7. Bond Payable

A borrower may split a large loan into many small units. Each of these units (or bonds) is essentially a note payable. Investors will buy these bonds, effectively making a loan to the issuing company. Bonds were introduced, from an investor's perspective, in the Long – term Investments chapter. The specific terms of a bond issue are specified in a bond indenture. This indenture is a written document defining the terms of the bond issue. In addition to making representations about the interest payments and life of the bond, numerous other factors must be addressed:

- Are the bonds secured by specific assets that are pledged as collateral to insure payment? If not, the bonds are said to be debenture bonds; meaning they do not have specific collateral but are only as good as the general faith and credit of the issuer.

- What is the preference in liquidation in the event of failure? Agreements may provide that some bonds are paid before others.

- To whom and when is interest paid? In the past, some bonds were coupon bonds, and these bonds literally had detachable interest coupons that could be stripped off and cashed in on specific dates. One reason for coupon bonds was to ease the recordkeeping burden on bond issuers -- they merely paid coupons that were turned in for redemption. Coupon bonds also had certain tax implications that are no longer substantive. But, in modern times, most bonds are registered to an owner. Computerized information systems now facilitate tracking bond owners, and interest payments are commonly transmitted electronically to the registered owner. Registered bonds are in contrast to bearer bonds, where the holder of the physical bond instrument is deemed to be the owner (bearer bonds are rare in the modern economic system).

- Must the company maintain a required sinking fund? A sinking fund bond may sound bad, but it is quite the opposite. In the context of bonds, a sinking fund is a required escrow account into which monies are periodically transferred to insure that funds will be available at maturity to satisfy the obligation. As an alternative, some companies will issue serial bonds. Rather than the entire issue maturing at once, portions of the serial issue will mature on select dates spread over time.

- Can the bond be converted into stock? One "exciting" type of bond is a convertible bond. These bonds enable the holder to exchange the bond for a predefined number of shares of corporate stock. The holder may plan on getting paid the interest plus face amount of the bond, but if the company's stock explodes upward in value, the holder may do much better by trading the bonds for appreciated stock. Why would a company issue convertibles? First, investors love these securities (for obvious reasons) and are usually willing to accept lower interest rates than must be paid on bonds that are not convertible. Another factor is that the company may contemplate its stock going up; by initially borrowing money and later exchanging the debt for stock, the company may actually get more money for its stock than it would have had it issued the stock on the earlier date.

- Is the company able to call the debt? Callable bonds provide a company with the option of buying back the debt at a prearranged price before its scheduled maturity. If interest rates go down, the company may not want to be saddled with the higher cost obligations and can escape the obligation by calling the debt. Sometimes, bonds cannot be called. For example, suppose a company is in financial distress and issues high interest rate debt (known as "junk bonds") to investors who are willing to take a chance to bail out the company. If the company is able to manage a turnaround, the investors who took the risk and bought the bonds don't want to have their "high yield" stripped away with an early payoff before scheduled maturity. Bonds that cannot be paid off earlier are sometimes called nonredeemable. If you invest in bonds, and want to buy nonredeemable debt, be careful not to confuse it with nonrefundable. Nonrefundable bonds can be paid off early, so long as the payoff money is coming from operations rather than an alternative borrowing arrangement. Lastly, you should note that convertible bonds will almost always be callable, enabling the company to force a holder to either cash out or convert. The company will reserve this call privilege because they will want to stop paying interest (by forcing the holder out of the debt) once the stock has gone up enough to know that a conversion is inevitable.

Your head is probably spinning with all these new terms, and you can see that bonds are potentially complex financial instruments. Who enforces all of the requirements for a company's bond issue? Within the bond indenture agreement should be a specified bond trustee. This trustee may be an investment company, law firm, or other independent party. The trustee is to monitor compliance with the terms of the agreement, and has a fiduciary duty to intervene to protect the investor group if the company runs afoul of its covenants.