. With this automatic conversion it is possible to restructure a distressed company. Nevertheless, the problem is upstream; it would be interesting to meet an investor willing to buy a bond with such characteristics. Indeed, in the case of conversion, investors will become shareholders of a weak company with a low share price caused by the dilution effect upon conversion. In a liquidation scenario, those holding new shares upon conversion will be placed at the bottom of the list of priorities, a place that most of the time is out of money, meaning that they will lose their initial investment. Last but not least, a manager might have an interest in forcing conversion by activating the trigger, so damaging the interests of bondholders.

From the perspective of the issuer, in the case of conversion, the company’s debt will be restructured, and this will intervene in a going concern without the expense of insolvency proceedings. The existing shareholders will see the dilution of the equity. However, they will maintain unaltered their shareholdings owing to the pre-emption right provisions granted to them as envisaged by the Companies Act 2006[[4]](#endnote-4). Thus, they will not be affected at all.

It is not by chance that the model devised by the Harvard scholars was developed for the banking system and not for corporations. Henkel and Wulf state that the main role for CoCos embedding an automatic trigger is to restructure the debt of a bank with financial difficulties; a restructuring which intervenes in a going concern[[5]](#endnote-5). According to Koffer, this kind of CoCo bond can be considered the most suitable security for compliance with the rules envisaged first by Basel III and then by the European Union with the Capital Requirements Directive IV[[6]](#endnote-6). Keown et al. point out that with CoCos issued by non-financial companies, the trigger hit gives bondholders the option either to convert or to put back holdings to the issuer[[7]](#endnote-7). Marquardt and Wiedman highlight that such options, when conferred, can be considered as ‘sweeteners’ granted to the holder for making the security more appealing[[8]](#endnote-8).

CoCos issued by corporations might work as a preventive restructuring tool, but it is more theoretical than practical; a prudent investor would exercise the right to put back CoCos in exchange for money instead of exercising the right to convert. The rationale relies on the fact, as explained above, that he will not want to lose the initial investment. In this scenario, the debt of the issuer would remain the same instead of reducing because he would have to buy back outstanding debt from bondholders using money, so not ameliorating the financial conditions of the company, but perhaps making them worse.

By contrast, Finnerty et al. point out that in such a hypothetical situation the investor can be divided into two main groups, namely the non-institutional investor, like the one described above, and the institutional investor. The authors state that the latter group is formed by mutual funds, hedge funds and private equity funds that may be eager to manage this kind of contingent convertible bond. For example, by exercising the conversion right, sophisticated investors becoming new shareholders of the company could easily acquire and so manage the company[[9]](#endnote-9). It can be inferred that the trigger embedded into CoCos issued by corporations could work as a preventive restructuring tool. However, from the point of view of the issuer this could be very risky due to being taken over by institutional investors. Thus, CoCos issued by corporations could be a double-edged sword in a restructuring scenario.

CoCos Embedding the Trigger Event for Financing Merger & Acquisition Transactions

If, on the one hand, as highlighted above, using CoCos embedding a trigger event as a restructuring tool can be very risky for the issuer, on the other hand, they can be used as a system of financing in mergers & acquisitions. According to De Pamphilis, a lawyer can opt to use several forms of financing for completing either an acquisition or a merger, such as cash, shares, debt and hybrid securities[[10]](#endnote-10). Clearly, even though not specified by the author, CoCos are a hybrid security. Ismail and Krause point out that the positive completion of the operation depends on the choice among the different systems of financing. Thus, the authors state that a business lawyer will keep in mind several factors to determine the choice of one over the other form of payment. The most important factors are information asymmetry, taxation and managerial control[[11]](#endnote-11).

Regarding the problem of information asymmetry in merger & acquisition transactions, CoCos could ameliorate it. De Pamphilis points out that this problem arises due to the lack of information between the acquirer and the seller, even with proper due diligence. For example, assuming a case of acquisition, the acquirer could underestimate the price of the target or the seller could overprice it[[12]](#endnote-12). Finnerty et al. highlight that such mispricing derives from the fact that the seller may have private information but does not want to share it with the acquirer, and vice-versa. The authors state that information asymmetry can be avoided by using convertible bonds. This is because according to optimal conversion strategy, the target holder will be inclined to convert when the share value is high, whereas the acquiring-issuer will incline to exercise the call option when the redemption price is low. In case of conversion, the new shares are the missing price, namely the final consideration, whereas in the case of neither conversion nor redemption, bonds will constitute the final consideration[[13]](#endnote-13).

Despite the lack of literature on CoCos in merger & acquisition transactions, it can be inferred that they can achieve the same or even better results. As convertibles, they embed a conversion option and a call option, enabling them to operate in the same way. Moreover, by using the trigger they avoid the risk element deriving from the strategy of conversion which can be exercised at any time by the CoCo holders. Indeed, the option either to convert or to redeem can be exercised only once the trigger is hit. For example, Marquardt and Wiedman highlight that CoCos issued by Tyco were able to finance the acquisition of Lucent Power Systems, a deal of $3.45 billion. The CoCo embedded a market price trigger fixed at 110% of the conversion price paid per share. The authors show the trigger was never hit, but that nevertheless the operation was successful[[14]](#endnote-14). Clearly, CoCos can work as well as or perhaps even better than a simple convertible.

Regarding the problem of taxation, CoCos embedding the trigger can bring the tax advantages of conventional debt. However, as they are financial hybrids, there may be some problems; Strnad points out that hybrid securities present features of both equity and debt. Thus, when the issuer and the bondholder are treated in the same way for tax purposes there are no problems[[15]](#endnote-15). According to Eberhartinger and Six, when there is a cross-border transaction financed by hybrid securities there can be a problem of double taxation due to possible differences among countries in the tax treatment of hybrids. For example, the country of the issuer could treat it as debt and so tax-deductible, whereas the country of the recipient as equity and so non-tax-deductible[[16]](#endnote-16).

Clearly when a lawyer opts for CoCos as a form of financing for the transaction, he must keep in mind their hybrid nature. When the transaction is going to be closed in the same country, where there is the same tax treatment there is no problem. The case of Tyco International Ltd highlighted above represents an example of this. Indeed, Tyco (the acquirer) and Lucent Power Systems (the target) are both American companies. Nevertheless, the problem can arise when the transaction is cross-border due to the likely different tax treatment of financial hybrids by the two countries. This means that using financial hybrids like CoCos may be very convenient in some cases and less so in others. Surely such a problem cannot be generalized. In the case of CoCos issued by Tyco, the trigger was never hit, meaning that bonds were never converted into shares. Thus, by comparison with an ordinary convertible, the use of the trigger might freeze the debt part, and so the benefit of deduction, perhaps forever.

Regarding the issue of managerial control, the issuance of CoCos embedding the trigger as a form of financing can reduce the risk for the managers of being replaced in case of the exercise of conversion. According to Ismail and Krause managers are reluctant to issue new shares for financing merger & acquisition operations due to the risk of dilution and consequent replacing[[17]](#endnote-17). Indeed, Amihud et al. point out that the best option to solve this problem is to issue conventional debt because it not only gives any participation right to bondholders, but it also provides an anti-takeover shield[[18]](#endnote-18). Harris and Raviv highlight as the dark side that issuing excessive conventional debt increases the risk of going bankrupt[[19]](#endnote-19). Ferran points out the problem could be addressed by issuing convertible bonds because according to section 560 and subsequent sections of the Companies Act 2006 the issuance of convertibles must be accompanied by the issuance of corresponding pre-emptive rights in favour of the existing shareholders so as not to alter the proportion of shareholdings in the company[[20]](#endnote-20).

The issuance of CoCos for implementing mergers and acquisitions presents the advantage of conventional debt without the risk of diluting the existing shares; likewise, the issuance of ordinary convertibles described by Ferran and Cho. Now assuming as an example the case highlighted by Marquardt and Wiedman with regard to Tyco, the trigger was fixed at 110% of the conversion price for the common shares, meaning that in the hypothetical exact moment in which the trigger would been hit, the value of shares would have been very high, so high that in fact the trigger was never hit and the dilution never occurred. Clearly, such a mechanism depends from a very masterpiece of contract, because devising a trigger able to work in such a way requires legal art. Despite that, the risk can be avoided but not erased; in fact by law even the issuance of CoCos, being a convertible as well, is supposed to be accompanied by the corresponding pre-emptive rights in favour of existing shareholders according to the sections of the Companies Act 2006. Nonetheless, by contrast, the conversion and so the dilution of the ordinary convertible depends from the conversion strategy adopted by bondholders, meaning that the risk to convert and so to dilute is higher than with CoCos. With no doubt, CoCos embedding a well-designed trigger are strong allies to implementing mergers & acquisitions.

The Trigger vs. Contingent Payments

One of the challenges lawyers face in merger & acquisition transactions consists in finding the best price suitable for both acquirer and seller. Most of the time, as highlighted above, there are some divergencies due to information asymmetry that cannot be levelled with ordinary due diligence. In order to address this problem, lawyers resort to tools called contingent payments. This means that when the problem arises, an initial, non-definitive price will be fixed that will be adjusted at the close of the operation. Such contingent payments are the earnout, warrants, the contingent value rights, the escrow account, rights to intellectual properties and consulting agreements[[21]](#endnote-21).

It is interesting to note that some of these contingent payments, such as warrants and CVRs, work the same way as CoCos embedding the trigger. This means that CoCos, in some operations, can work as substitutes for contingent payments. Reiling points out that warrants give the holder the right to acquire a pre-fixed number of shares when the stock price reaches a predetermined value. The author highlights the features such an instrument has in common with convertibles, apart from the fact that a warrant can be considered as a form of junior equity with consequences in terms of both accounting and tax treatment[[22]](#endnote-22). They work as contingent payment because the initial price offered to the seller is less, so that exercising the conversion option of the warrant will adjust the final price by compensating the holder with new shares [[23]](#endnote-23). It is clear that a warrant behaves exactly like the conversion option embedded into a CoCo bond.

Regarding contingent value rights, Chatterjee and Yan state that this form of contingent payment confers to the holder the right to put back to the issuer-acquirer a kind of security in exchange for either cash or shares. The authors highlight this contingent value, extremely commonly used in acquisitions, gives the holder a put option. As an example, they cite the acquisition of Paramount by Viacom where the shares initially offered had a value of 48 dollars. If the value of the shares had been less than 48 dollars at closing, the remaining part would have been paid in cash[[24]](#endnote-24). Even in this case, this kind of security behaves exactly like the put option embedded into CoCos.

It can be inferred that CoCos combine the same characteristics of both warrants and CVRs, benefiting from the same options, namely the conversion option and the put option. Indeed, a CoCo bond, with its distinctive features, can substitute for these forms of contingent payments. Using CoCos could save a considerable amount of money because the drafting of either warrants or CVRs can be very expensive. By comparison with the warrant, which is considered junior equity, CoCos can benefit from the deduction of tax over interests, because they are considered debt. By comparison with CVRs, the latter gives the holder the same put option granted by a CoCo bond. Both CVRs and warrants seem the perfect copy of a trigger, just securitized into a white paper and attached to an ordinary security. Both can be considered sweeteners as well as the options embedded into a CoCo and made exercisable by the holder once the trigger is hit. Leaving apart some considerations regarding the pros and cons in financial terms of using warrants and CVRs instead of CoCos, and vice-versa, it can be said that CoCos embedding a trigger could constitute a new form of contingent payment to use in mergers & acquisitions.

**CONCLUSIONS**

The corporate contingent convertible bond is a hybrid security presenting features of both equity and debt. It is defined as mezzanine finance, being placed in between senior debt and equity. It is formed by a host body which is a conventional bond, presenting the classical features of a conventional bond such as a par value, a maturity date and a rate of interest. Despite that, its distinguishing feature is a trigger event, namely a contingency event which, once hit, gives the bondholder a conversion option and a put option. The former gives the right to convert bonds into a predetermined number of shares according to a conversion premium agreed at the time of issuance, whereas the latter gives the right to put bonds back to the issuer in exchange for money.

There are three families of triggers, namely market price triggers, accounting triggers and regulatory triggers. Their analysis not only allows us to highlight the limits and perspectives of corporate CoCos in financial terms, but also to identify the differences in order to compare their major counterparts, namely CoCos issued by banks and convertible bonds. Thus, by comparison with corporate CoCos, it emerges that banking CoCos present an automatic trigger that once hit will automatically involve either conversion into equity or the write-down of outstanding CoCos. In some cases, such CoCos present a regulatory trigger that once hit will allow resolution authorities to force either conversion or write-down of debt. These two kinds of triggers are incompatible with corporate CoCos. Indeed, such triggers can work only into the legal framework of Basel III and the Capital Requirements Directive aimed to maintain an adequate level of capital and in case of distress, to provide a preventive restructuring of the bank at both in ‘going concern’ and ‘gone concern’.

The absence of the trigger event allows the comparison with convertible bonds, from which it emerges that they give a conversion option to the holder only once there is a change in the rate of interest. As result corporate CoCos appear to be safer and more appealing for both the issuer and investors. An ordinary convertible is a bearer of higher risk, particularly for the issuer who is subjected to the strategy of conversion of investors.

The use of corporate CoCos embedding a trigger event could be a valid tool for the amelioration of the agency cost of debt, one of the major concerns for management when deciding to issue new debt. Such a cost is formed by three elements, namely the loss of wealth as a consequence of issuing new debt, on which the issuer does have to pay interest to bondholders, the monitoring and bonding costs, bankruptcy or reorganisation costs. CoCos embedding a trigger will pay a lower rate of interest because management, in order to avoid the trigger, will opt for less risky projects, so reducing the first element of wealth loss. For the same reason, the trigger event embedded into CoCos could be used as substitute for conventional covenants, a very expensive contract, so reducing the monitoring cost. The tax-deductibility of CoCos in favour of the issuer will increase the value of the firm so reducing the third element of the cost, namely bankruptcy and reorganisation costs.

Corporate CoCos have deviated from the purposes for which they were intended. Initially they were devised as a preventive restructuring tool for recapitalizing distressed companies in going concern. Upon the occurrence of the trigger event, CoCos would have been turned into equity automatically. Despite the initial idea being for corporates, this mechanism found a rationale for banking CoCos for which it was implemented. Indeed, with regard to corporate CoCos the same mechanism could be unappealing, it being hard to place among investors a security that will automatically convert from debt to equity, leaving holders with low price shares that in the case of liquidation will be placed at the bottom of the list of priorities. Moreover, even assuming a CoCo bond is embedding the trigger for preventive restructuring purposes, they can be very risky due to the exercise of the put option by bondholders which may prejudice the fortunes of the company.

Despite that, corporate CoCos embedding a trigger event may operate as a valid ally for financing merger & acquisition transactions. Indeed, they might reduce the information asymmetry between the acquirer and the seller. Being hybrids, they can bring tax advantages to operations when they are considered as debt, even though some problems of double taxation can arise when they are used in cross-border transactions involving different countries. Managers may be interested in using CoCos embedding the trigger because avoiding the triggering at any cost it will reduce the risk of dilution and so replacement, which is higher in ordinary convertibles. Moreover the trigger, combining the characteristics of warrants and contingent value rights, can enable CoCos to work as a new form of contingent payment to use in mergers & acquisitions.

To conclude, corporate contingent convertible bonds embedding a trigger event, as opposed to contingent convertible bonds issued by banks, may work as a valid alternative to ordinary convertible bonds. They can ameliorate the problem of the agency cost of debt, which is probably the major concern for management issuing new debt. They can work as a preventive restructuring tool in going concerns, though this could end up being a double-edged sword, particularly for the issuer. Despite that, they can have a brilliant future in merger & acquisition transactions.

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12. See De Pamphilis, (n.10)405 [↑](#endnote-ref-12)
13. John D. Finnerty, Jie Jiao and An Yan,’ Convertible Securities in Merger Transactions’, (2012) Journal of Banking & Finance, 278 [↑](#endnote-ref-13)
14. See Marquardt and Wiedman (n.8) 491 [↑](#endnote-ref-14)
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