

Restructuring Debt Securities: Options and Legal Considerations

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Introduction

The coronavirus (COVID-19) is having an extreme impact on global markets, and has led to a dramatic widening of credit spreads and tightening in the credit markets. While this market upheaval is limiting refinancing options for companies with outstanding debt securities, declining secondary market prices for debt securities also present 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 thereby reduce the related interest costs. This memorandum outlines some key considerations for companies contemplating restructuring their outstanding debt securities.¹

Summary of restructuring options

A company that decides to restructure its outstanding debt securities can do so with or without the use of cash. 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 for cash. 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. In either case, for a financially distressed company the redemption price 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, potentially 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 all of its outstanding debt. In many situations, covenants in bank or other debt agreements restrict the company's ability to restructure its debt securities. Typical restrictions include the following:

¹ This memorandum addresses restructuring options outside of bankruptcy proceedings for straight (*i.e.*, non-convertible) debt securities. There will be additional legal considerations that apply to any restructuring of convertible debt securities and equity securities, and bankruptcy proceedings will result in a different framework for restructuring debt securities.

- In the case of a repayment or redemption of existing debt securities for cash, existing bank or other debt agreements may limit a company's ability to repay other debt securities prior to their maturity. These covenants may limit repayment of debt that is junior (whether in terms of payment or lien priority) to the debt outstanding under the relevant bank or other debt agreement.
- In the case of an exchange offer involving the issuance of new debt securities, restrictions on incurring debt and liens must be carefully analyzed to determine whether the newly issued debt is permitted. Typically refinancing indebtedness will be permitted, but the specific conditions for permitted refinancing indebtedness may not be met depending on the terms of the new debt securities and the exchange offer. For example, the new debt securities may not constitute permitted refinancing indebtedness if they have a shorter maturity, or if they are effectively senior to, the existing debt securities the subject of the exchange offer (e.g., because they have the benefit of collateral that does not secure, or that has higher priority to the collateral securing, the existing debt securities being exchanged).

Waivers of these types of covenants may not be available while the company is in financial distress. In most situations, there will be some limited exceptions to these types of restrictions, and the company will need to ensure that the terms of any proposed restructuring fit within those limited exceptions.

Cash purchases and tender offers

Cash 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**). Among other things, a cash tender offer will need to 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, as discussed in more detail below.²

There is no U.S. rule that specifically regulates the form of, or content required in, any offering materials used in the tender offer. In addition, assuming that consideration in the tender offer would be cash only, no offering document needs to be filed with the SEC. However, preparation of an offer to purchase document is customary, and that document must be materially accurate to avoid liability under U.S. federal securities law (as purchases of securities are subject to Rule 10b-5 under the Exchange Act, as discussed below).

Cash purchases

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, the company should work with legal counsel to carefully structure repurchases

² Tender or exchange offers for straight debt securities that are open to all holders may be able to take advantage of the five business day abbreviated tender offer rules, as discussed below.

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, 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 penalties.

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 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 of 1933, as amended (the **Securities Act**), and thus must be registered under 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 below.

There is no U.S. rule that specifically regulates the form of, or content required in, any offering materials used in the exchange offer for straight debt securities. However, 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 from the company’s auditors as well as customary legal opinions, including so-called “10b-5 letters.”

There are generally three options for conducting an exchange offer, namely exempt exchange offers under Section 3(a)(9), exempt exchange offers on a private placement basis under Section 4(a)(2), and SEC-registered exchange offers, each as described in more detail below.

Exempt exchange offers under Section 3(a)(9)

Section 3(a)(9) of the Securities Act permits a company to issue securities solely in exchange for existing securities without registration under the Securities Act. The securities issued in the exchange offer will

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.

have the same restrictions on transferability, if any, as the existing debt securities for which they are exchanged.

The principal disadvantage of this type of exchange offer is that Section 3(a)(9) does not permit the company to 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 security holders, 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.

Private exchange offers under Section 4(a)(2)

The second option is to conduct the exchange offer on a private placement basis under Section 4(a)(2) of the Securities Act, which requires limiting offerees to accredited investors (such as large institutional investors) and non-U.S. persons. One of the principal limitations of this alternative is that no “general solicitation” is permitted, so that an offering document cannot simply be provided to all holders. Instead, holders must pre-qualify through an eligibility questionnaire or certification 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 can be the difficulty of obtaining an “exit consent.” To incentivize 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,” whereby 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, and 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 and the company receives consents in excess of the applicable threshold required under the terms of the existing debt securities, 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.

Many indentures include “payment for consent” provisions that require any consideration offered to holders in connection with a consent be offered to all holders of the existing debt securities. In a private placement exchange offer with an exit consent, non-accredited investors are not permitted to participate and, as a result, the exit consent may violate those provisions. To address this, 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. Alternatively, in some instances companies have sought to address this by offering alternative arrangements to non-accredited investors that allow them to receive a similar economic benefit to that received by holders who are permitted to participate in the exchange offer.

Registered exchange offers

A company can also conduct an exchange offer on a registered basis by filing a Form S-4 registration statement with the SEC to register the debt or equity securities being issued to holders in the exchange. In a registered exchange offer, a dealer manager can solicit tenders, and all holders can participate.

The principal disadvantage is timing. The Form S-4 registration statement must be filed with the SEC and is subject to SEC review, which can be lengthy. Although the company can commence the registered exchange offer prior to receiving SEC clearance, the exchange offer cannot be consummated until the SEC declares the Form S-4 effective, the timing of which is uncertain. Moreover, any material changes

required to the Form S-4 as a result of the SEC's review could potentially require an extension of the exchange offer period beyond the required 20 business days. Even though the company may have an existing "shelf" registration statement on Form S-3, or may be a well-known seasoned issuer eligible for automatic effectiveness of a Form S-3 shelf, a registered exchange offer must be done on Form S-4 and cannot use an existing or new Form S-3 shelf (although if the company is Form S-3 eligible, the company's SEC filings can be incorporated by reference). In addition, companies are subject to heightened liability standards under the Securities Act in the context of a registered exchange offer as compared to exchange offers conducted pursuant to Section 3(a)(9) or Section 4(a)(2) of the Securities Act.

Issues to consider in cash purchases, tender offers and exchange offers

Antifraud provisions

Tender and exchange offers are subject to the antifraud provisions of U.S. federal securities law, including 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.

Cash purchases that are not classified as "tender offers" under the Exchange Act are also subject to Rule 10b-5. However, 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 and 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 (including, for example, the impact of a pandemic such as COVID-19 on previously announced guidance), (b) knowledge of future redemption or restructuring plans, and (c) even simply the knowledge that the company 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. The Southern District of New York decision, *Alexandra Global 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." However, other federal courts are not bound by this decision and could find to the contrary, and 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.

Rules applicable to tender and exchange offers

Tender and exchange offers are also subject to Section 14(e) of the Exchange Act and Regulation 14E adopted thereunder. These rules prohibit fraudulent and manipulative activity, and among other things also 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.

As discussed in our [prior client memorandum](#), the SEC issued a no-action letter in January 2015 allowing the minimum offering period to be shortened to five business days, instead of the 20 business days prescribed by Regulation 14E, for both investment grade and high yield debt securities. To be eligible to conduct a five business day tender offer, the offer must, among other things, be an offer for any and all debt securities of the relevant class, and the consideration must consist only of cash and/or

qualified debt securities (essentially debt securities that are identical in all material respects to the existing debt securities the subject of the offer, other than in respect of maturity, interest rate and payment dates, and redemption provisions).

In addition, a number of market practices have developed that, while not shrinking the 20-business day period, serve to incentivize holders to tender early in the period to provide a company with greater certainty as to the results before the tender offer expires. In particular, 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.

Disclosure requirements

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

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 be tendered.

Companies also frequently include incentives to encourage holders to accept an 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.

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 exchange an outstanding low coupon, junior debt security for a higher coupon, more senior debt instrument with guarantees and/or collateral, 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 describes the typical 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 debt" (**COD**) income in an amount equal to such discount;
- in the case of a debt-for-debt exchange involving publicly traded debt (which is broadly defined for this purpose), the company will generally recognize COD 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; and
- in the case of a stock-for-debt exchange, the company will generally recognize COD 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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