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Winning the Lottery on Partial Redemptions: Who Gets What?

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Nearly every series of corporate bonds, whether investment grade or high yield, has some sort of redemption feature allowing or requiring the issuer to "call" all or a portion of the series prior to maturity. Often, the issuer has the right to redeem all or a portion of a series of bonds prior to maturity (and sometimes after a "no call" period) at a premium, whether a fixed premium decreasing over time to par or a "make-whole" premium that "makes whole" a bondholder when prevailing interest rates (and therefore reinvestment rates) are lower than the coupon on the outstanding bonds. Many bonds also contain an optional "par call," allowing the issuer to redeem the bonds a short time prior to maturity (how short is often a function of the original tenor of the bonds). High-yield bonds often have mandatory redemption provisions requiring the issuer to use all or a portion of the proceeds of asset sales or equity issuances (a so-called "equity clawback") to redeem a portion of the bonds.

Assuming that the issuer has the right or obligation to redeem a portion of a series of bonds, the question then arises as to which bonds actually get redeemed. There are two common ways to redeem a portion of a series of bonds, either a portion of the bonds are chosen by lottery or all of the bonds are partially redeemed pro rata. In a lottery, the trustee (typically) chooses the bonds to be redeemed (in whatever the minimum authorized denominations are) from among the entire series. Thus, one bondholder may get all or some of its bonds redeemed and another bondholder may not get any of its bonds redeemed. The benefit of a lottery is that all bonds that remain outstanding will still have a principal amount equal to par. The downside of a lottery is that some bondholders may get redeemed while others may not (being redeemed may be a good or bad thing depending on a number of factors). In a pro rata redemption, the optional redemption payment is paid pro rata to all bondholders. The benefit of a pro rata redemption is that all bondholders are treated equally. The downside of a pro rata redemption is that the outstanding principal amount of each bond is below par which can be confusing in secondary trading or liability management exercises.

So, What's Typical? The method of selecting the bonds to be redeemed is prescribed by the indenture or fiscal agency agreement governing the bonds. The ABA Model Simplified Indenture states that: "[i]f less than all the Securities are to be redeemed, the Trustee shall select the Securities to be redeemed by a method that complies with the requirements, if any, of any stock exchange on which the Securities are listed and that the Trustee considers fair and appropriate, which may include selection pro rata or by lot." This or a similar formulation is almost universal. But this formulation doesn't tell bondholders (or the issuer) what bonds will actually get redeemed. Additionally, since most corporate bonds are held by The Depository Trust Company ("DTC"), there may only be one "security" from which the trustee could choose making redemption by lottery impractical.

For clarity on the actual process, we need to look to the DTC 2023 Corporate Actions Redemptions Service Guide and a little-noticed "Important Notice" issued by DTC in October 2024.

To start with, DTC receives notices of redemption from either the issuer or, more typically, the trustee or paying agent and then distributes the information to its participants. In the event of a partial redemption, DTC will process a computerized call lottery to determine the participants' individual holdings that are to be redeemed. After the call lottery is completed by DTC, DTC's electronic system notifies participants whether or not they had a position in the called security in their DTC account as of the close of business on the day prior to the publication date of the call. On the redemption date (or the next business day if the redemption date falls on a weekend or holiday), DTC allocates the redemption proceeds to participants having a position in the redeemed portion of the series and deletes such participants' position from DTC's records. Interestingly, the DTC Redemptions Service Guide does not even contemplate pro rata partial redemptions.

In October 2024, DTC published an Important Notice in which it clarified that DTC can only facilitate two redemption methods: pro rata pass-through distribution of principal and lottery redemptions. The Important Notice says that "DTC does not support the announcement or payment of pro rata redemptions and governing document references to pro rata redemptions often drive confusion and should be avoided, instead clarifying between pro rata pass-through distribution of principal or lottery redemption."

The Important Notice then goes on to provide for specific procedures to be followed when bonds are intended to be paid pro rata, including:

1. The governing documents of the security and the offering materials should clearly indicate that a "partial redemption" processed through DTC will be treated by DTC, in accordance with its rules and procedures, as a "Pro Rata Pass-Through Distribution of Principal." The phrase "pro rata" alone is not sufficient.

2. When submitted through DTC's underwriting system, the underwriter must use the value "Pro Rata" and not "Lottery."

According to the Important Notice, if the offering materials do not appropriately identify "Pro Rata Pass-Through Distribution of Principal" at the time of eligibility or the trustee or paying agent does not provide the same identification when submitting any partial redemption notice, the partial redemption will be processed via a random lottery.

So why is all of this seemingly "back office" procedure important? While few, if any, investment grade issuers optionally redeem a portion of a series prior to maturity (the make-whole price is almost always higher than the value of the bonds except as the bonds approach their maturity), high yield indentures often have mandatory redemption provisions that would result in a redemption of only part of a series. And even with investment grade bonds, it is still important to make sure the disclosure is clear to avoid both liability as well as disgruntled bondholders.

A search of the SEC's EDGAR database shows only a small handful of issuers explicitly say that the bonds to be redeemed will be chosen by lottery. Much more common is either no disclosure about how partial redemption of book-entry notes will be treated or disclosure that says "For so long as the notes are held by DTC (or another depositary), the redemption of the notes shall be done in accordance with the policies and procedures of the depositary, which may be made on a pro rata pass-through distribution of principal basis." As noted above, this language isn't actually helpful as the partial redemption may be, or may not be, made on a pro rata pass-through distribution of principal basis.

We believe that issuers and their underwriters should agree as to what type of redemption is intended, confirm the methodology with the trustee or paying agent and then draft disclosure clearly reflecting that methodology. If the intention is to use the lottery method, we would suggest the following language: "For so long as the notes are held by DTC (or another depositary), the partial redemption of the notes will be made in accordance with the policies and procedures of the depositary. DTC's current practice in the case of a partial redemption is to determine by random lottery the amount of interest of each direct participant in the notes to be redeemed." If the intention is to use the pro rata method, we would suggest the following language: "For so long as the notes are held by DTC (or another depositary), the partial redemption of the notes will be made on a pro rata pass-through distribution of principal basis and otherwise in accordance with the policies and procedures of the depositary."

As with all offering disclosures, clarity and precision are essential: say what you mean and mean what you say.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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