Restructuring Debt Securities: Options and Legal Considerations

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Introduction

While the current worldwide economic slowdown and credit crunch have limited refinancing options for companies which 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 which 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 publicly held debt can be redeemed. Redemption may be an unattractive option though, because the redemption price generally is at a premium to the face amount (which, for a financially distressed company, will likely exceed the market value). Another obstacle may be covenants in bank or other debt agreements that 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.

» ***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 from the face amounts.

» ***Cash tender offer***: In a cash tender offer, the company makes a public offer to purchase some or all of its outstanding debt securities.

» ***Exchange offer***: A company which 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 for the outstanding debt securities.

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[1] This memo assumes the restructuring of non-convertible debt securities that were originally offered under Rule 144A/Regulation S by a non-reporting foreign private issuer, and that any restructuring would involve U.S. holders and therefore implicate U.S. securities law. The discussion on exchange offers also assumes that any new securities offered in exchange for the original securities are also debt securities. Under different circumstances, there may be additional legal considerations.

[2] This memo does not discuss bankruptcy alternatives.

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 U.S. Securities Exchange Act of 1933, 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. These purchases would generally not be classified as "tender offers" under the Exchange Act. However, because U.S. federal securities law does not define the term "tender offer" and there is a great deal of case law and SEC commentary on this topic, companies should work with legal counsel to carefully structure repurchases so as to ascertain whether or not their repurchase plan will be classified as a tender offer.[3] In general, a company wishing to avoid its repurchase plan being classified as a tender offer would:

» solicit a limited number of holders, preferably sophisticated investors, so as to avoid characterization as 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 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, which 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. As a result, a company engaging in a cash purchases should ensure that any material information about the company has been publicly disclosed prior to engaging in such purchases.

Tender and exchange offers for straight debt securities are subject to the tender offer rules in Regulation 14E under the Exchange Act.[4] Regulation 14E prohibits purchases and sales based on material, non-public information and requires 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, consideration offered or a dealer's soliciting fee. However, the SEC has

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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.

[4] Note that exemptions from some of these rules are available if U.S. residents represent 10% or less of holders of the outstanding debt securities (Tier I) or more than 10% but not more than 40% of holders of the outstanding debt securities (Tier II). As these exemptions require detailed calculation and analyses, please consult with counsel to determine eligibility.

issued no-action letters exempting certain tender offers from the minimum offering period requirements. The company must also comply with the anti-fraud and anti-manipulation provisions promulgated under Section 14(e) as well as Rule 10b-5. There is no U.S. rule, however, that specifically regulates the content required in any offering materials used in the tender offer. Furthermore, assuming that the consideration in the tender offer would be cash only and that the company's securities are not registered under the Exchange Act, no filing of any offering document need be made with the SEC in connection with the proposed tender offer. Companies should consult with counsel when structuring a repurchase plan to ensure that the plan complies with the applicable rules.

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 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 unless an exemption from registration is available. Exchange offers are also subject to the tender offer rules under the Exchange Act, as discussed above.

Contractual Restrictions on Debt Repurchases

When considering a cash purchase, tender offer or exchange offer for debt securities, a company must consider whether such a transaction will cause a default under or otherwise breach its other contractual obligations. For example, if the company has any senior debt securities, repurchases of subordinate debt will likely constitute a "restricted payment" under the terms of such securities. Moreover, if the company has any outstanding bank debt, the credit agreement might prohibit or limit the repurchase of any other debt. Companies should conduct due diligence and consult with legal counsel to ensure that its debt restructuring program will not conflict with any of its other agreements.

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

There will frequently be holders who 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 that a substantial percentage (typically 90% or more) of the outstanding securities must accept an exchange offer, although in a tender offer with exit consents (see below), the required percentage may be lower.

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, so holders are willing to accept the new securities. To accomplish this, companies often solicit "exit consents" simultaneously with the offer, 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. For example, the company might propose amendments that would cause the old securities to become more junior in the capital structure. These covenants can usually be amended with the approval of holders of either a majority or two-thirds of the old securities. 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.

Another strategy is to structure proration rights to create an incentive for holders to tender early. Because the Exchange Act's tender offer rules do not require the company to offer any proration rights in an offer for debt securities, the company can establish a date after which old securities tendered will not be prorated. If the offer is oversubscribed before the end of the proration period, any old securities tendered after the proration period will not be purchased, although the offer remains open for the minimum 20 business days. If the minimum amount sought is not obtained before the end of the proration period, all old securities tendered before the expiration of the proration period will be accepted in full and any securities tendered thereafter will be accepted on a first-come, first-served basis. Similarly, because the "best price" rule does not apply to tender and exchange offers for straight debt securities, the company can establish offer prices for the debt securities that decline over time 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 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 encourage holders to accept the offer.

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If you have any questions regarding this memorandum, please call your Davis Polk contact.