

Cleary Gottlieb Discusses the State of the Convertible Bond Market

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Comment

Convertible notes issuances have been surging in the last few years to a market size of approximately \$300 billion. The increased activity has been bolstered by the high-interest rate environment, favorable equity market dynamics and macro uncertainty. Secular growth trends in AI-linked sectors, such as datacenters, energy and power systems, also have been a key driver of demand, accounting for approximately 20% of global convert issuance in 2025. Deals have been getting bigger and bigger, with scores of issuances last year in the billion-dollar range.

Convertible notes combine debt and equity, allowing issuers to take advantage of lower interest rates (compared to straight debt) while minimizing dilution (compared to straight equity). Investors earn a reduced coupon relative to straight debt, but in exchange receive equity upside.

In the 2024 version of this alert memo, we focused on traditional capital markets convertible notes. In this 2025 update, we expand our focus to capture convertible instrument issuance in the PIPE (private investment in public equity) and pre-IPO markets, where the features may vary significantly. The evolution in this market reflects the growing presence of private credit and special situations investors drawn in by favorable opportunities for equity-upside economics with credit-downside protections. We also outline liability management techniques for convertible notes.

I. Capital Markets Convertible Notes

A. Basic Terms

1. Convertible notes combine features of debt and equity.

- Like straight debt, a convertible note has a fixed maturity (typically, five to seven years) and regular (typically, semi-annual) interest payments.
- Like a call option for equity securities, a convertible note allows its holder to convert into shares with a predetermined number of shares deliverable for each note (the “conversion rate”).
- Investors accept a lower interest coupon in exchange for the equity upside.

2. The share price at which the note converts is the “conversion price.”

- The conversion price is equal to the principal amount of a note divided by the conversion rate.
- The conversion price is higher than the current stock price (typically, a premium of 25% to 30%).
- The conversion rate is adjusted upon specified corporate events, such as dividends, spin-offs and stock splits.

3. Convertible notes are usually contingently convertible, meaning investors can convert only at certain times.

- Generally, investors can convert only in a specified window near maturity (typically, 3-6 months prior) or if certain events occur, including upon:
 - a fundamental change or other transformative transaction;
 - a significant increase in share price (typically, 130% of the conversion price);
 - the notes trading at a discount to their as-converted value; or
 - the issuer choosing to redeem the notes.
- Issuers often have a “soft call” right to effectively force conversion if the share price exceeds, g., 130% of the conversion price for a certain period of time after a specified date.

B. Structuring Considerations

1. Convertible notes can be structured with different settlement methods. This choice usually is driven by accounting implications and expected availability of liquidity. The standard options are:

- full physical settlement (the issuer delivers only shares on conversion);
- cash settlement (the issuer delivers value of shares in cash);
- full flex settlement (also called “instrument X”), where the issuer may choose physical or cash settlement or a combination; or
- net share settlement (also called “instrument C”), where the issuer must deliver the principal amount in cash and may use shares, cash, or a combination for any further value.

2. The issuer should work with its accountants to understand the consequences of settlement choices when structuring the convertible note and when electing a settlement method.

3. Convertible notes are attractive to multiple types of investors, but generally increase short interest in an issuer.

- Fundamental investors invest in convertible notes for the coupon and the possibility of converting at maturity.
- Technical investors invest in convertible notes and seek to make money by hedging the embedded option – which entails shorting the issuer’s shares.

- Special situations and other opportunistic credit investors invest in convertible notes to obtain equity and growth upside while retaining credit downside protections.
- Private equity investors and sovereign wealth firms invest in convertible notes as a way of acquiring minority or structured equity ownership, and are critically focused on the equity story and valuation.
- The size of available stock borrow in the issuer's stock may be an important factor in sizing the overall notes offering, and bankers may suggest concurrent transactions to increase borrow for certain issuers.

4. Convertible notes can be issued on an SEC-registered basis or privately using Rule 144A.

- Convertible note investors tend to be large and sophisticated institutions, so many issuances are done privately using Rule 144A.
- "Well-known seasoned issuers" ("WKSIs") – generally, public companies with a market cap exceeding \$700 million – may use an automatically effective SEC shelf registration statement to offer convertible notes on an SEC-registered basis. There is no delay for SEC review.
- If a non-WKSI does not have already effective SEC shelf registration statement covering convertible notes, the issuer instead may use Rule 144A to allow for faster execution and avoid SEC review.
- Rule 144A also affords an exemption from Regulation M. This can be useful to manage dilution risk and offset short selling by technical investors, because it facilitates issuer arrangements to buy back shares at the time of issuance of the notes.

5. Capital markets convertible notes (e., registered or 144A converts) tend to have standard anti-dilution adjustments designed to preserve the agreed-upon conversion price in the event of corporate changes, such as stock splits, combinations, dividends, rights offerings and tender offers.

- By contrast, PIPEs and pre-IPO convertible instruments may have more complicated price-adjustment mechanisms, as discussed below.

6. NYSE and Nasdaq shareholder approval requirements may impose structural constraints.

- In general, offerings that are "public offerings for cash" (e., widely marketed, and not merely an SEC-registered offering) are not subject to shareholder approval requirements.
- If an offering otherwise involves an issuance of 20% or more of an issuer's common stock or voting power (including through securities convertible into common stock), then shareholder approval is needed unless the offering price is at least equal to the "minimum price."
 - The minimum price is the lower of the (i) official closing price immediately before pricing and (ii) average closing price for the five trading days immediately preceding pricing.
 - In general, for a capital markets convertible note with standard anti-dilution and make-whole features, this test should be satisfied. In cases with ratchets or other atypical features, such as PIPE convertible notes (discussed below), more careful analysis is warranted.
- Shareholder approval also may be needed for issuances to related parties and in circumstances that result in a change of control. "Change of control" is not defined, but can include a large minority investment with board representation or significant governance rights (which again is more typically a concern in the PIPE context).
- Non-U.S. issuers generally can follow their home country requirements on governance matters and are not subject to these shareholder approval rules.
- A limited exception from shareholder approval rules also is available in cases where delaying the transaction to obtain shareholder approval would jeopardize the issuer's financial viability.

7. Capital markets convertible notes generally trade in a decentralized manner in over-the-counter transactions, with broker-dealers quoting bid and ask prices.

C. Considerations

1. Fundamental changes generally allow investors to put their notes to the issuer at par or convert for a temporary conversion rate increase (called a "make whole").

- A fundamental change generally includes a change of control, disposition of "all or substantially all" assets of the issuer, a transaction in which the existing stock is replaced by consideration that consists of less than 90% exchange-traded securities, or a delisting or insolvency of the issuer.
- Future M&A, spin-offs and asset transfers may have a variety of consequences under a convertible note, including triggering a fundamental change and requiring the successor to become the obligor under the notes, and must be carefully analyzed.
- The make-whole conversion rate increase generally applies if an issuer exercises its "soft call" right.

2. Traditional capital markets convertible notes typically have few covenants, but do require attention to compliance.

- Failure to fulfill a conversion obligation and failure to give notice of a fundamental change generally allow acceleration.
- Convertible notes typically limit jurisdictions in which a successor entity can be organized.
- Failure to file SEC reports or legend Rule 144A notes at the appropriate time typically incur a step-up in interest rates.
- Convertible notes may require notice of extraordinary dividends and rights offerings well in advance of distribution.

3. Issuers can offset their obligations under convertible notes by entering into an accompanying over-the-counter derivative transaction known as a "call spread" with banks.

- In a call spread, the issuer buys a call option on its shares at the conversion price, offsetting the obligation to deliver shares or cash to investors upon conversion.
- The call option is subject to a cap price. The dealer does not deliver additional value to the issuer if the share price at conversion is above that cap price.
- For the issuer, this effectively increases the conversion price of the notes to this higher cap price, mitigating the risk of dilution if the convertible notes are converted.
- Call spreads can be structured using two derivatives – a bond hedge (set at the conversion price) and warrant (a call option sold at the cap price) or as a capped call (a single call option, subject to a cap). Economically, these are similar, though each has its pros and cons, and the choice between them generally depends on complex tax considerations.

II. PIPE Convertible Notes

A. PIPE Basic Structure[1]

1. In a private investment in public equity (PIPE) transaction, a public company makes a private placement of securities to a single or limited group of accredited investors.
2. After the PIPE, the securities are usually registered with the SEC for resale. A PIPE can minimize execution risk and offer quick financing to issuers while providing discounted pricing and favorable terms to investors.
3. Historically, distressed, small, or mid-sized issuers have used PIPEs when other options for financing are not feasible. However, because PIPEs are a relatively quick and discreet way to raise capital, larger, well-capitalized issuers now also may choose PIPEs, especially when markets are volatile. PIPE activity spiked, for example, at the outset of the COVID-19 crisis.
4. An issuer might prefer a PIPE over a traditional offering for several reasons.
 - Because PIPEs are not registered offerings, they avoid the potential delays of SEC review.
 - Another advantage is that issuers may disclose the transaction publicly only after investors commit to purchase the securities.
 - A capital markets convertible note can be marketed confidentially, too, but investors typically will agree to be “wall-crossed” and restrict trading only for short periods of time.
 - In the PIPE context, an investor, particularly a private credit investor with a longer-term or more strategic horizon, might agree to a longer restriction.
 - A longer confidentiality agreement also facilitates the ability of the issuer, where useful, to share material non-public information with the investor that goes beyond the mere fact of the offering, and, so long as the investor remains subject to a confidentiality obligation, to not have to disclose it in connection with consummating the PIPE (e.g., a potential M&A deal, the disclosure of which would be premature).
 - This discreetness can minimize pressure on the issuer’s stock price and harm to its reputation if the offering is not completed.

B. Common Features

1. A PIPE might be offered to a broader set of investors than a traditional SEC-registered or Rule 144A convertible note. Private equity funds, strategic investors, sovereign wealth funds, mutual funds and family offices may be interested, among others, particularly if they have long-term investment horizons or have or wish to develop a relationship with the issuer.
2. Instead of being widely publicly marketed, the offering process generally is more limited and focuses on a smaller group of investors with more flexibility on terms. The deal may be marketed on an agency basis by a smaller advisor or by the issuer directly, in contrast to one or more bulge-bracket banks.
3. In the PIPE convertible notes space, investors and issuers often negotiate bespoke features such as:
 - Governance rights, such as board or observer seats, and the right to vote the underlying shares on an as-converted basis.
 - Consent rights over items such as changes of control, M&A or other extraordinary transactions; material asset sales, investments, expenditures, borrowings, or issuances; related party transactions; material changes to organizational documents or lines of business; and other material adverse changes.
 - Guarantees or collateral.
 - Financial covenants.
 - Prepayment provisions.
 - Purchase price adjustments beyond standard anti-dilution provisions in capital markets convertible notes – e.g., ratchets for lower-priced issuances within a certain period.
 - A full ratchet simply matches the lower price, while a weighted average ratchet reflects the relative size of the lower-priced offering.
 - These adjustments may be subject to caps, and can be narrowly based on shares outstanding or more broadly based on potential shares outstanding, taking into account convertible instruments.
 - Equity sweeteners, such as warrants.
 - Paying interest cash or in kind (PIK interest), or a combination of the two.
 - Alternative return calculations – e.g., based on a specified internal rate of return (IRR) or multiple on invested capital (MOIC).
 - An extended lock-up or standstill for the investor, as well as restrictions on hedging and transfers.
 - In contrast to capital markets convertible notes, PIPE convertible instruments tend to be highly illiquid given their bespoke nature. Of course, the underlying common stock generally will be listed on a stock market and liquid.
 - Registration rights to facilitate SEC-registered resale.
 - Issuing in the form of preferred stock, rather than debt.
4. In circumstances where shareholder approval is required but not readily obtainable – e.g., there is an urgent need for financing – issuers sometimes will issue up to just under 20% of their outstanding common stock and, for amounts exceeding that threshold, issue common-equivalent preferred shares, with an undertaking to seek shareholder approval at the next annual meeting until it is obtained.

III. Pre-IPO Convertible Notes

A. Background

1. As many companies increasingly have deferred an IPO for years, private company financing has grown in complexity.
2. Traditional preferred stock issued to venture capital investors has become increasingly bespoke and attracted new types of investors to the private markets, such as crossover, hybrid capital and credit investors.
3. Simple instruments, such as simple agreements for future equity (SAFES), and traditional borrowing also have become more tailored, with convertible notes now playing a growing role in the pre-IPO ecosystem.
4. For a company able to bear a debt load and with a credible near- to medium-term path to an IPO, a convertible note can be an attractive lower-cost borrowing option.

B. Considerations

1. Like a SAFE, a convertible debt instrument can be used to defer a discussion around valuation – e.g., if the issuer wants to avoid a “down round” – by pegging the conversion price to the next round or IPO price.
2. Unlike a SAFE, which often is used for early-stage issuers with highly uncertain prospects, a convertible debt instrument has a specified maturity date and can bear interest, although it may well be in PIK form.

3. Like a PIPE, the private nature of the company and the investors can allow for greater negotiation of terms and a structure better suited to the needs of both the issuer and investors than a more standardized instrument.
4. Many of the features negotiated in the PIPE context are similarly up for discussion in the pre-IPO environment.
5. Some pre-IPO convertible notes survive in whole or in part beyond the IPO, which can make IPO marketing more complicated. IPO investors will need education around a potentially complex liability remaining on the balance sheet, especially if it contains price adjustment or complex return features.

IV. Convertible Note Liability Management

A. Background

1. Liability management refers to the techniques used to manage outstanding debt – *g.*, to loosen covenants, refinance outstanding obligations (such as when interest rates move or the company’s credit changes significantly), or fund upcoming maturities.
2. Issuers typically want to consider liability management well ahead of maturity – often, more than a year in advance.
 - This provides flexibility to address equity volatility and select an optimal market window.
 - When contemplating a convertible note issuance, it is important to consider the timing of any future takeout, which may center around redemption or put dates, and the form of a potential takeout transaction.
3. Liability management techniques also play a critical role in the distressed context, as issuers increasingly opt for non-bankruptcy restructuring of their balance sheets.

B. Liability Management Techniques

1. Liability management techniques include:
 - Consent solicitations: A fee is paid to holders to amend a covenant or other provision that poses a problem for the issuer (*g.*, to loosen a ratio in a financial covenant). Because convertible notes tend to have fewer covenants than non-convertible debt, especially high yield debt, this technique is less commonly used.
 - Redemption: If the notes have a call feature and the conditions for exercising it are met, the issuer may choose to redeem, often effectively forcing a conversion of the notes into equity.
 - Privately negotiated repurchases: The issuer purchases notes for cash from a limited number of sophisticated holders. This technique can be useful if an issuer has available cash and the notes are favorably priced. Cash repurchases also often are financed by a new offering of convertible notes.
 - The issuer must be careful not to inadvertently commence a “creeping tender” – effectively, purchases that should have been structured under SEC rules as formal tender offer. This can limit the scope of the repurchases.
 - Privately negotiated exchanges: The issuer avoids cash expense and offers to exchange new notes or shares of common stock for the outstanding notes in privately negotiated transactions with a limited number of sophisticated holders.
 - Like privately negotiated repurchases, privately negotiated exchanges must be carefully structured to avoid an inadvertent tender offer.
 - Induced conversions: The issuer temporarily increases the conversion rate on the notes, creating an incentive to convert into the underlying equity while leveraging the conversion mechanics in the note itself.
 - Tender offers: The issuer launches a formal tender offer to all holders in compliance with SEC rules to repurchase or exchange the outstanding notes.
 - Because convertible notes are equity instruments, requirements for formal tender offers in respect of convertible notes of reporting issuers are relatively burdensome, making these offers less common.
2. These techniques may be combined in certain instances – *g.*, an “exit consent” where exchanging noteholders consent to adversely amend covenants on outstanding notes concurrently with exchanging them, making the existing notes less attractive and therefore disincentivizing holdouts.
3. They also can be deployed at different times during the lifecycle of the instrument – *g.*, privately negotiated purchases to opportunistically exploit favorable market conditions, followed by a larger exercise closer to maturity.
4. Liability management is an especially critical tool for distressed issuers, particularly as they seek to use negotiated arrangements to avoid formally filing for bankruptcy. In recent years, increasingly innovative deals have been structured to achieve this result.

V. Treatment of Convertible Notes in Bankruptcy

1. In the event of a chapter 11 bankruptcy filing by the issuer, all outstanding convertible notes (*e.*, notes that have not been converted into equity as of the date of the chapter 11 filing) will be treated as debt, rather than equity – unless, as discussed below, the notes are “recharacterized” as equity instruments. Otherwise, in accordance with the absolute priority rule, and notwithstanding the conversion feature of the notes, holders of convertible notes will recover ahead of equity.
2. The treatment of claims of holders of convertible notes relative to other creditors depends on whether the convertible notes are secured or unsecured.
 - If the convertible notes are secured by a lien on collateral, the claims of noteholders will receive priority over all other claims up to the value of the pledged collateral (subject to any senior or parity liens).
 - If the convertible notes are unsecured, the noteholders’ claims will receive recoveries that are pro rata from the issuer’s unencumbered property with claims of all other unsecured claimholders.
3. With any debt instrument that has equity-like characteristics, including convertible notes, there exists a risk of “recharacterization” by the bankruptcy court. The recharacterization doctrine (which originates in tax law) is based on the principle that form must not be elevated over substance.
 - With respect to “capital markets” converts, absent certain specific and unusual facts, there is no risk of recharacterization as equity. For privately negotiated and bespoke converts, there are factors that need to be considered in the structuring of the notes, with these issues being specific to each deal and focused on whether the instrument truly was intended to be debt and not a disguised equity interest.
 - If a court “recharacterizes” convertible notes as equity interests rather than debt, the absolute priority rule dictates that noteholders will receive no recovery on account of the notes unless and until all creditors have recovered in full.

VI. Outlook

The convertible bond market rides into 2026 on strong momentum from previous years and a positive outlook for further growth. Heightened convertible notes issuance is expected to continue through 2026, driven by issuers looking to refinance existing convertible debt, particularly in vintages from the COVID era when converts issuance ticked up dramatically. Issuers looking to refinance “straight” (*i.e.*, non-convertible) debt should continue to consider converts issuance as way of reducing interest expense in an otherwise stubbornly high-for-longer interest rate environment. Demand remains strong among sophisticated asset managers seeking – and finding – in the convertible bond a canvas for their flexible, evolving investing mandates.

ENDNOTE

[1] Section II.A. is largely extracted from Cleary Gottlieb Alert Memo, *Alternative Capital Raising for Public Companies* (ed. 2022), adapted from Adam E. Fleisher & Sophie Grais, *Alternative Capital Raising for Public Companies*, in *FINANCIAL PRODUCT FUNDAMENTALS: LAW, BUSINESS, COMPLIANCE*, ch. 23 (Clifford E. Kirsch, ed., 2d ed. 2012 & Supp. 2021) (©2022 by Practising Law Institute, www.pli.edu. Reprinted with permission. Not for resale or distribution. Available at www.pli.edu/financialproductfundamentals.)

This post is based on a Cleary Gottlieb Steen & Hamilton LLP memorandum, “The State of the Convertible Bond Market: Traditional Believers and New Converts,” date January 22, 2026, and available [here](#). Richard Cooper, Luke Barefoot, and Jack Massey contributed to the memorandum.