Restructuring Debt Securities: Options and Legal Considerations

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November 2008

Introduction

While the current economic slowdown and credit crunch have limited refinancing options for companies that have previously issued debt securities, the recent decline in secondary market prices for debt securities has presented an opportunity for companies to restructure their debt on more favorable terms. By repurchasing their debt securities for cash or exchanging them for new securities, companies may be able to retire their existing indebtedness at less than the original face value and reduce the related interest costs. This memo outlines some basic legal considerations for companies considering such a debt restructuring.[1]

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Summary of Restructuring Options

A company that decides to restructure its outstanding debt securities can do so with or without the use of cash.[2] Alternatives include:

- ***Cash redemption***: If the terms of the debt permit redemption and the company is able to raise the necessary funds, the debt can be redeemed. Redemption may be an unattractive option though, because the redemption price generally is the face amount or, in many cases, is at a premium to the face amount (which, for a financially distressed company, will likely exceed the market value).
- ***Cash purchases***: The company may be able to acquire its outstanding debt securities through open market purchases or in privately negotiated transactions, perhaps at a significant discount to the face amount.
- ***Cash tender offer***: In a cash tender offer, the company makes a public offer to purchase some or all of its outstanding debt securities, perhaps at a significant discount to the face amount.
- ***Exchange offer***: A company that does not have access to the cash necessary to implement the above options can make an offer to holders of its outstanding debt securities, agreeing to exchange newly issued debt or equity securities for the outstanding debt securities, perhaps with a fair value at a significant discount to the face amount of the old securities.

Contractual Limitations

Before a company embarks on a debt restructuring, it should carefully review the terms of its outstanding debt. In many situations, covenants in bank or other debt agreements will restrict the company's ability to redeem its debt securities. Waivers of these covenants may not be available while the company is in financial distress. In most situations, there will be some limited exceptions to this restriction, and the company will need to ensure that the terms of any proposed restructuring to fit within such limited exceptions.

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[1] This memo addresses the restructuring of straight (*i.e.*, non-convertible) debt securities. Under different circumstances, there may be additional legal considerations.
[2] This memo does not discuss bankruptcy alternatives.

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Cash Purchases and Tender Offers

If a company decides to purchase its outstanding debt securities for cash, it may make a public offer, or "tender offer," to purchase some or all of the securities. A cash tender offer will require compliance with the tender offer rules of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Alternatively, a company may try to make cash purchases of its outstanding debt securities from individual holders through open market purchases or privately negotiated transactions in a manner that would not be classified as a "tender offer" under the Exchange Act. However, because U.S. federal securities law does not define the term "tender offer" and there is not a great deal of case law or SEC commentary on this topic, a company should work with legal counsel to carefully structure repurchases so as to avoid classification of its repurchase plan as a tender offer.[3] In general, a company wishing to avoid having its repurchase plan classified as a tender offer would:

- solicit a limited number of holders, preferably sophisticated investors, so as to avoid a general solicitation;
- make the repurchases over a fairly long period of time, with no deadlines or other types of pressure applied to holders to sell their securities;
- purchase on different, separately negotiated terms and prices from different holders;
- consider limiting the aggregate amount of securities purchased through open market purchases; and
- if both a repurchase and tender offer are contemplated, to undertake them separately, including by introducing a "cooling off" period between the two events, to avoid the repurchase being aggregated into, and considered part of, the tender offer.

A repurchase that is later found to be a non-compliant tender offer could expose the company to a variety of sanctions.

Issues to consider in Cash Purchases and Tender Offers

For a cash purchase that is not classified as a "tender offer" under the Exchange Act, the most significant legal issue is avoiding liability under the antifraud provisions of U.S. federal securities law, particularly Rule 10b-5. Rule 10b-5 generally prohibits the use of materially misleading statements or omissions in connection with the purchase or sale of a security and otherwise prohibits the use of manipulative or deceptive devices to purchase or sell a security.

The application of Rule 10b-5 in the context of an open market purchase is the subject of some confusion. It is quite clear that if a company chooses to speak in the context of the purchase, if the statements made are materially misleading or incomplete, the seller will be able to bring a Rule 10b-5 claim as a result. What is less clear, however, is whether a company can be held liable in a situation where the purchase is done through an agent and no statements are made to the buyer, but at a time when the company is in possession of material non-public information. This material non-public information could take the form of (a) knowledge of recent operating results, (b) knowledge of future redemption or restructuring plans and (c) even simply the knowledge that the issuer is buying securities in the market (which will tend to increase prices in the market). Rule 10b-5 imposes liability for omissions where the seller has a "duty" to disclose material non-public information and has not done so. A recent Southern District of New York decision, *Alexandra Global*

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[3] Eight factors have been held to characterize a tender offer and thus are generally considered to be relevant to determining whether purchases of securities constitute a tender offer: (1) active and widespread solicitation of holders; (2) solicitation made for a substantial percentage of the outstanding debt; (3) the offer to purchase is made at a premium over the prevailing market price; (4) the terms of the offer are firm rather than negotiable; (5) the offer is contingent on the tender of a fixed minimum number of securities and is often subject to a fixed maximum as well; (6) the offer is open for only a limited period of time; (7) the offeree is subject to pressure to sell his or her securities; and (8) the public announcement of a purchasing program precedes or accompanies rapid accumulation of the target's securities.

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Master Fund v. Ikon Office Solutions (S.D.N.Y., 2006), held that, because companies owe no fiduciary duties to their debtholders, they have no affirmative duty to disclose material non-public information. This case would suggest that companies can be silent and purchase debt while in possession of material non-public information, assuming that their existing disclosure is not "incorrect." Companies should be cautioned that other federal courts are not bound by this decision and could find to the contrary, and that creative plaintiffs could try to identify other claims, including under common law fraud, where a duty to disclose may be inferred even absent a fiduciary duty.

Tender and exchange offers, like cash purchases that are not tender offers, are also subject to Rule 10b-5. In addition, tender and exchange offers are subject to Section 14(e) of the Exchange Act and the rules adopted thereunder. These rules prohibit fraudulent and manipulative activity and require that the tender offer be kept open for a minimum of 20 business days from commencement and 10 business days from notice of a change in the percentage of securities sought, the consideration offered or a dealer's soliciting fee. The SEC has issued no-action letters exempting certain tender offers for investment-grade securities from the minimum offering period requirements. In addition, a number of market practices have developed that, while not shrinking the 20-day period, serve to incent holders to tender early in the period to provide a company with greater certainty as to the results before the tender offer expires. There is no U.S. rule that specifically regulates the content required in any offering materials used in the tender offer. Furthermore, assuming that consideration in the tender offer would be cash only, no filing of any offering document need be made with the SEC. However, preparation of an offer to purchase document is customary and such document must be materially accurate to avoid liability.

A company engaging in open market purchases or a tender or exchange offer would also have to consider any disclosure requirements under the rules of any stock exchange where the company's equity is listed or any stock exchange where the relevant debt instruments are listed.

Exchange Offers

In an exchange offer, a company makes an offer to holders of its outstanding debt securities, agreeing to exchange newly issued debt or equity securities (usually with terms more favorable to the company) for the outstanding debt securities. The offer and issuance of new securities in an exchange offer is considered to be an offering of the new securities under the Securities Act, and thus must be registered under the Securities Act of 1933 (the "Securities Act") unless an exemption from registration is available. Exchange offers are also subject to the tender offer rules under the Exchange Act, as discussed above.

Because an exchange offer is an issuance of new securities, it is customary to prepare an offering document. In addition, due to liability concerns, dealer/managers (where there are dealer/managers) will generally undertake due diligence efforts and seek customary comfort letters and legal opinions, including so-called "10b-5 letters."

There are generally three options for conducting an exchange offer:

» **Section 3(a)(9) exchange offer**: Section 3(a)(9) of the Securities Act permits a company to issue securities solely in exchange for existing securities without registration. The principal disadvantage of this type of offer is that one condition of Section 3(a)(9) is that the company cannot pay a dealer/manager to solicit tenders. The SEC has promulgated no-action letters that permit a financial advisor to undertake certain activities, including pre-launch discussions with sophisticated securityholders, so long as the financial advisor is not paid a success fee. However, despite the no-action letters, many companies decide that they need an active dealer/manager to solicit exchanges and therefore select another form of exchange offer.

» **Section 4(2) exchange offer**: The second option is to conduct the exchange offer on a private placement basis, limiting offerees to accredited investors, such as large institutional investors, and non-U.S. persons. One of the principal limitations of a private placement is that no "general solicitation" is permitted, so that an offering document cannot simply be mailed to all holders; instead holders must pre-qualify through an eligibility

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questionnaire before receiving an offering document. In most exchange offers, we have not found this to be an impediment to significant participation in the offer.

» The most important limitation of a private placement is the difficulty of obtaining an "exit consent." To incent holders to tender, and to avoid the need to comply with covenants in the existing debt that the company is seeking to repurchase through the exchange, companies often solicit "exit consents," where the holders of the old securities are asked to consent to amendments or waivers of covenants or other terms of the old securities as a condition to their acceptance of the offer. Because holders willing to accept the new securities in the exchange offer or holders who are tendering in a tender offer would no longer be concerned about the covenants and other protections provided to holders of the old securities, these solicitations can be very successful. If the consent solicitation is successful, any holders who refuse to accept the offer would continue to hold their old securities with the payment terms intact, but the covenants and other protections in the old securities would be changed or eliminated. Cases applying New York law (the law that governs most indentures) suggest that an exit consent is valid only so long as all holders are given the same opportunity to consent. In a private placement exchange offer with exit consent, non-accredited investors are not permitted to participate. In some exchange offers, companies have launched a stand-alone consent solicitation that is available to all holders, taking the position that in this way, the non-accredited investors have the same opportunity to participate in the consent as other holders.

» **Registered exchange offer:** A company can file an S-4 registration statement with the SEC and register the debt or equity securities being issued to holders. In a registered offer, a dealer/manager can solicit tenders, and all holders can participate. The principal disadvantage is timing: the S-4 must be filed with the SEC and is subject to SEC review, which can be lengthy. Even though the issuer may have an existing "shelf" registration statement on Form S-3, or be a well-known seasoned issuer eligible for automatic effectiveness of an S-3 shelf, a registered exchange offer must be done on Form S-4 and cannot use an existing or new S-3 shelf. In addition, companies are subject to heighted liability standards under the Securities Act of 1933 in the context of a registered offering.

Strategies for Enticing Owners to Accept a Tender Offer or an Exchange Offer

Usually, some holders do not accept a tender offer or exchange offer, either because they are not willing to agree to the terms or because they cannot be found. To discourage holdouts, companies usually require, as a condition to accepting securities tendered, that a substantial percentage of the outstanding securities must be tendered.

Companies also frequently include incentives to encourage holders to accept the offer. The key to a successful offer is, in the case of a tender offer, to make the option of holding on to the outstanding debt securities less attractive than tendering, and in the case of an exchange offer, to make the new securities more attractive than the old securities. To accomplish this, companies often solicit "exit consents" simultaneously with the offer. For example, the company might propose amendments that would cause the old securities to become more junior in the capital structure. If the consent solicitation is successful, any holders who refuse to accept the offer would continue to hold their old securities with the payment terms intact, but the covenants and other protections in the old securities would be changed or eliminated.

Another strategy is to create an incentive for holders to tender early. Because the Exchange Act's "best price" rule does not apply to tender and exchange offers for straight debt securities, the company can establish an early tender payment or early consent payment for debt securities tendered early in the tender offer period as a means of encouraging holders to tender their debt securities early during the offer period.

Companies may also encourage acceptance of the exchange offer by providing separate cash payments or terms for the new securities that are better for the holders than the terms of the old securities. For example, the company might offer to

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exchange an outstanding high coupon, junior debt security for a lower coupon but more senior and perhaps secured or guaranteed debt instrument, if covenants contained in its other debt agreements will permit (or amendments can be obtained to permit) such an exchange.

A natural result of a successful offer is a more limited trading market for the old securities that remain outstanding. This lack of liquidity and its likely adverse impact on the trading prices for the old securities may also encourage holders to accept the offer.

Tax Implications of Debt Buybacks and Exchanges

Companies also need to consider the tax consequences of debt buybacks and exchange offers. Although the exact tax consequences depend on the specific facts of the transaction (for example, special rules can apply if the company is "insolvent" for tax purposes), the following are typically the tax consequences that result from a debt buyback or exchange offer:

- If a company (or a related party) buys back the company's debt at a discount, the company will generally recognize "cancellation of indebtedness" ("COI") income in an amount equal to such discount.
- In the case of a debt-for-debt exchange involving publicly traded debt, the company will generally recognize COI income equal to the excess of the amount owed on the outstanding debt over the fair market value of the newly issued debt.
  - If the fair market value of the new debt is less than its principal amount, the newly issued debt will generally be considered to have been issued with original issue discount equal to such difference, which holders of the newly issued debt will be required to include in income, and the company will be entitled to deduct (subject to certain limitations) over the term of the debt.
- In the case of a stock-for-debt exchange, the company will generally recognize COI income equal to the excess of the amount owed on the outstanding debt over the fair market value of the stock delivered in the exchange.

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If you have any questions regarding this memorandum, please contact any of the lawyers listed below or your regular Davis Polk contact.

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