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News Bulletin

March 5, 2009

Liability Management: Is Now the Time to Rebalance Your Balance Sheet?

We really do live in interesting times. Over the last two years, most Americans have come to reduce or defer personal expenditures of one kind or another. Homeowners are sharply focused on the burden of mortgage payments, and record numbers of leased automobiles are showing up back at the dealerships. In short, Americans are rethinking and restructuring their personal balance sheets. Some by choice and others out of necessity. It's essentially the same for issuers. Thinking hard about balance sheet restructuring has become an imperative for a large proportion of issuers in the United States. The following discussion highlights a number of balance sheet restructuring approaches on which issuers currently are focused.

Repurchases for cash

- Redemptions – a purchase of outstanding debt securities for cash in accordance with the terms of the security;
- Repurchases – opportunistic repurchases of debt securities for cash, including privately negotiated and open market repurchases; and
- Tender offers – an offer made to all bondholders to repurchase outstanding debt securities for cash.

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Tenders not involving cash

- Exchange offers, including:
- Private exchange offers – unregistered debt for debt exchanges pursuant to Section 4(2) usually made to qualified institutional buyers ("QIBs") as defined under Rule 144A under the Securities Act of 1933, as amended (the "Securities Act") and non-U.S. persons under Regulation S;
- Section 3(a)(9) exempt exchange offers – exempt debt for debt exchanges; and
- Registered exchange offers – public debt for debt exchanges registered with the Securities and Exchange Commission ("SEC") and subject to the tender offer rules.

One-off exchanges

- Exchanges involving non-debt securities – exchanges of securities that are subject to the tender offer rules.

We also discuss related matters such as consent solicitations, both on a standalone basis and as "exit consents" in connection with an exchange offer.

Why consider repurchases, exchanges or tenders?

New business and market realities. With the prolonged financial crisis resulting in market volatility, declining stock prices, ratings downgrades, asset write downs and modified earnings projections, this is the time for an issuery to recalibrate its debt/equity mix.

Deleveraging efficiently. Many debt securities and hybrids are trading at significant discounts. An issuer may be able to effect an efficient repurchase/tender given market conditions—optimize its balance sheet, reduce its interest expense, etc.

Tax considerations. Recent changes to the tax laws facilitate the repurchase of debt securities.

Investor perceptions. Investors may be more willing to consider exchange and restructuring opportunities. Investors may seek liquidity or appreciate the opportunity to move up in the capital structure.

Tax considerations

Each restructuring transaction we discuss herein may have federal income tax consequences. We discuss below the general tax considerations applicable to these transactions as well as provide a more specific discussion of the tax consequences for each transaction.

Issuers

Central to the tax considerations for an issuer restructuring its debt is the potential recognition of cancellation-of-indebtedness ("COD") income. Under the Internal Revenue Code (the "Code"), taxpayers with outstanding debt are often subject to tax on COD income when all or a portion of such debt has been economically cancelled unless special exceptions apply (for example, in the event of bankruptcy or insolvency of the taxpayer). In addition, corporations that issue obligations with original issue discount ("OID") as part of their restructuring also must consider potential limitations on the deductibility of such discount. For corporations that issue certain high-yield obligations with significant OID ("AHYDOs"), a portion of such discount is treated as a nondeductible dividend under Section 163(e)(5) of the Code, while the remaining discount may not be deducted until actually paid.

Issuers should be aware that the American Recovery and Reinvestment Act of 2009 (the "Recovery Act"), signed into law on February 17, 2009, provides temporary relief from these COD and AHYDO rules. Generally, these provisions should make the refinancing and restructuring of existing corporate debt more attractive.

With respect to COD income, at the election of the taxpayer the Recovery Act defers the recognition of such income in connection with certain repurchases, modifications, and exchanges (referred to as "reacquisitions") of debt instruments after December 31, 2008 and before January 1, 2011. For reacquisitions in 2009, the deferral is five years; for reacquisitions in 2010, the deferral is four years. At the end of the deferral period, the taxpayer must include the COD income ratably over the next five years. Among other things, the deferral applies only to the debt of C corporations, and in the case of all other taxpayers, trade or business debts. Original issue discount on certain new debt instruments issued as part of, or in connection with, the reacquisition will not be deductible during the deferral period but will be deductible during the period in which deferred COD income is recognized. The death of, liquidation of, or other similar event with respect to a taxpayer will accelerate deferred COD income. If a taxpayer elects deferral, other possible exceptions to COD income in the Code may be unavailable. Special rules apply to pass-through entities, such as partnerships.

With respect to the AHYDO provisions, the Recovery Act suspends these rules for AHYDOs issued in exchange for non-AHYDOs of the same corporation between August 31, 2008 and January 1, 2010. The Recovery Act grants the Treasury the authority to extend the suspension and also expands the Treasury's ability to adjust the base rates used to determine whether an instrument is an AHYDO. The suspension does not apply to certain obligations with contingent interest determined, among other things, by reference to the income, value or dividends of the debtor (or a related person), nor does the suspension apply to obligations issued to related persons.

Debtholders

In part, the tax consequences to debtholders depend on whether the restructuring constitutes a "recapitalization" within the meaning of Section 368(a)(1)(E) of the Code. Generally, debt exchanges involving debt securities with terms longer than five years will qualify as recapitalizations. On the other hand, a repurchase of debt securities will result in gain or loss to the debtholder equal to the difference between the amount of cash received and the holder's adjusted tax basis in the debt security. If the holder acquired the debt security with market discount, a portion of any gain may be characterized as ordinary income.

Repurchases for Cash

Redemptions

An issuer may redeem its outstanding debt securities in accordance with their terms, assuming that the debt securities do not prohibit redemption. A credit line may prohibit prepayment; the debt securities may have absolute call protection and may not be redeemable. An issuer also may find that other debt securities have limited call protection, and may be redeemable following expiration of a certain period of time after issuance, often five or ten years. Specific kinds of debt securities also may be more or less likely to contain redemption provisions – for instance, zero coupon bonds generally are not by their terms redeemable.

Contractual and other approvals

Prior to deciding to redeem outstanding debt securities, an issuer must ensure that the redemption is permitted, not just under the terms of the debt security in question, but also under the issuer's other debt instruments. Many credit agreements limit an issuer's ability to redeem other outstanding debt. The usual areas of concern include definitions of, and restrictions on, "permitted indebtedness," "permitted refinancings," "permitted liens" and "restricted payments," as well as covenants regarding incurrence of indebtedness. An issuer should review carefully its existing debt instruments to ensure that a redemption is permitted and that a redemption would not trigger repayment obligations. There also may be other, non-financial agreements, such as lease agreements or even acquisition agreements, that may affect an issuer's ability to redeem its securities. In addition, redemption may require prior approval by the issuer's board of directors.

The process for redeeming an outstanding debt security is spelled out in the instrument governing the debt security, usually the indenture. Typically, an issuer must give holders not more than 60 and not less than 30 days' prior notice of redemption. This notice also may require that the issuer include other information, such as the redemption price, the redemption date, and identify the securities (if not all) which are being selected for redemption. If not all of the securities are being redeemed, the securities will be redeemed either on a pro rata basis or by lot; the process usually is determined by the trustee.

The terms of the debt securities, which were negotiated at the time of issuance, usually will specify the redemption price. The redemption price typically will reflect the holders' "yield to maturity" on the outstanding debt securities and debtholders will be made whole. The price typically will equal the face amount of the debt security, plus the present value of future interest payments. The effect of this is that the debt securities will be redeemed at a premium. For issuers with limited cash on hand, redemption may not be a viable option. In addition, as we discuss above, an issuer is required to provide at least 30 days' prior notice of redemption. If the issuer announces a redemption on fixed rate debt securities, it runs the risk that the proceeds it intends to use for the redemption, which at the time the notice was issued were at a lower cost, may have increased, and may even increase above the redemption cost.

Disclosure and other considerations

In connection with any redemption of outstanding debt securities, an issuer also must ensure that it has complied with securities law antifraud provisions. In particular, if in the offering documents an issuer has not adequately disclosed, for instance, that a specific series of debt securities may be redeemed, the issuer may be liable under Rule 10b-5 of the Securities Exchange Act of 1934, as amended (the "Exchange Act") for material misstatements or omissions in the prospectus as they relate to the redemption.[1]

As we discuss above, the terms of the indenture typically will require the issuer to distribute a redemption notice. In connection with delivery of this notice, an issuer often will announce via press release that it has decided to redeem the debt securities in accordance with their terms. An issuer should publicly disclose a redemption, to the extent that its broader impact on an issuer's financial condition would be viewed as material, prior to contacting debtholders. We discuss disclosure considerations below.

Privately negotiated and open market debt repurchases

An issuer that has cash, or can obtain it quickly, may determine that a privately negotiated or open market repurchase (or repurchases) of its debt securities is an efficient use of capital. In the context of a debt repurchase, an issuer also will need to review the terms of all of its outstanding debt instruments and other securities to determine that repurchases are permissible. The terms of the indenture will not dictate the purchase price payable by an issuer in connection with repurchases. As a result, an issuer may (and should) negotiate the purchase price with securityholders in order to achieve the best possible pricing.

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[1] *Harris v. Union Electric Co.,* 787 F. 2s 355 (8th Cir. 1986), *cert. denied,* 479 U.S. 823 (1986).

How to choose among the various options?

Legal, accounting, ratings, regulatory capital and tax considerations should all be factored into the choice.

Cash? If the issuer has cash on hand, open market repurchases or a tender will be possible.

No cash? If the issuer does not have cash on hand, or a repurchase would not be considered a prudent use of resources, an issuer should consider an exchange.

Holders? The issuer will have to consider whether the securities are widely held and the status (retail versus institutional) of the holders.

Buying back a whole class of debt securities? Open market repurchases will provide only selective or limited relief. A tender may be necessary to buy all of a class of outstanding bonds.

Straight debt? Convertible debt? Hybrid? The issuer's options will depend on the structure of the outstanding security. A repurchase/tender for straight debt typically will be more streamlined.

Tender? Again, the structure and rating of the outstanding security will drive whether the issuer can conduct a fixed spread or fixed price offer.

Covenants. Is the issuer concerned about ongoing covenants as well as de-leveraging?

Part of a broader effort? The issuer should consider whether a buyback is only a precursor to a restructuring or recapitalization or whether an exchange offer/tender is only one element of a bigger process. The issuer should keep the bigger picture in mind.

Mix and match? Well, not really. It may be possible to structure a variety of transactions. However, an issuer should be careful to structure any liability management transactions carefully. Open market repurchases in contemplation of a tender may be problematic.

Benefits of a debt repurchase

Repurchases may be conducted with little advance preparation, they require limited or no documentation and generally can be conducted for little cost to the issuer (outside of the purchase price). Privately negotiated and open market purchases usually are most effective if the issuer is seeking only to repurchase a small percentage of an outstanding series of debt securities, or if the class of debt securities is held by a limited number of holders. Repurchases may be conducted in a number of different ways – the issuer may negotiate the purchase price directly with securityholders; the issuer may purchase the debt securities on the secondary market; the issuer may engage a financial intermediary to identify holders, negotiate with holders and repurchase the debt securities; or the issuer may agree with a financial intermediary to repurchase debt securities that the financial intermediary purchases on a principal basis. If the issuer's debt securities are trading at a discount, a repurchase will be efficient. An issuer that repurchases its debt securities at a discount and cancels the debt securities will be able to improve its overall capital position. For a financial institution, the issuer may be able to increase its Tier 1 capital levels by doing so.

An issuer often may engage a financial intermediary to effect open market repurchases. This entity usually will be the same entity that acted as an underwriter for the initial issuance of the debt securities because the investment bank's sales force will have better knowledge regarding the secondary market for the issuer's debt securities, including the most appropriate pricing. The financial intermediary will be able to contact holders and easily negotiate the terms of the transaction.

Regulation FD

In connection with a privately negotiated or open market repurchase, an issuer needs to ensure that it complies with all applicable laws, including those enacted under the Securities Act and the Exchange Act. Among other things, these rules and regulations affect the information that an issuer must provide to its securityholders in connection with debt repurchases.

Private negotiations with creditors, including debtholders, can trigger disclosure or other obligations under Regulation FD. In particular, concerns may arise when an issuer conducts discussions with one or more bondholder or lender groups to "test the waters" with respect to a particular repurchase plan. Regulation FD provides, subject to certain exceptions, that whenever an issuer, or any person acting on its behalf, such as a financial adviser, discloses any material nonpublic information regarding that issuer or its securities to market professionals or holders of the issuer's securities who may trade on the basis of such information, the issuer shall make public disclosure of that information either simultaneously, in the case of an intentional disclosure, or "promptly," in the case of a non-intentional disclosure. In the context of privately negotiated repurchases, the fact that an issuer is conducting these repurchases may be considered material nonpublic information in and of itself. A repurchase that is part of a restructuring, because of its broader impact on an issuer's financial condition and in many circumstances, its ability to operate, may be viewed as material. Disclosure of the repurchases to a debtholder may trigger a disclosure obligation on the issuer's part. However, the issuer may avoid the obligation to disclose such information if the person that receives the information is either under a duty of trust or confidentiality or such person expressly agrees to keep the information confidential. An issuer should consider whether to use a confidentiality agreement.

An issuer also should consider when it will disclose information regarding a repurchase to the public. If the issuer engages in private repurchases over time, it may not be appropriate to disclose each repurchase until the process ends. Similarly, negotiations over the terms of a restructuring (including a tender or exchange offer) may take time or may ultimately be fruitless. In those cases, debtholders may object to being kept out of the market for such an extended time, and may negotiate a specific time or event by which disclosure must be made public by the issuer or a determination made that the information is no longer material or current for any reason, including because of the occurrence of superseding events.

An issuer should consider the benefits of disclosing either in general terms or specific terms its restructuring goals, and giving up some negotiating flexibility for disclosure protection. The issuer may consider announcing the debt restructuring program (if there is a program, as opposed to opportunistic repurchases) with a press release and file the release as an exhibit to a Current Report on Form 8-K. The issuer may disclose its intentions in a periodic report, such as in its Annual Report on Form 10-K or a Quarterly Report on Form 10-Q. However, this may raise concerns about a "tender," which we discuss below. The disclosure need not be very detailed and may simply state that the issuer will repurchase its debt securities in the open market or in privately negotiated transactions if market conditions warrant. More specific disclosure may be problematic.

An issuer also should take care to avoid entering into discussions with debtholders that may rise to the level of an "offer" under the securities laws. If this occurs, the "offer" must: qualify as a bona fide private offer; be registered with the SEC, or be exempt from the registration requirements of the Securities Act by virtue of Section 3(a)(9).

Prior public disclosure

To avoid violating the antifraud provisions of the federal securities laws, particularly Rule 10b-5 under the Exchange Act, by purchasing a security and/or issuing a security at a time when the issuer has not disclosed material nonpublic information, whether or not related to the repurchase, the issuer should plan to disclose all material nonpublic information in advance. Examples of material information include unreleased earnings or an unannounced merger, both of which may need to be disclosed before purchasing securities from a debtholder. This can usually be done in an Annual Report on Form 10-K or a Quarterly Report on Form 10-Q but may also be accomplished by filing a Current Report on Form 8-K. In addition, if an issuer engages in privately negotiated or open market repurchases in advance of conducting a tender offer, it may be considered manipulative – the issuer will have prior knowledge of its intention to commence a tender that it did not disclose to holders from whom it is purchasing.

Regulation M and other considerations

Although Regulation M does not apply to investment grade non-convertible debt securities, it does apply to equity securities, non-investment grade and convertible debt securities. An issuer that is engaged in a distribution while effecting a repurchase program must ensure that it complies with Regulation M. Rule 102 under Regulation M makes it unlawful for an issuer or its affiliates "to bid for, purchase, or attempt to induce any person to bid for or purchase, a covered security during the applicable restricted period." This prohibition is intended to prevent an issuer from manipulating the price of its securities when the issuer is about to commence or is engaged in a distribution. A distribution may be deemed to take place in connection with a proxy mailing. In addition, issues under Regulation M arise when an issuer uses the proceeds from a new offering to repurchase outstanding debt securities. The new offering may be a distribution under Regulation M and any purchases under the buyback may be prohibited. An issue also arises if the debt repurchases are for debt securities that are convertible into the issuer's equity securities. Under certain circumstances, repurchases of convertible debt securities could be deemed a forced conversion and, therefore, a "distribution" of the underlying equity security for purposes of Regulation M.

Avoiding the tender offer rules

An issuer repurchasing its debt securities, either in privately negotiated transactions or in open market purchases runs the risk that it may inadvertently trigger the tender offer rules. The tender offer rules were adopted to ensure that issuers, and others, tendering for equity securities would be prohibited from engaging in manipulative practices in respect of those tenders. With equity securities, in particular, the market price is subject to manipulation as it fluctuates based on market pressures. However, debt securities are not subject to the same considerations as equity securities and therefore, a debt tender poses less risk than one for equity. For a debt tender, it is possible to structure the purchases to avoid the application of these rules.

Section 14(e) of the Exchange Act does not define "tender offer." Without a clear definition from the SEC, courts have provided a set of eight factors to help differentiate between a tender offer and other public solicitations. The eight-part test (and the case implementing that test) involved equity securities. It is likely, though, that any discussion on debt securities and tender offers would begin with the eight characteristics listed below. An issuer considering an open market or privately negotiated repurchase of its debt securities should review carefully the impact of the eight factors and structure the transaction to avoid the tender offer rules. Courts have found the following eight characteristics typical of a tender offer:

(1) active and widespread solicitation of public shareholders for the shares of an issuer;

(2) solicitation is made for a substantial percentage of the issuer's stock;

(3) offer to purchase is made at a premium over the prevailing market price;

(4) terms of the offer are firm rather than negotiable;

(5) offer is contingent on the tender of a fixed number of shares, often subject to a fixed maximum number to be purchased;

(6) offer is open only for a limited period of time;

(7) offeree is subjected to pressure to sell his stock; and

(8) public announcements of a purchasing program concerning the target issuer precede or accompany a rapid accumulation of large amounts of the target issuer's securities.[2]

These elements need not all be present for a transaction to constitute a tender offer, and the weight given to each element varies with the individual facts and circumstances.[3] To ensure that a debt repurchase does not trigger application of these rules, it should be made for a limited amount of securities and to a limited number of holders, preferably sophisticated investors, should be made over an extended period of time (with no pressure for holders to sell), and prices should be privately, and individually, negotiated with each holder, with offers that are independent of one another.

How can an issuer benefit from a repurchase or exchange of debt securities?

- Perception. A buy back may signal that an issuer has a positive outlook.
- Deleveraging.
- Recording of accounting gains if securities are repurchased at a discount to par. The issuer will have to consider the structure of its buyback, exchange or tender.
- Reducing interest expense.
- Potential EPS improvement.
- Potential regulatory and ratings benefits.
- Alternative to more fundamental restructuring or potential bankruptcy.

Debt tenders

In some cases, privately negotiated or open market repurchases of debt securities may not provide an issuer with the desired results, particularly if the issuer wishes to retire all or a significant portion of a series or class of outstanding debt securities. Privately negotiated or open market purchases may not be efficient for an issuer if the debt securities are widely held or the issuer plans a simultaneous consent solicitation. In those situations, a tender offer may be the most appropriate way to restructure the indebtedness. A tender offer allows an issuer to approach or make an offer to all of the holders of a series of its debt securities. Because tender offers do not have to close until specified (and disclosed) conditions are satisfied (including receipt of consents from the debtholders to modify the terms of the debt securities that remain outstanding, completion of any necessary financing for the tender offer and receipt of other necessary consents from third parties), it may be possible to conduct a tender offer and achieve the issuer's objectives.

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[2] *Wellman v. Dickinson*, 475 F. Supp. 783, 823–24 (S.D.N.Y. 1979).
[3] For example, an open-market purchase of 25% of an issuer's stock was held not to constitute a tender offer because: (1) the purchaser contacted only six of the 22,800 securityholders; (2) all six of those securityholders were highly sophisticated; (3) the purchasers did not pressure the securityholders in any way that the tender offer rules were designed to prevent; (4) the purchasers did not publicize the offer; (5) the purchasers did not pay a significant premium; (6) the purchasers did not require a minimum number of shares or percentage of stock; and (7) the purchasers did not set a time limit for the offer. *Hanson Trust PLC v. SMC Corp.*, 774 F. 2d 47, 57–59 (2d. Cir. 1985).

Cash tenders for straight debt securities

Cash tender offers for straight debt securities may be completed more quickly and at a lower cost than other tenders because of the absence of specific disclosure or structuring requirements. In a cash tender for straight debt securities, an issuer typically will mail tender offer materials to holders describing the terms of the offer and providing them with material information. An issuer often will announce the commencement of a tender offer in a press release, and may even supplement that announcement by publishing notice of the tender in a nationally circulated newspaper.

Certain rules apply to tender offers. These rules were adopted in 1968 and are referred to collectively as the Williams Act. Regulation 14E and Rules 14e-1, 14e-2 and 14e-3 under the Exchange Act apply to all tender offers – both equity and debt. These rules do not apply to tenders or exchanges of securities that are exempt securities under Section 3(a) of the Securities Act. In addition, the SEC has provided no-action guidance that limits the applicability of some of these rules to tenders of investment grade debt securities. If the tender involves equity securities (which for purposes of the tender offer rules includes debt securities with equity components, such as convertible or exchangeable notes) additional rules apply. We discuss these rules below under "Cash tenders for convertible debt securities."

Rule 14e-1 sets forth certain requirements for tender offers generally.

- **Offer Period** – Rule 14e-1 provides that a tender offer must generally be held open for at least 20 business days from the date the tender offer commences.[4] The offer must also stay open for at least ten business days from the date of a notice of an increase or decrease in: (1) the percentage of securities to be acquired pursuant to the tender (if the change exceeds two percent of the original amount); (2) the consideration offered, without any *de minimis* exception; or (3) any dealer-manager's solicitation fee, is first published or sent to the holders of the relevant securities. A tender offer subject only to Regulation 14E must remain open for a minimum of five business days for any other material change to the offer or waiver of a material condition.[5]

- **Extension of Offering Period** – Rule 14e-1 also provides that any extension of the offer period must be made by a press release or other public announcement by 9:00 a.m. Eastern time, on the next business day after the scheduled expiration date of the offer, and the press release or other announcement must disclose the approximate number of securities tendered to date.[6]

- **Prompt Payment** – The offeror must either pay the consideration offered or return the securities tendered promptly after termination or withdrawal, respectively, of the offer.

Under Regulation 14E, an issuer is not required to file tender offer documents with the SEC and the rules do not prescribe any form requirements. Any offer to purchase, and other tender offer documentation, is subject to the general antifraud provisions of the Exchange Act, notably Rule 10b-5 and Section 14(e), and, therefore, may not contain any material misstatement or omission.

While a cash tender for straight debt securities can be a relatively straightforward transaction, if a cash tender is combined with a consent solicitation, the process may become more complicated. Further, because cash tender offers for straight debt securities are not subject to the "best price" rules applicable to equity tender offers (discussed below), it is common practice to encourage participation in the tender by providing for an "early tender premium." Holders that tender early in the offering period, typically within the first ten business days, may receive the "total consideration." Holders that tender after the early tender period terminates will receive lesser consideration for their securities. The early tender feature benefits the issuer because it may have greater visibility regarding the success of the tender offer. An issuer needs to be mindful that the falling away of the "premium"

[4] The date on which the tender offer is first published or sent or given to the holders of the relevant securities is the first business day.
[5] *See*, SEC Release No. 34-42055 (Oct. 22, 1999), *available at* http://www.sec.gov/rules/final/33-7760.htm.
[6] If the securities are registered on one or more national securities exchange, the announcement must be made by the first opening of any one of such exchanges on the business day following expiration.

may, under in certain circumstances, constitute a change in consideration that may require that the tender stay open for an additional ten days as discussed above.

Rule 14e-1 does not specifically require withdrawal rights. However, it is standard practice to provide holders with withdrawal rights for tender offers for straight debt securities. These withdrawal rights typically expire after an initial period, often after the first ten business days. An issuer also should consider whether it should reinstate limited withdrawal rights following the occurrence of any material change in the terms of the tender offer or the waiver of a material condition.

Rule 14e-2 requires that the issuer subject to a tender offer disclose to its securityholders its position with respect to the bidder's tender – whether it recommends it, expresses no opinion or is unable to take a position. Interestingly, Rule 14e-2 does not contain an explicit exemption for issuer tenders, though the subject issuer and the bidder would be the same entity. It is common for an issuer to include in its tender offer materials a statement that the issuer makes no recommendation as to the tender.

Rule 14e-3 contains an antifraud prohibition on activities of a person conducting a tender offer. If such person is in possession of material nonpublic information that he knows or has reason to know is nonpublic and knows or has reason to know was acquired from the offering person, the issuer or any of its directors, officers or employees, it is unlawful for that person to purchase or sell or cause to be purchased or sold any of the securities being tendered for. In the case of an issuer tender, an issuer must be careful not to conduct a tender at a time when it possesses material nonpublic information. This information may include unreleased earnings, a potential change in an issuer's credit ratings or an unannounced merger. The issuer should, to avoid any issues, disclose this information prior to commencing a tender offer.

Pricing considerations

Typically, in its tender offer documents, an issuer will specify the amount of securities it is seeking to purchase, as well as the price at which it will purchase these securities (or the method, as we discuss below, of calculating the purchase price). However, in some cases, an issuer may specify the amount of securities to be tendered, but may set the price using a modified "Dutch auction" pricing structure. In this structure, the issuer sets a cascading range of prices at which a holder may tender its securities. The purchase price will be the highest price at which the issuer is able to buy all of the securities for which it has solicited a tender (or a smaller amount, if not all the securities are tendered). This price is often referred to the "clearing price." The SEC has permitted tender offers to proceed without the issuer disclosing this range in the tender offer documents, so long as the aggregate amount of securities to be purchased is disclosed (and the range of securities to be purchased if the offer were fully subscribed).[7] Usually the permitted price range is very narrow – often no more than 15% of the minimum price.

[7] *See*, SEC No-Action Letter, *Alliance Semiconductor Corporation* (Sep. 22, 2006).

Challenges to consider

Holdouts

The issuer and its advisers should consider how to address potential holdouts—one approach may be to include a high minimum tender or exchange condition (such as 90% or higher).

Timetable

Starting out with a timetable that complies with both contractual deadlines and tender offer rules is key to a successful process.

Bondholder committees

A bondholder committee may be helpful in the context of a broad restructuring or recapitalization. However, the interests of bondholders may not be aligned. For example, the interests of hedge fund holders of convertible debt may not be compatible with the interests of institutional investors that hold straight debt or hybrid securities. Disagreements among committee members can delay or prevent a successful tender or exchange offer.

Cash tenders for investment grade debt securities

The requirements of Regulation 14E may be limiting for an issuer conducting a tender offer. Specifically, if an issuer must keep the offer open for 20 business days or extend the offer period if there are any changes in the consideration or percentage sought, it can adversely affect the tender because the issuer is subject to market risk during this time. Most debt tender offers occur when interest rates are low – the issuer is trying to lower its cost of funds by retiring high interest rate debt securities with the proceeds from new securities issued at a lower rate, or a lower-interest rate credit facility. If interest rates decline during the offer period, an issuer will not retire as much debt and if rates increase, the retired debt will come at a higher price. Longer offer periods translate into increased uncertainty.

Because the SEC staff believes that issuer debt tender offers for cash for any and all non-convertible, investment grade debt securities may present considerations that differ from any and all or partial issuer tenders for a class or series of equity securities or non-investment grade debt, it consistently has granted relief to issuers of investment grade debt in the context of tenders for their debt securities. An issuer need not keep the tender open for 20 business days, provided the following conditions are met:[8]

- Offers to purchase were made for any and all of the investment grade debt, non-convertible debt of a particular series or class;
- The offer is open to all record and beneficial holders of that series or class;
- The offer is conducted so as to afford all record and beneficial holders of that series or class the reasonable opportunity to participate, including dissemination of the offer on an expedited basis in situations where the tender offer is open for a period of less than ten calendar days; and
- The tender offer is not being made in anticipation of or in response to other tender offers for the issuer's securities.

Following these no-action letters, investment grade debt issuers were no longer subject to the ten- and 20-business day requirements. In 1990, the SEC staff expanded this no-action relief for investment grade debt.

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[8] *See*, SEC No-Action Letter, *Salomon Brothers Inc.* (Mar. 12, 1986); SEC No-Action Letter, *Goldman Sachs & Co.* (Mar. 26, 1986); SEC No-Action Letter, *Merrill Lynch, Pierce, Fenner & Smith Inc.* (July 2, 1986).

Salomon Brothers Inc. proposed to conduct an offer wherein the issuer would offer to purchase its debt securities from tendering holders at a price determined on each day during the offer period by reference to a fixed spread over the then - current yield on a specified benchmark U.S. Treasury security determined as of the date, or a date preceding the date, of tender. This is referred to as a "fixed-spread" tender offer. In connection with a fixed spread tender, the SEC staff required that the offer provide that information regarding the benchmark Treasury security will be reported each day in a daily newspaper of national circulation and that all tendering holders of that class will be paid promptly for their tendered securities after the securities are accepted, within the standard settlement period (now, three days).[9]

The SEC followed by expanding again the breadth of the no-action relief for tenders of investment grade debt securities. This relief applies to tenders for investment grade debt securities for which the nominal purchase price would be calculated by reference to a stated fixed spread over the most current yield on a benchmark U.S. Treasury security determined *at the time* the holder tenders, rather than by reference to a benchmark security as of the date, or date preceding the date, of tender. This is referred to as a "real-time fixed-spread" tender offer. The SEC imposed the following additional requirements for a real-time fixed spread tender:

- The offer must clearly indicate the benchmark interest rate to be used and must specify the fixed spread to be added to that yield;
- The offer must state the nominal purchase price that would have been payable under the offer based on the applicable reference yield immediately preceding commencement of the tender offer;
- The offer must indicate the reference source to be used during the offer to establish the current benchmark yield;
- The offer must describe the methodology used to calculate the purchase price; and
- The offer must indicate that the current benchmark yield and the resulting nominal purchase price of the debt securities will be available by calling a toll-free phone number established by the dealer-manager.[10]

With the assistance of counsel, an issuer should be able to structure its tender offer for investment grade debt securities to fit within existing no-action letter guidance. Structuring within the guidance will relieve the issuer of the burden of complying with the ten - and 20-business day requirements.[11]

We believe the staff's no-action guidance will have particular importance over the next several years as financial institutions that have issued debt guaranteed by the Federal Deposit Insurance Corporation (the "FDIC") address the impending maturity dates of those government guaranteed debt securities. Under the terms of the FDIC's temporary liquidity guarantee program, the guarantee must mature no later than June 30, 2012.[12]

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[9] SEC No-Action Letter, *Salomon Brothers, Inc.* (Oct. 1, 1990).
[10] SEC No-Action Letter, *Merrill Lynch, Pierce, Fenner & Smith Inc.* (July 19, 1993).
[11] The SEC also has granted no-action relief in the context of preferred and hybrid securities that behave more like debt securities than equity securities. *See*, SEC No-Action Letter, *BBVA Privanza International Limited and Banco Bilbao Vizcaya Argentaria, S.A.*, (Dec. 23, 2005).
[12] However, the FDIC does not permit the proceeds of FDIC-guaranteed debt to repay or redeem non-FDIC guaranteed debt.

A Comparison:
Investment Grade v. Non-Investment Grade Debt

Investment Grade Debt:

- Generally must remain open for 7-10 calendar days;
- Offer must be extended 5 calendar days for certain modifications to terms;
- Must be conducted to afford all holders the reasonable opportunity to participate, including dissemination of the offer material on an expedited basis (within two days after commencement);
- Able to price using a fixed-price spread or a real-time fixed price spread.

Non-Investment Grade Debt:

- Must remain open for 20 business days;
- Offer must be extended 10 business days for certain modifications to terms;

Cash tender offers for convertible debt securities

As we discuss above, certain provisions of the Williams Act, such as Rule 13e-4, are applicable only to tenders of equity securities, including tenders of convertible or exchangeable debt. If an issuer has a class of equity securities registered under the Exchange Act or is otherwise reporting under the Exchange Act, tenders for a debt security with equity features must comply with the provisions of Rule 13e-4. The obligation to comply with these provisions makes tender offers for convertible or exchangeable debt securities more complicated and time-consuming, and subject the offer to SEC review, which could result in additional time delays.

We discuss below the principal additional requirements for a tender subject to Rule 13e-4.

- **Filing with the SEC** – Rule 13e-4 requires that an issuer file a Schedule TO for a self tender for convertible or exchangeable debt securities on the day that such tender offer commences. Schedule TO has a number of specific disclosure requirements; disclosures must be made either in the Schedule TO itself or in the documentation sent to securityholders. Schedule TOs are subject to review by the SEC,[13] and material changes in the information provided in the Schedule TO must be included in an amendment filed with the SEC. Rule 13e-4 also requires that all written communications regarding the tender offer be filed with the SEC.[14] By reason of the Schedule TO filing obligation, the tender offer then becomes subject to the requirements of Regulation 14D, which governs the form and content of the Schedule TO.
- **Offers to all holders** – Under Rule 14e-4, generally, tender offers must be made to all holders of the relevant securities.
- **Best price** – The consideration paid to any securityholder for securities tendered in the tender offer must be the highest consideration paid to any other securityholder for securities tendered in the tender

[13] The SEC, aware of the length of the offer period, will typically provide any comments within the first ten days.
[14] Issuers should be sensitive to whether there are written communications, such as in a press release or a Form 10-K, Form 10-Q or Form 8-K, that are often made in advance of the "commencement" of the tender offer, and that must be filed pursuant to Rule 13e-4(c) – for example, by "checking the box" on the cover of Form 8-K.

offer. Note that this does not prevent an issuer from offering holders different types of consideration as long as the holders are given an equal right to elect among each type of consideration, and the highest consideration of each type paid to any securityholder is paid to any other securityholder receiving that type of consideration.

- **Dissemination** – Rule 13e-4 provides alternative methods for disseminating information regarding an issuer tender offer. The most common method of dissemination is to publish a "tombstone" advertisement in *The Wall Street Journal* or other daily newspaper with national circulation.[15]
- **Withdrawal rights** – Rule 13e-4 requires that the tender offer permit tendered securities to be withdrawn at any time during the period that the tender offer remains open. In addition, Rule 13e-4 specifically permits withdrawal after 40 business days from the commencement of the tender offer if the securities have not yet been accepted for payment.
- **Purchases outside the tender offer** – Rule 13e-4(f)(6) provides that until the expiration of at least ten business days after the date of termination of the issuer tender offer, neither the issuer nor any affiliate shall make any purchases, otherwise than pursuant to the tender offer, of: (1) any security that is the subject of the issuer tender offer, or any security of the same class and series, or any right to purchase any such securities; and (2) in the case of an issuer tender offer that is an exchange offer, any security being offered pursuant to such exchange offer, or any security of the same class and series, or any right to purchase any such security.[16]

The requirements of Rule 13e-4 result in less flexibility for tenders for convertible or exchangeable debt securities compared to tenders for straight debt securities. A good illustration of this reduced flexibility is that it is not possible for issuers to "sweeten" the tender offer for convertible or exchangeable debt securities with an "early tender premium" as is the case for straight debt securities.

Accounting and other considerations

Convertible or exchangeable debt securities raise special accounting issues and issuers should carefully consider the accounting aspects of repurchasing their convertible debt before doing so. While some effects (such as the elimination of the retired debt from the issuer's balance sheet) may be more intuitive, others may not be. Issuers may wish to consult their accountants early on, even more so because accounting for convertible debt securities has changed recently.[17] Issuers that intend to restructure their outstanding convertible debt also should consider the effects of such tender on any of their "call spread" transactions or share lending agreements.

Special rules for European tenders

It may be the case that the holders of an issuer's debt securities are located in foreign jurisdictions. For instance, if an issuer sold its securities pursuant to Rule 144A in the United States and pursuant to Regulation S outside the United States. Many frequent debt issuers issue and sell their debt securities pursuant to Euro medium-term note programs or market and sell U.S. registered securities into the European Union ("UE") or other foreign jurisdictions. For these tenders, an issuer must not only focus on the various considerations spelled out above, but also must be cautious that its tender does not violate any rules in the home country of its securityholders.

In the EU, there are two directives about which an issuer should be concerned. First, The Market Abuse Directive ("MAD"). As its name suggests, MAD is intended to prevent abuses relating to insider trading. Similar to

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[15] The tender offer rules have not been revised or amended to take into account greater reliance on the Internet.
[16] This requirement is in addition to the prohibition in Rule 14e-5 that, with certain exceptions, prohibits "covered persons" from, directly or indirectly, purchasing or arranging to purchase any subject securities or any related securities (that is, securities immediately convertible or exchangeable for the subject securities) except as part of the tender offer. "Covered persons" include the offeror, its affiliates and the dealer-manager and its affiliates.
[17] Please see our Client Alert , "New FASB Accounting Rules on Convertible Debt" for a discussion of accounting changes related to convertible debt *at* http://www.mofo.com/news/updates/files/Client_Alert_FASB_Accounting.pdf

Regulation FD, MAD requires that an issuer announce without delay information directly concerning it. MAD applies to financial instruments admitted to trading on a regulated market or for which a request for admission to trading has been made. The statute is intended to address insider dealing, market manipulation and the dissemination of false or misleading information. Under MAD, an issuer should perform an analysis similar to that under Regulation FD – is the insider in possession of material nonpublic information. In the case of a debt tender, the terms of the transaction likely was announced, so an issuer need only consider whether it possesses other information that may be considered material.

In the EU, an issuer need also be mindful of anti takeover restrictions contained in Directive 2004/25/EC. This directive pertains to takeover bids for the securities of issuers governed by the laws of a member state, where all or some of the securities are admitted to trading on a regulated market. A takeover bid means a public offer (other than by the offeree issuer itself) made to the holders of securities to acquire all or some of the securities with the objective of acquiring control. Though not directly applicable, the directive provides guidance that an issuer should follow in conducting a tender for its own securities. In particular, all holders must be treated equally and must have sufficient time and information to enable them to reach an informed decision.

Regulation M

Although Regulation M does not apply to investment grade non-convertible debt securities, it does apply to equity securities, non-investment grade debt and convertible debt. An issuer that engages in a tender offer must ensure that it complies with Regulation M. Rule 102 under Regulation M makes it unlawful for an issuer or its affiliates "to bid for, purchase, or attempt to induce any person to bid for or purchase, a covered security during the applicable restricted period." This prohibition is intended to prevent an issuer from manipulating the price of its securities when the issuer is about to commence or is engaged in a distribution.

Tax considerations

An issuer that repurchases its debt securities at a discount to its adjusted issue price generally will recognize ordinary COD income in the amount of the discount. This results whether the issuer repurchases the debt securities directly or repurchases the debt securities through a related party, such as an intermediary. We discuss certain exceptions to the recognition of COD income, including under the Recovery Act above under "Introduction—Tax considerations".

A debtholder whose debt security is repurchased by the issuer will recognize gain or loss equal to the difference between the amount of cash received in the repurchase and the holder's adjusted tax basis in the debt security. If the holder acquired the debt security with market discount, a portion of any gain may be characterized as ordinary income.

Non-cash Tender Offers

If an issuer does not have or want to use its available cash resources, an alternative to a cash tender is an exchange offer. In an exchange offer, the issuer offers to exchange a new debt or equity security for its outstanding debt or equity securities. For distressed issuers, an exchange offer may be the best non-bankruptcy restructuring option. Exchange offers enable an issuer to reduce interest payments or cash interest expense (by exchanging debt securities with a high rate for a lower one), reduce the principal amount of outstanding debt (in the case of a debt equity swap), manage its maturity dates (by exchanging debt securities that are coming due for debt securities with an extended maturity) and reduce or eliminate onerous covenants (if coupled with an exit consent). We discuss these alternatives below. Another benefit to conducting an exchange offer is that the issuer may "sweeten" the deal by providing a cash payment to the holder as an inducement to exchange. It is important for issuers to note that a cash tender may trigger disclosure obligations under the Exchange Act. An issuer may need to file a Form 8-K for a cash tender if, under Item 2.04, the tender may be considered an acceleration of a financial obligation.

Securities Act considerations

An exchange offer must comply with the tender offer rules. However, because an exchange offer involves the offer of new securities, it also must comply with, or be exempt from, the registration requirements of the Securities Act. For this reason, documentation for an exchange offer must be more detailed than that for a cash tender offer and must describe the terms of the new securities. In addition, because the exchange involves the offer of new securities, participants are liable under the antifraud protections of Section 11 of the Securities Act. To the extent an issuer engages a financial intermediary to assist with the solicitation of tenders, that entity may be subject to statutory underwriter liability and will conduct its own diligence review of the issuer and will require delivery of legal opinions and comfort letters.

An exchange offer may either be exempt from registration or registered with the SEC. An issuer may rely on the private placement exemptions provided under Section 4(2) of the Securities Act or the exemption provided by Section 3(a)(9) of the Securities Act. In addition, an exemption pursuant to Regulation S for offers and sales to non-U.S. persons may be available on a standalone basis or combined with other applicable securities exemptions.

An exchange offer may either be exempt from registration or registered with the SEC. An issuer may rely on the private placement exemptions provided under Section 4(2) of the Securities Act or the exemption provided by Section 3(a)(9) of the Securities Act. In addition, an exemption pursuant to Regulation S for offers and sales to non-U.S. persons may be available on a standalone basis or combined with other applicable securities exemptions.

Incentives and disincentives

As we discuss, there are a number of structural considerations that may create incentives to tender or to tender early. A company should consider the following:

- **Minimum threshold**. To discourage holdouts require, as a condition to the tender or exchange, require that a substantial percentage (typically 90% or higher) of the outstanding securities be tendered.

- **Sweeteners**. Encourage acceptance of the tender or exchange offer by providing a cash payment or better terms for the new securities. Consider offering tendering/exchanging holders an inducement in the form of a warrant "kicker" or common stock (if there is potential for future upside), or exchanging high coupon, unsecured debt for low coupon, secured debt. In addition, consider providing recourse to collateral.

- **Exit consents**. Solicit "exit consents" simultaneous with the tender or exchange offer to penalize holdouts (by stripping protective covenants and events of default from the old securities").

- **Early tender premium or consent payment**. Motivate holders to tender early by establishing an early tender premium or early consent payment. The "best price" rule does not apply to tender and exchange offers for straight debt securities.

- **The bankruptcy threat**. In a restructuring, convey that bankruptcy is unavoidable if the tender or exchange offer fails and that debtholders will be in a better position if bankruptcy is avoided. This involves a delicate balancing act.

Regulation M

As we discuss above with respect to cash tenders, an issuer must be mindful of Regulation M's prohibitions on bidding for, or purchasing, its securities when it is engaged in an offer. If the debt being exchanged is convertible into the issuer's equity securities, under certain circumstances, repurchases of convertible debt securities could be deemed a forced conversion and, therefore, a "distribution" of the underlying equity security for Regulation M purposes.

Private exchange offers

An exchange offer may be conducted as a private placement. Because the issuer must structure the exchange within the confines of Section 4(2), it may not engage in a "general solicitation" of its securityholders. In addition, any offerees must be "sophisticated investors." Typically, if an issuer is relying on Section 4(2) for its exchange, it will limit its offer only to QIBs as a precaution. To ensure that the offer restrictions are satisfied, an issuer often will "pre-certify" its holders to ensure that they meet the requirements (either QIB or accredited investor status). If the issuer has engaged a financial intermediary, this entity will identify debtholders and contact them in advance. Often, the financial intermediary will have certifications on file for the debtholder and verify its status, or it may obtain the requisite certification on the issuer's behalf. This typically can be accomplished by requiring that the holder sign a letter confirming its status. As with any other restructuring, an issuer must ensure that the transaction is permitted under the governing debt instrument, as well as under its other financial arrangements.

If an issuer conducts a private exchange, the newly issued securities will not be freely tradable, as they were issued pursuant to an exemption from registration. In the past, an issuer covenanted with the holders to register the securities issued in the exchange, either through a resale registration statement or via a registered exchange. In light of recent amendments to Rule 144 that shortened the holding period for restricted securities, holders may no longer require an issuer to register their securities issued in the exchange. Under the Rule 144 amendments, unaffiliated holders may sell their securities without restriction after a six-month holding period, provided the issuer is a reporting company and has current information. Whether registration rights are requested may depend on the type of security issued (for instance, holders exchanging equity for debt may want liquidity sooner than holders exchanging debt for debt). Rule 144(d)(3)(ii) provides that a holder of a security may tack the holding period of the underlying security to its holding period for an exchanged security in certain circumstances. Rule 144(d)(3)(ii) states: "If the securities sold were acquired from the issuer solely in exchange for other securities of the same issuer, the newly acquired securities shall be deemed to have been acquired at the same time as the securities surrendered for conversion or exchange, even if the securities surrendered were not convertible or exchangeable by their terms."

Section 3(a)(9) exchange offers

Another option is an exchange offer exempt pursuant to Section 3(a)(9). Section 3(a)(9) of the Securities Act applies to "any securities exchanged by the issuer with its existing securityholders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange."

Section 3(a)(9) has five requirements:

- **Same issuer** – the issuer of the old securities surrendered is the same as the issuer trying to effectuate an exchange of the new securities;
- **No additional consideration from the holder** – the securityholder must not be asked to part with anything of value besides the outstanding security;
- **Offer only to existing holder**s – the exchange must be offered exclusively to the issuer's existing securityholders;
- **No remuneration for solicitation** – the issuer must not pay any commission or remuneration for the solicitation of the exchange; and
- **Good faith** – the exchange must be in good faith and not as a plan to avoid the registration requirements of the Securities Act.

Same issuer

Section 3(a)(9) exempts any securities exchanged by the issuer with "its" securityholders. The SEC has interpreted the word "its" to mean that the new securities being issued and the securities that are being surrendered must originate from a single issuer. While this concept may seem relatively straight forward, there are a number of scenarios that can complicate an identity of issuer analysis. The SEC has granted no-action relief in response to facts and circumstances that do not fit neatly within the "single issuer" requirement. For example, the SEC has granted no-action relief for an exchange of guaranteed debt securities of a subsidiary for the securities of the parent issuer guarantor.[18] The SEC concluded that the exchange as a whole involved a single issuer. In its analysis, the SEC first held that as a matter of economic reality, the holders of the subsidiary's securities were in fact holders of the parent issuer's securities. Next, the SEC placed heavy emphasis on the relationship between the parent issuer and the subsidiary. The subsidiary was established by the parent issuer to issue securities and finance the activities of the parent issuer. The subsidiary had minimal assets and liabilities that were tied to the issuance of securities. "In economic reality, it is the [parent issuer's] financial position and business prospects and the value of the [parent issuer's] securities to be issued …that will be of interest to investors in making their investment decisions."[19]

In another no-action letter, an issuer transferred its common stock to a trust.[20] The issuer wanted to execute an exchange whereby the trust would facilitate an exchange of old securities for new ones. The issue was whether the issuance by the trust, which is ostensibly a different issuer, would preclude the issuer from relying on Section 3(a)(9). The SEC found this exchange exempt under Section 3(a)(9), finding that the trust was a "special purpose entity established for the sole purpose of allowing … investors to obtain the economic right in [a security]. The [trust] does not engage in any activities unrelated to this purpose and has no independent financial or economic activity."

These two no-action letters, which we discuss only for illustrative purposes, demonstrate that the SEC will look at the underlying economic reality when confronted with an identity of issuer question. There are a number of other no-action letters and other SEC guidance that provide additional interpretation in satisfying the conditions of Section 3(a)(9).[21]

No additional consideration from the holder

The term "exclusively" in Section 3(a)(9) refers to the consideration that securityholders are required to exchange. This excludes from the safe harbor of Section 3(a)(9) all exchange offers where the holder must give up anything other the than old securities. Conversely, an issuer relying on Section 3(a)(9) is free to include cash in what it *gives to* the securityholders.

Rule 149 under the Securities Act provides an exception to the no-cash payment rule "to effect an equitable adjustment, in respect of dividends or interest paid or payable on the securities involved in the exchange, as between such securityholder and other securityholders of the same class accepting the offer of exchange." An example of an equitable adjustment is when, due to the timing of interest payments and intra-securityholder sales

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[18] *See*, SEC No-Action Letter *Echo Bay Resources Inc.*, (May 18, 1998).
[19] However, the SEC did not find a single identity of issuer between a subsidiary and its parent where the subsidiary had outstanding a class of debentures guaranteed by its parent and the subsidiary proposed to offer a new debenture in exchange for the guaranteed debenture that would not be guaranteed by its parent. *See*, SEC Division of Corporation Finance, *Compliance and Disclosure Interpretations*: Securities Act Sections (#125.05) (November 26, 2008), *available at* http://www.sec.gov/divisions/corpfin/guidance/sasinterp.htm
[20] *See*, SEC No-Action Letter, *Grupo TMM, S.A. de C.V.*, (June 27, 2002).
[21] *See*, SEC Division of Corporation Finance, *Compliance and Disclosure Interpretations*: Securities Act Sections, *available at* http://www.sec.gov/divisions/corpfin/guidance/sasinterp.htm, *See*, SEC Division of Corporation Finance, *Compliance and Disclosure Interpretations*: Securities Act Rules, *available at* http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm, *See*, SEC Division of Corporation Finance, *Compliance and Disclosure Interpretations*: Exchange Act Sections, *available at* http://www.sec.gov/divisions/corpfin/guidance/exchangeactsections-interps.htm, and *See*, SEC Division of Corporation Finance, *Compliance and Disclosure Interpretations*: Exchange Act Rules, *available at* http://www.sec.gov/divisions/corpfin/guidance/exchangeactrules-interps.htm.

(that is, sales not involving the issuer), one securityholder may get the benefit of an interest payment due to another securityholder. Should this be the case, the issuer may, in an exchange offer, require an unjustly enriched securityholder to reimburse the issuer for an extra interest payment. Section 3(a)(9) does permit an issuer to require the securityholders waive the right to receive an interest payment or other consideration accruing from a security.[22]

Offer only to existing holders

Any exchange offer conducted in reliance on Section 3(a)(9) may be made only to existing holders. Though it appears simple, this requirement can sometimes be breached if an issuer is conducting a simultaneous offering of new securities for cash. In this case, the issuer must take care to keep the two offerings separate.

No remuneration for solicitation

Section 3(a)(9) expressly prohibits an issuer from paying a "commission or other remuneration …directly or indirectly for soliciting such exchange." In conducting a "commission …remuneration" analysis, it is important to consider:

- the relationship between the issuer and the person furnishing the services;
- the nature of the services performed; and
- the method of compensation for those services.

An issuer's officers, directors and employees may solicit participation provided that they were not hired for such purpose, have responsibilities other than soliciting participation and are not paid a bonus or special compensation for such solicitation.[23] Issuers also are permitted to engage third parties, such as financial advisers and investor relations firms, to assist in a Section 3(a)(9) exchange, however restrictions apply. The services provided by the third party must be "ministerial"[24] or "mechanical."[25] Any services not deemed mechanical must be "by [their] nature ancillary to the effective mechanical operation of the process of formulating a restructuring proposal in a work-out situation."[26] An issuer needs to be particularly mindful of firms, such as investor relations firms, that communicate with securityholders. Hiring a firm to communicate with securityholders could be construed as payment for solicitation. The SEC allows investor relations firms to participate in exchanges in a limited capacity. We discuss the role of a financial intermediary in Appendix B. Third parties assisting in an exchange are not permitted to make any recommendations to securityholders regarding the exchange offer,[27] though an investment bank may provide a fairness opinion in connection with an exchange provided it is not acting as a dealer manager and conducting solicitation activities.[28]

Other considerations

Securities issued in a Section 3(a)(9) exchange may be subject to limitations on transfer because Section 3(a)(9) is a transactional exemption only. In a Section 3(a)(9) transaction, the newly issued securities are subject to the same restrictions on transferability, if any, of the original securities.[29] An issuer also needs to be cautious of

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[22] *See,* SEC Division of Corporation Finance, *Compliance and Disclosure Interpretations*: Securities Act Sections (#125.04) (Nov. 26, 2008), *available at* http://www.sec.gov/divisions/corpfin/guidance/sasinterp.htm.
[23] *See,* SEC No-Action Letter, *URS Corporation,* (May 8, 1975).
[24] *See,* SEC Division of Corporation Finance, *Compliance and Disclosure Interpretations*: Securities Act Sections (#125.03) (November 26, 2008), *available at* http://www.sec.gov/divisions/corpfin/guidance/sasinterp.htm.
[25] *See*, SEC No-Action Letter, *Exxon Mobil Corp.*, (June 28, 2002).
[26] SEC No-Action Letter, *Seaman Furniture Co., Inc.*, (Oct. 10, 1989).
[27] SEC No-Action Letter, *Dean Witter & Co., Inc.*, (Nov. 21, 1974). *See also,* SEC No-Action Letter, *Stokley-Van Camp, Inc.*, (Mar. 31, 1983).
[28] *See,* SEC Telephone Interpretation No. 25 of Securities Act Sections (July 1997), *http://sec.gov/interps/telephone/cftelinterps_securitesactsections.pdf.*
[29] *See, e.g.* SEC Division of Corporation Finance, *Compliance and Disclosure Interpretations*: Securities Act Sections (#125.08) (Nov. 26, 2008), *available at* http://www.sec.gov/divisions/corpfin/guidance/sasinterp.htm.

having its exchange offer "integrated" with other securities offering conducted in close proximity to the exchange. In making a determination regarding integration, an issuer must apply the SEC's five factor integration test.[30]

Why are repurchases and exchanges (debt for debt; hybrid; debt/equity) particularly important for financial institutions?

Many qualifying financial institutions have relied on government guarantee programs to issue three-year debt. Financial institutions are facing a "cliff" of coming maturities.

New government programs (such as the Treasury CAP and modifications to the FDIC's TLGP) permit the issuance of mandatory convertible preferred stock and mandatory convertible debt securities. Qualifying issuers may consider using the CAP to exchange out of the original Treasury CaPP securities.

Rating agencies, analysts and commentators are focused on "tangible common equity" and similar measures. This may motivate financial institutions to restructure. Exchange offers in order to create higher quality regulatory capital.

A financial institution will benefit (from a capital perspective) by buying back debt securities that are trading at a discount and cancelling such securities.

May be a component of insurance company and bank "reorganizations" and/or good bank-bad bank or other split offs.

As potential "exit" from government support.

Registered exchange offers

If an issuer is unable to conduct a private exchange, or rely on Section 3(a)(9), it may instead conduct a registered exchange offer. As with a tender offer, additional Exchange Act rules will apply to exchanges of debt with equity characteristics, such as convertible debt. We discuss below the rules applicable to exchanges of equity securities.

The registration statement

A registered exchange offer must be registered on a Form S-4 registration statement (Form F-4 for foreign private issuers).[31] It may be time consuming to prepare a registration statement, particularly if the issuer does not have the ability to incorporate by reference information from its Exchange Act filings. Also, unlike a Form S-3, a Form S-4 registration statement does not become effective automatically upon filing,[32] and except to the limited extent described below, the exchange offer may not be commenced until the registration statement is declared effective. The SEC review process and uncertainty concerning timing may make a registered exchange offer a less desirable option for an issuer.

The registration statement must include descriptions of the securities being offered, the terms of the exchange offer, a description of the issuer and its business and risk factors. In addition, depending on the extent of the

[30] The five factor test requires that an issuer consider: whether the offerings are part of a single plan of financing; whether the offerings involved issuances of the same class of securities; whether the offerings were made at or about the same time; whether the same type of consideration is received; and whether the offerings were made for the same general purposes. *See*, SEC Release No. 33-4552 (Nov. 6, 1962).
[31] Because Forms S-3 and F-3 are available only for offerings for cash, they are not available for an exchange offer.
[32] This is a particular issue for "well known seasoned issuers" or "WKSIs," who may be used to automatic effectiveness of their registration statements.

restructuring, the issuer may be required to provide pro forma financial information statements reflecting the affects of the exchange.

Early commencement activities

Rule 162 under the Securities Act provides some flexibility by allowing an issuer to elect "early commencement"of its exchange offer. Rule 162 permits solicitations of tenders in certain exchange offers before the registration statement is declared effective.[33] An issuer may begin the offering period prior to effectiveness (shortening the time after effectiveness that it must remain open), provided that no securities are actually exchanged/purchased until the registration statement is effective and the tender offer has expired in accordance with the tender offer rules. Rule 162 is available for exchange offers that comply with Rule 13e-4 and Regulation 14D.

Early commencement of exchange offers for straight debt securities

In December 2008, Rule 162 was amended so that it might be available for exchange offers for straight debt securities provided that: (1) the offeror provides the same withdrawal rights as it would if the offering were for equity securities; (2) if a material change occurs in the information published, sent or given to the debtholders, the offeror disseminates information about the material change to the debtholders in compliance with Rule 13e-4; and (3) the offer is held open with withdrawal rights for the minimum periods specified in Rule 13e-4 and Regulation 14D. For exchange offers of straight debt securities, an issuer must decide whether the benefits of early commencement outweigh the ability to provide no or limited withdrawal rights, or to provide for an early tender option.

Consent solicitations

Often, an issuer may wish to solicit consents from its debtholders, whether on a standalone basis or coupled with a tender offer or exchange offer. The purpose of soliciting such a consent is to modify the terms of the debt security being tendered or exchanged. The first step is to undertake a review of the applicable indenture provisions to determine the consent requirements for amendments or waivers. In addition, amendments involving a significant change in the nature of the investment to the remaining holders may result in the remaining securities being deemed a "new security" which would have to be registered under the Securities Act or be subject to an exemption from registration.[34] There are a few limitations with respect to consents, in that under most indentures and under Section 316(b) of the Trust Indenture Act of 1939, consents cannot reduce principal or interest, amend the maturity date, change the form of payment or make other economic changes to the terms of the debt securities held by non-tendering debtholders.

Standalone consents

In certain situations, for example, in order to permit a potential transaction, such as an acquisition, reorganization or refinancing, an issuer may want to conduct a "standalone" consent solicitation as a means of amending restrictive covenants or events of default provisions under an existing indenture that otherwise would limit its ability to engage in the transaction. In the current environment, some issuers must modify indenture covenants that restrict or prohibit a restructuring of other debt in order to preserve "going concern" value and avoid bankruptcy. Because consenting holders will remain subject to the terms of the indenture as amended or waived, holders may be reluctant to agree to significant changes. Standalone consent solicitations typically remain open for a minimum of ten business days, although a supplemental indenture giving effect to the amendments or

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[33] Many market participants and commentators note that there remains a need to examine the registration requirements for exchange offers, particularly as they affect WKSIs. In particular, market participants have suggested that registration statements on Form S-4 filed by WKSIs become effective immediately upon filing. *See,*Letter from Securities Industry and Financial Markets Association to the Securities and Exchange Commission, dated January 27, 2009.

[34] An attempt to revise key payment terms such as maturity, interest rate or type of interest paid may be considered an offer and sale of a "new security" under SEC interpretations, which would be treated as an exchange offer for securities law purposes. *See*, Bryant B. Edwards and Jon J. Bancone, "Modifying Debt Securities: The Search for the Elusive 'New Security' Doctrine," 47 BUS LAW, 571 (1992).

waivers sought may be executed and delivered as soon as the requisite consents from securityholders are obtained.

Exit consents

If an issuer would like to change significantly restrictive indenture provisions, a tender offer or exchange offer coupled with a consent solicitation can be an attractive option. "Exit consents" are different from standalone or ordinary consent solicitations because they are given by tendering or exchanging debtholders (who are about to give up the old securities) as opposed to continuing holders of the old debt securities. The tendering debtholders will be required to consent to the requested amendments as part of the tender of securities pursuant to the tender offer or exchange offer.

If the requisite percentage of holders (specified in the indenture) tender their securities, the issuer will be able to amend the terms of the indenture and bind all the holders. Exit consents can prove to be a useful incentive to participate in a tender or exchange offer and to address "holdout" problems. These amendments or waivers generally will not affect the tendering holders that receive cash or new securities upon the consummation of the offer.[35] However, the result of obtaining the requisite consents is that non-tendering holders will be bound by the changes. Accordingly, when an issuer announces that the requisite number of holders (for example a majority) has decided to participate in the tender offer or exchange offer, for all practical purposes the remaining debtholders must decide whether to tender/exchange, or be left with a debt obligation with significantly reduced protections.

Generally, a consent solicitation is not subject to any legal framework other than that applicable to tender offers and exchange offers. U.S. courts have viewed exit consents as permissible contract amendments governed by basic contract law principles.[36] The total consideration offered in a tender or exchange may include a consent payment available only to holders that tender on or prior to the consent deadline, typically ten business days after the commencement of the offer and consent solicitation (a tender offer or exchange offer must be kept open for 20 business days). Typically, the payment deadline also is the expiration time for withdrawal rights, unless such rights are required by statute to remain available longer.

In some instances, the modifications effected by the consent solicitation or exit consent may rise to the level of a modification for tax purposes. We discuss the consequences of such a determination above, under "Non-cash tenders – Tax consequences."

Tax considerations

An issuer that exchanges new debt for old debt will recognize ordinary COD income to the extent the adjusted issue price of the old debt exceeds the issue price of the new debt. A modification of existing debt will be treated as an exchange of such debt for new debt if the modification is "significant." Generally, modifications are significant if, among other things, (1) the yield changes by the greater of 25 basis points and 5% of the existing yield, (2) scheduled payments are materially deferred, (3) modified credit enhancements change payment expectations, or (4) the nature of the security changes (*e.g.*, from debt to equity or from recourse to nonrecourse). By contrast, certain consent solicitations that seek to change "customary accounting or financial covenants" would not, in themselves, constitute significant modifications. For a discussion of certain exceptions to the recognition of COD income and relief from the AHYDO rules, see "Introduction—Tax considerations", above.

Assuming the exchange or modification constituted a recapitalization, such exchange or modification generally should not result in gain or loss to the debtholder. However, depending on the terms of the new debt relative to the old debt, certain tax consequences could follow. For example, if the principal amount of the new debt

[35] The effectiveness of the amendments and waivers is typically subject to the condition that the tendered securities have been accepted for payment or exchange pursuant to the offer.
[36] *See, e.g.*, Katz v. Oak Industries, 508 A. 2d 873 (Del. Ch. 1986).

exceeded that of the old debt the holder could recognize gain equal to the fair market value of such excess. Exchanges and modifications also can create OID or, conversely, an amortizable premium, due to differences in the issue price of the new debt and the stated redemption price at maturity.

In each case, particular attention must be paid to terms of art like issue price, the meaning of which may vary depending on a number of factors. For example, if existing debt is publicly traded, the "issue price" of new debt issued (or constructively issued, in the case of a modification) in exchange for such debt is deemed the current market price. Given current economic conditions, debt exchanges or modifications will often result in COD income because the market prices of many existing debt securities are steeply discounted from their adjusted issue prices.

Other Exchanges

Debt equity swaps

A debt equity swap is another means of recalibrating an issuer's balance sheet. In a debt equity swap, the issuer exchanges already outstanding debt for newly issued equity securities. It is, in essence, an exchange offer. A debt equity swap may be executed with a bank lender, or it may be executed with holders of an issuer's debt securities. In fact, in recent years, it has become more common for a bank or other lender to engage in a debt equity swap rather than force a defaulting issuer into bankruptcy. Lenders often hope that they will receive a higher return on their investment by taking an equity position. The issuer, by changing its debt to equity ratio, benefits financially from the exchange, and may improve its ratings.

Securities law considerations

There are a number of considerations that an issuer must bear in mind in carrying out a debt equity swap. The issuer must be mindful that any exchange of securities must comply with the tender offer and exchange rules described above. If a lender extinguishes a bank line in exchange for equity, the issuance of the equity securities must comply with all applicable securities laws – namely it must either be registered or exempt from registration. In addition, an issuer needs to be mindful of the disclosure obligations that may be triggered by such an event, as it may constitute a material event.

Corporate governance and other considerations

The number of shares to be issued depends on the value of outstanding debt to be exchanged. An issuer seeking to engage in a debt equity swap must ensure that it has sufficient authorized capital available prior to commencing the exchange. If the issuer lacks sufficient authorized capital, it may be necessary to amend the issuer's certificate of incorporation to increase the share capital. This can often be a time consuming process since it entails seeking shareholder approval. An issuer also needs to determine the percentage of equity securities that may be issued; an issuance of over 20% of pre-transaction total shares outstanding may trigger national securities exchange limits,[37] and may require shareholder approval. Because the issuance of equity securities as part of a debt equity swap will be dilutive to existing holders, this may prove difficult.

Because the lender or debtholder will be effectively subordinating its position by giving up its creditor status, it may require a "sweetener" – this may come in the form of issuing preferred stock or convertible preferred stock, or issuing participating preferred. An issuer needs to consider carefully the terms of the security it will offer, including the class, voting rights and dividend.

[37] We discuss these issues in Appendix A.

Tax considerations

An issuer that engages in a debt equity swap will recognize ordinary COD income to the extent the adjusted issue price of the debt exceeds the market value of the equity it issues. We discuss certain exceptions to the recognition of COD income, including under the Recovery Act, above under "Introduction – Tax considerations." Similar to debt for debt exchanges, a debt for equity swap also should not result in gain or loss to the holder if the exchange constitutes a recapitalization. It should be noted market discount accrued on the exchanged debt will carryover to the equity.

Equity for equity exchanges

When an issuer tenders for its own equity securities, a number of considerations arise. First, an issuer must ensure that it is permitted to engage in the exchange under state law. Section 160(a)(1) of the Delaware General Corporation Law prohibits a corporation from purchasing its own stock if the entity's capital is impaired or if such purchase would impair capital.

In the context of an equity for equity exchange, an issuer must be mindful of its disclosure obligations under Regulation FD and the securities law antifraud provisions, particularly Rule 10b-5. Under Rule 10b-5 an issuer is prohibited from purchasing its stock when it is in possession of material nonpublic information. The same considerations that apply to a purchase of debt securities are applicable in this context. An issuer must determine whether the transaction itself constitutes material nonpublic information. An issuer also must determine whether it is in possession of other information, such as unreleased earnings or an unannounced acquisition, that must be disclosed prior to commencing an exchange.

In addition, an issuer must comply with all tender offer rules when conducting an equity exchange. Sections 13(d), 13(e), 14(d), 14(e) and 14(f) all are applicable to an equity exchange. An issuer also is required, as it is with an exchange of convertible debt, to file a Schedule TO with the SEC.

An issuer must be cautious that its equity exchange does not inadvertently trigger the "going private" rules under Rule 13e-3 of the Exchange Act. These rules apply if any purchase of an issuer's equity securities is intended to cause the equity security of an issuer registered under Section 12(g) or Section 15(d) of the Exchange Act to be held by fewer than 300 persons. Rule 13e-3(g)(2) contains an exemption from the "going private" rules if the securityholders are offered or receive only an equity security that: (1) has substantially the same rights as that being tendered, including voting, dividends, redemption and liquidation rights (except that this requirement is deemed satisfied if non-affiliated holders are offered common stock), (2) is registered pursuant to Section 12 of the Exchange Act (or reports are required to be filed by the issuer pursuant to Section 15(d)), and (3) is listed on a national securities exchange or authorized to be quoted on Nasdaq (if the tendered security also was so listed or quoted).

If an equity exchange involves a "distribution" under Regulation M, the issuer is prohibited from making bids for, or purchasing, the offered security. These prohibitions will not apply to investment grade rated, nonconvertible preferred stock, however. These restrictions typically commence when the exchange offer materials are mailed and continue through the conclusion of the offer.

Liability Considerations

Restructuring transactions, whether redemptions, privately negotiated or open market purchases, or tender or exchange offers, involve the "purchase and sale of [a] security." Therefore, these transactions are subject to the general antifraud provisions of Section 10(b) of the Exchange Act and Rule 10b-5. Section 10(b) of the Exchange Act is an implied cause of action covering all transactions in securities and all persons who use any manipulative or deceptive devices in connection with the purchase or sale of any securities. Rule 10b-5 covers substantially the same ground as Section 10(b) and prohibits, among other matters, the making of any untrue statement of a material fact or the omission of a material fact necessary to make the statements made not misleading. Under

Rule 10b-5, the issuer, its directors, officers and employees, and its agents, including financial intermediaries retained by the issuer, may be held liable.

Tender and exchange offers are also subject to Section 14(e) of the Exchange Act and the rules promulgated thereunder. In addition to specific procedural requirements, Section 14(e) contains substantially identical prohibitions regarding material misstatements and omissions as Section 10(b) and Rule 10b-5.

If the exchange offer is registered under the Securities Act, participants, in addition to liabilities under the Exchange Act, will be subject to liability under the Securities Act, including Section 11 liability (with respect to registration statements) and Section 12 (with respect to the prospectuses and oral communications).[38] Financial intermediaries in particular may be subject to liability as "statutory underwriters" in connection with solicitations of participation in the exchange offer.[39] It is therefore customary for a dealer-manager, in order to avail itself of a due diligence defense to Securities Act liability, to engage in appropriate due diligence regarding the issuer and its operations, financial status and prospects as well as to receive legal opinions and comfort letters from the issuer's accountants. The diligence process also adds time and cost to the exchange offer.

Legal Challenges

Restructurings may lead to legal challenges. The legal challenges usually come from holders of securities that do not participate in the restructuring and believe that the value if these securities or protections afforded by their securities are adversely affected. In addition, because the "all holders" rule does not apply to tender offers for straight debt securities, holders who are not offered the right to participate (for example, because the offering is limited to QIBs) may also claim that their securities are impaired. The effects of litigation can be burdensome. In some instances, the litigation will enjoin the issuer from completing the tender or exchange offer. However, if litigation is resolved after the completion of the transaction, it is unclear how the violation would be remedied because in the case of an exchange, holders already hold the new securities.

Realogy Case

A recent Delaware court case crystallizes some of the challenges associated with debt restructurings. In the Realogy case,[40] Realogy Corporation ("Realogy") announced an exchange offer for its outstanding notes (Senior Notes due 2014, Senior Toggle Notes due 2014 and Senior Subordinated Notes due 2015) for up to $500 million of additional term loans issued pursuant to an accordion feature under Realogy's senior credit facility. This accordion feature allowed Realogy to incur additional indebtedness under the credit facility. The new term loans would be secured, whereas existing notes were unsecured. The terms of the offer set a priority as to which holders were entitled to accept the offer – holders of Senior Subordinated Notes ($125 million), then holders of Senior Notes ($500 million) and then holders of Toggle Notes ($500 million, less any amounts tendered by the other classes). As a result of this priority, holders of Toggle Notes would likely be unable to participate in the exchange offer and would, effectively, be subordinated to tendering holders from the other classes who would receive secured debt.

The trustee and a noteholder controlled by Carl Icahn, High River L.P., sued Realogy on the basis that, among other things, the exchange offer violated the terms of the indenture, specifically the "negative pledge" covenant. The senior credit facility allowed "Permitted Refinancing Indebtedness" to refinance the notes, provided the

[38] Cash tender offers are not registered under the Securities Act. Therefore, none of the participants, including financial intermediaries, will have Securities Act liabilities.
[39] Section 2(a)(11) of the Securities Act defines "underwriter" broadly as: "Any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or *participates or has a direct or indirect participation in any such undertaking*, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission." (emphasis added)
[40] *The Bank of New York Mellon and High River Limited Partnership v. Realogy Corporation*, Court of Chancery of the State of Delaware, C.A. No. 4200-VCL, Memorandum Opinion, December 18, 2008.

refinancing indebtedness had no greater security than the debt being refinanced. Because the new loans were secured, and the notes being exchanged were not, the court found in favor of the trustee, reasoning that the new loans were not "Permitted Refinancing Indebtedness" and, as a result, the liens securing the new loans were not "Permitted Liens" under the indenture. The court granted the plaintiffs summary judgment and the exchange offer did not proceed.

This case turned on contract negotiation and the specific terms of the contracts, and it highlights the need to ensure that a thorough and complete review of the underlying documents, other debt instruments and an issuer's capital structure is completed before commencing any refinancing.

Conclusion

For balance sheet restructuring, like so many other things in life, timing can be everything. Issuers are cautioned not to wait too patiently for their fortunes to improve. The most effective balance sheet restructuring occurs when an issuer's balance sheet is neither too healthy nor too stressed. It's a bit like Goldilocks' porridge – best eaten when not too hot and not too cold.

Contacts

Capital Markets and Corporate

Nilene Evans
(212) 468-8088
nevans@mofo.com

Mara Goldsmith
(212) 336-8472
mgoldsmith@mofo.com

David Lynn
(202) 887-1563
dlynn@mofo.com

Brandon Parris
(415) 268-6617
bparris@mofo.com

Anna Pinedo
(212) 468-8179
apinedo@mofo.com

Jim Tanenbaum
(212) 468-8163
jtanenbaum@mofo.com

Tax

Steven Feldman
(212) 336-8470
sfeldman@mofo.com

Thomas A. Humphreys
(212) 468-8006
thumphreys@mofo.com

Shane Shelley
(858) 720-5169
sshelley@mofo.com

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Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.

Appendix A
Other Considerations

Review of Exchange requirements

The securities exchanges – the New York Stock Exchange ("NYSE"), the Nasdaq Stock Market ("Nasdaq") and the NYSE Alternext ("Alternext" and collectively, the "Exchanges")[41] require shareholder approval for the issuance of equity securities by their listed issuers in various situations.[42] Each Exchange also applies these shareholder approval provisions to offerings of securities that are convertible into or, in the case of the NYSE and Nasdaq, exchangeable for, common stock, such as convertible debt. An issuer must carefully review the Exchange provisions if the security to be exchanged in a restructuring is either actual equity or convertible or exchangeable debt, or if the transaction cannot be categorized as a "public offering."

Under Nasdaq Rule 4350(i) and Alternext Rules 712 and 713, shareholder approval is required for transactions involving the issuance of:

- 5% or more of the current outstanding common stock in an acquisition, if a director, officer, or substantial securityholder of the issuer has a 5% interest (10% if a group) in the company or assets to be acquired,
- 20% or more of the current outstanding common stock in an acquisition, or
- **20% or more of the current outstanding common stock in any transaction other than a public offering**.

Under NYSE Rule 312.03, shareholder approval is a prerequisite to issuing additional shares equal to:

- more than 1% of the current outstanding common stock to an insider (an officer or director, or an entity affiliated with an officer or director) or a substantial holder; however, if the purchaser is only a substantial holder (and not an officer or director) and the cash purchase price is at least as great as each of the book and market value of the issuer's common stock, then shareholder approval will not be required unless the number of shares of common stock to be issued (or into which the security may be convertible or exercisable), exceeds either 5% of the outstanding common stock before the issuance, or
- **20% or more of the current outstanding common stock other than an issuance involving a public offering or a "bona fide private financing" (as defined in NYSE Rule 312.04(g))**.

The percentages in all cases apply both to outstanding common equity or common voting power.[43]

Each Exchange also requires shareholder approval when an issuance will result in a "change of control" of the issuer.[44] None of the Exchanges however, have adopted a definition of "change of control." A general rule of thumb (there are variations between the Exchanges) is that purchases of between 20% and 30% of the outstanding voting stock may be deemed a change of control, unless preexisting control positions are not displaced by the transaction. It is prudent to consider both the change of control rule and the 20% rule in any transaction that involves an issuance close to 20%. In many cases, it will be appropriate to consult the relevant Exchange early in the transaction process.

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[41] On October 1, 2008, NYSE Euronext completed its acquisition of the American Stock Exchange and changed the exchange's name to NYSE Alternext US.

[42] *See, e.g.,* Nasdaq Marketplace Rule 4350(i) (the "Nasdaq Rules"), and related publicly available interpretive guidance;: NYSE Issuer Manual Sections 312.00 – 312.07 (the "NYSE Rules"); and NYSE Alternext LLC Manual Sections 710-713 (the "Alternext Rules").

[43] Nasdaq Rule 4350(i)(3) and NYSE Rule 312.04(d) each provide that only shares actually issued and outstanding (excluding treasury shares or shares held by a subsidiary) are to be used in making any calculation provided for in this paragraph (i). Unissued shares reserved for issuance upon conversion of securities or upon exercise of options or warrants will not be regarded as outstanding. Alternext does not have a similar rule.

[44] *See*, Nasdaq Rule 4350(i)(1)(B), Alternext Rule 713(b) and NYSE Rule 312.03(d).

Shareholder approval is not required for financing transactions (involving share issuances) that are structured as "public offerings" under the rules or policies of any of the three Exchanges. It is important to note that an offering is not deemed to be a "public offering" for these purposes merely because it is effected under a registration statement. The Nasdaq and Alternext staffs will consider all relevant factors when determining whether an offering will qualify for the public offering exemption, including, but not limited, to: (i) the type of offering;[45] (ii) the manner in which the offering is marketed; (iii) the extent of the offering's distribution, including the number of investors who participate in the offering; (iv) the offering price; and (v) the extent to which the issuer controls the offering and its distribution. The NYSE does not offer formal guidance to determine when a particular offering would qualify as a public offering in the context of a restructuring. It should also be noted that restructurings effected under Rule 144A of the Securities Act are, by definition, not "public offerings" despite the fact that such offerings typically having many of the indicia of a public offering.

Each of the NYSE, Nasdaq and Alternext have indicated[46] that mere filing of tender offer documents with the SEC does not necessarily make the tender offer a "public offering," and that they should be contacted when a particular transaction arises for a definitive determination. Alternext suggested that two factors to be considered are (i) the market price of the security when issued compared to the price at which it is being exchanged; and (ii) the original price the debt was being issued and what the reset is. Because of the uncertainty regarding whether a registered exchange offer will be categorized as a "public offering," exchange offers may be structured with a "cap" (that is, the exchange is capped at 19.9% and the remaining percentage above 20% is subject to shareholder approval).[47]

Review FINRA requirements

If a financial intermediary (such as a dealer-manager) is involved in the restructuring, the requirements of The Financial Industry Regulatory Authority ("FINRA") may also apply. FINRA Rule 5110,[48] known as the Corporate Financing Rule, requires certain filings with FINRA to determine whether the compensation to the financial intermediary is fair. However, the financial intermediary does not have to file (although it will be required to comply with the substantive provisions of FINRA Rule 5110) if the transaction is an exchange offer where the securities to be issued are listed on Nasdaq, the NYSE or the Alternext; or the issuer qualifies to register an offering on Forms S-3, F-3, or F-10 under the Securities Act.[49] FINRA Rule 5110 will not apply at all if the transaction is a tender offer made pursuant to Regulation 14D, which regulates tender offers for equity securities. Absent any such exception, a registered exchange offer has to be filed with FINRA for review.

Involvement of affiliates

Under certain circumstances, affiliates of an issuer may seek to purchase the issuer's debt securities. This may occur on the corporate level, such as when a parent purchases securities of its subsidiaries or when subsidiaries purchase securities of its parent or other subsidiaries. It may also occur if officers, directors or significant shareholders seek to purchase the securities. In these instances, the "affiliates" would generally be considered insiders of the issuer and subject to the same disclosure obligations as the issuer. The issuer should coordinate closely with the affiliate in structuring any repurchase program, including to ensure that other corporate requirements are not implicated, such as an affiliate running afoul of the "corporate opportunity" doctrine. In

[45] For example, this may include: (1) whether the offering is conducted by an underwriter on a firm commitment basis; (2) whether the offering is conducted by an underwriter or placement agent on a best efforts basis; or (3) whether the offering is self-directed by the issuer. *See,* Nasdaq Interpretive Material 4350-3; Commentary to Alternext Section 713.
[46] Telephone conversations between this firm and each of the Exchanges in February 2009.
[47] In certain circumstances, if the issuance of the original securities was structured to comply with the 19.9% cap, the Exchanges may, unless the issuer can demonstrate a change of circumstances, aggregate any securities issued in the exchange with the remaining outstanding non-tendered securities for purposes of calculating the percentage. In addition, the exchange may calculate the percentage based on the issuer's outstanding share capital as of the *original* issue date as opposed to the exchange date.
[48] Formerly NASD Rule 2810.
[49] For FINRA purposes only, an issuer's qualification to register an offering on Form S-3, F-3 or F-10 is based on the eligibility requirements prior to October 21, 1992, which were conditioned on a 36-month reporting history and $150 million aggregate market value of the voting stock held by non-affiliates (or $100 million and an annual trading volume of 3 million shares).

many circumstances, involvement of an affiliate may preclude reliance on the Section 3(a)(9) exemption for an exchange offer.

Appendix B
The Role of Financial Intermediary

When should an issuer engage an investment bank or other financial intermediary to assist with liability management transactions? The short answer is that it depends – it depends on the issuer's situation and the transaction contemplated. Generally, the more complex and significant a restructuring, the more helpful it may be to engage an investment bank as financial adviser. The bank will help formulate a restructuring plan, locate and identify securityholders, structure the transaction, solicit participation, assist with presenting the structure to the various stakeholders, assist with rating agency discussions and manage the marketing efforts to achieve a successful restructuring. Issuers should consider a number of factors, such as the number of debtholders, their organization and sophistication and whether the issuer has information about, and any contact with, its debtholders. In a distressed situation, the challenges that many issuers face often lead them to contact an investment bank. Typically, such banks have "liability management," "restructuring" or "workout" teams specialized in debt restructurings. Issuers that wish to take advantage of declining secondary market prices for debt securities also may benefit from engaging an investment bank to locate, contact and negotiate with debtholders to sell (or exchange) their debt securities. The type of transaction will dictate the investment bank's role, which ranges from merely an advisory role or responsibilities as an agent, principal or as dealer-manager, as well as any limitations on its activities.

Debt repurchases

If the issuer has few debtholders that are already known to it, it may not need assistance from an investment bank. However, an investment bank may be involved in these transactions, for example, to contact and bring unknown debtholders to the table, acting either as an agent (acting as a broker for the issuer) on behalf of the issuer, or as principal (buying the debt securities from the debtholder and selling them back to the issuer). Both the issuer and its advisers must be mindful of any activities that put a repurchase at risk of being deemed a "tender offer."

Tender offers

The investment bank's role varies in tender offers. In a cash tender offer for straight debt, an issuer may engage an investment bank in an advisory role. In a tender offer for convertible debt securities, which is subject to additional tender offer rules, an issuer may choose to engage an investment bank in an advisory role to contact and negotiate the terms with debtholders or to act as a more active dealer-manager. In a tender offer coupled with a consent solicitation or a public tender offer for all outstanding debt securities, issuers usually engage a dealer-manger to manage the process. In these transactions, issuers also often use an investor relations firm to act as information agent during the process. There are no specific rules regarding compensation preventing issuers from using - and paying – an investment bank to solicit tenders.

Exchange offers

Private exchange offers

An issuer may choose to engage an investment bank in an advisory role for a private exchange offer, however, because the exchange involves a limited number of debtholders, a more active dealer-manager is not always needed. Issuers may engage the bank that acted as the initial purchaser for the old debt securities, this way, in an exchange offer under Rule 144A, the bank may have existing "QIB" letters on file to pre-qualify holders. The investment bank's activities cannot include any "general solicitation." There are no specific rules regarding compensation preventing issuers from using, or paying, an investment bank to solicit private exchanges.

Section 3(a)(9) exchange offers

Issuers are permitted to engage third parties, such as financial advisers and investor relations firms, to assist with Section 3(a)(9) exchanges, but their role must be limited. Under Section 3(a)(9), an issuer cannot pay anyone, including a financial adviser or dealer-manager, to solicit exchanges. Pursuant to SEC no-action guidance, a financial adviser may undertake certain activities so long as it is not paid a success fee. Issuers facing a complex restructuring may decide that they need a dealer-manager to solicit exchanges and manage the process to ensure a successful restructuring.

The SEC has provided guidance as to how an investment bank may be compensated in a Section 3(a)(9) exchange. In general, an investment bank *can*:

- engage in pre-launch discussions or negotiations with legal and financial representatives of bondholder committees;
- provide a fairness opinion;[50] and
- only provide debtholders with information that was included in communications sent directly by the issuer.

In general, an investment bank *cannot*:

- solicit (directly or indirectly) exchanges or consents; and
- make recommendations regarding the exchange offer to debtholders or their advisors.

If an investment bank is involved in a Section 3(a)(9) exchange offer, it should be paid a fixed advisory fee, as opposed to a success fee for its services. Although, paid promotion is strictly off-limits, the issuer can still reimburse an advisor for expenses related to the exchange.

The issuer may rely on an investor relations firm or other sales force, such as engaging an information agent, to inform securityholders of the exchange offer.[51] Filling this role with an investment bank is efficient as the firm that sold the securities in the first place may be in the best position to contact its former customers. The permitted activities are limited to contacting securityholders to confirm that the issuer's mailings were received, that the securityholder understands the mechanical requirements necessary to participate in the exchange, and to determine whether or not the securityholder intends to participate in the exchange offer.[52] Under this arrangement, however, payment would have to be made on a flat, per-contact basis, and communications with securityholders may not include any recommendation regarding the decision to accept or reject the exchange offer.[53] An issuer should instruct its agents to defer on all questions relating to the merits of the offer if the issuer wishes to use the Section 3(a)(9) exemption.

Registered exchange offers

In a registered exchange offer, there is more flexibility regarding the investment bank's role. Often, an issuer engages an investment bank to act both as adviser and dealer-manager (which includes soliciting holders if the exchange offer is coupled with a consent). The dealer-manager for a registered exchange offer (or public tender offer) may actively solicit acceptances and be compensated for these activities, including with a success fee. Because of the heightened liability standard involved with a registered exchange offer, the dealer-manager will want to conduct due diligence comparable to the diligence conducted for an ordinary registered offering. In addition, the dealer-manager may require delivery of legal opinions, a 10b-5 negative assurance letter with respect

[50] An issuer is permitted to hire an investment bank to render a fairness opinion on the terms of the exchange; however, if the investment bank also is acting as a dealer-manager and conducting solicitation activities, the SEC has held that obtaining a fairness opinion would violate Section 3(a)(9). *See*, SEC Division of Corporation Finance, *Compliance and Disclosure Interpretations*: Securities Act Sections (#125.07) (November 26, 2008), *available at* http://www.sec.gov/divisions/corpfin/guidance/sasinterp.htm.
[51] Other permitted activities involve confirming debtholder contact details, confirming their receipt of all requisite materials and reminding debtholders of approaching deadlines.
[52] SEC No-Action Letter, *Dominion Mortgage & Realty Trust*, (April 3, 1975).
[53] This second requirement applies to any of the issuer's agents who contact the securityholders, and not only to dedicated sales departments.

to disclosure, and a comfort letter or agreed upon procedures letter.[54] The dealer-manager must keep in mind all rules relating to pre-filing or pre-launch communications with debtholders to avoid gun-jumping issues and Regulation FD issues.

[54] These deliverables are usually also requested by the dealer-manager in a tender offer. The scope of these deliverables can significantly increase the cost of the tender offer or exchange offer and are often negotiated between the parties.