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## *Expert Analysis*

### **Exchange-Offer Alternatives for Issuers Of Debt Securities**

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The current credit crisis and worldwide recession, coupled with a substantially frozen market for new high-yield debt issuances, have led to a significant number of current and prospective defaults by issuers of high-yield debt. A number of companies have failed to pay interest on their debt, while others have defaulted on principal payments at maturity. This trend is expected to continue in 2009 and possibly beyond.

As the credit crisis continues, companies need to anticipate issues they may face as cash flow declines and debt comes due, particularly if refinancing options are not available. Issuers of debt securities have recently been turning to exchange offers both as a substitute for financings and to restructure their balance sheets and obtain some relief from debt-service requirements.<sup>1</sup>

This commentary discusses certain aspects of exchange offers that may be useful to issuers contemplating a debt restructuring.

#### *Fundamentals*

In an exchange offer, a company makes an offer to holders of its outstanding securities to exchange the existing debt for newly issued debt securities or a package of debt and equity securities designed to accomplish the company's financial goals. An issuer considering an exchange offer must carefully analyze its other contractual obligations, particularly senior credit facilities and senior indenture covenants, which may prohibit or restrict the issuer's ability to consummate the offer.

Typically, the exchange offer is tailored to meet the issuer's financial goals while attempting to attract bondholder interest. The offered debt may include lower face amounts and extended maturities compared to the old debt. The new debt may also be more senior in the capital structure or include a collateral package.

In some instances interest requirements on the newly offered debt may be higher than on the old debt in order to incentivize holders to exchange their bonds. However, if an issuer needs cash-flow relief, interest requirements may

be lower, in which case issuers will likely need to give new debt holders a higher priority in the capital structure through a new collateral package or otherwise.

From a securities law perspective, an exchange offer is an offering of new securities and must be registered with the Securities and Exchange Commission unless an exemption from registration is available. In addition, an exchange offer is subject to the anti-fraud provisions of the Securities Act of 1933 and Rule 10b-5 under the Securities Exchange Act of 1934.

A non-convertible debt exchange offer is also subject to only the most basic tender offer rules in Regulation 14E — for example, it must be held open for 20 business days — while tenders for convertible securities may be subject to the full panoply of tender-offer rules applicable to equity securities.

Exchange offers often include consent solicitations requiring the consent of holders of a majority (or in some cases two-thirds) of the principal amount of the old bonds to remove most or all the financial and operating covenants and related events of default from the old debt indentures, thus leaving non-tendering bondholders with bonds that do not have significant covenant protections, as well as a potentially illiquid security.

However, under the Trust Indenture Act of 1939 fundamental economic terms of bonds cannot be amended without the consent of each holder. Therefore, because it is almost always impractical to obtain the consent of every bondholder, an issuer can only change the economic terms of its debt by offering its bondholders a new security. This gives rise to the problem of hold-outs since an existing debt holder can always preserve its economic terms — although not necessarily its covenant protections — simply by declining to make the exchange.

### *Types of Exchange Offers*

An exchange offer can be structured in one of three basic ways: as a registered exchange offer, a Section 3(a)(9) exchange offer or a private exchange.

#### Registered Exchange Offer

In a registered exchange offer, a company will prepare and file with the SEC a registration statement on Form S-4 covering the new securities being offered. The registration process requires substantial public disclosure and can be expensive and time-consuming because the registration statement is subject to SEC review.

Registered exchange offers may be beneficial in situations where bonds are widely distributed or are not held by holders eligible to purchase new debt in a private placement (generally qualified institutional buyers, or QIBs). In addition, new bonds in a registered exchange offer are freely transferable, which provides bondholders with greater liquidity than with privately placed bonds. Exchange offers combined with prepackaged plans of reorganization are typically undertaken as registered exchange offers.

#### Section 3(a)(9) Exchange Offer

A Section 3(a)(9) exchange offer is made pursuant to Section 3(a)(9) of the Securities Act of 1933, which provides for an exemption from registration for any security exchanged by an issuer with its existing securities holders if the following conditions are met:

- No payment is made by the issuer for solicitations made in connection with the offer;
- The old bonds, new bonds and any equity offered in the exchange are all offered by the same issuer (there are limited interpretive exceptions for substantially identical issuers and other specific fact situations); and
- Bondholders are not required to contribute cash or other property, other than the old bonds, in exchange for the new bonds. However, cash or other consideration can be offered by the issuer with the new bonds.

New securities issued in a Section 3(a)(9) exchange offer will be restricted securities for resale purposes only if the old securities were restricted.

The prohibition on payments for solicitation prevents an issuer from hiring an investment banker where the banker's fees are based on the success of the offer. Such prohibitions can impede communications with bondholders and make it more difficult to persuade them to tender their securities, which is always a difficult process.

A Section 3(a)(9) exchange offer avoids SEC registration and review, thus allowing faster completion of an offer than in a registered exchange. Such an offer can also be made to individuals and unsophisticated investors. However, a Section 3(a)(9) exchange is considered a public offering, which can lead to integration issues if an issuer is conducting a simultaneous private placement in connection with the exchange.

## Private Exchange Offer

New securities may also be offered in a private placement exempt from registration under Section 4(2) of the Securities Act.<sup>2</sup>

In a private exchange offer, offers are typically limited to QIBs and offshore investors under Regulation S (or in some cases, accredited investors). The securities issued in a private exchange offer will be restricted securities. However, as with a Section 3(a)(9) exchange offer, private exchange offers are generally less costly and can occur more quickly than registered exchange offers.

Issuers may also pay bankers to solicit holders of outstanding bonds in a private exchange offer. However, any bonds not held by QIBs or offshore investors are generally not eligible to be tendered and will therefore remain outstanding following completion of the exchange offer.

### *Exchange-Offer Strategies*

Bondholders with a significant stake in the outcome of an exchange offer often form ad hoc committees to evaluate the terms of an exchange offer and negotiate better terms with an issuer.

Exchange offers also sometimes attract distress buyers that purchase large blocks of bonds to provide leverage to renegotiate the terms of the offer and obtain more value for the outstanding bonds. Issuers often must struggle through intense, lengthy negotiations in order to complete a proposed exchange offer. Members of an ad hoc committee may become insiders, which restricts their ability to trade in the issuer's securities.

Given bondholders' general reluctance to agree to principal and interest reductions (which may be even further impaired in a post-exchange bankruptcy proceeding), issuers need to create strong incentives for bondholders to participate in an exchange offer.

Accordingly, as noted above, issuers will often combine an exit-consent solicitation with the exchange offer.

In situations where a payment default and subsequent bankruptcy are a real possibility, an issuer can combine an exchange offer with a prepackaged plan of reorganization under Chapter 11 of the Bankruptcy Code and solicit debt exchanges and plan acceptances simultaneously. If the higher threshold for exchange-offer acceptance is not met, the company can implement the exchange in bankruptcy to all holders

with the vote of two-thirds in amount and a majority in number of old bondholders.

Exchange offers can be useful tools in restructuring overburdened capital structures. However, they can be difficult to execute and may involve lengthy negotiations with various constituencies and the risk of litigation.

Issuers that carefully plan with their advisers how to address the complex financial and legal issues and creditor dynamics involved in an exchange offer may be able to successfully restructure their balance sheets, improve their financial health and avoid an insolvency proceeding.

### *Notes*

- <sup>1</sup> There are other restructuring options not addressed in this memorandum that may be available to issuers with sufficient cash resources, such as optional redemptions, cash-tender offers and privately negotiated purchases.
- <sup>2</sup> A private exchange offer can also be conducted under Regulation D to accredited investors. However, recent offers have generally been conducted under Section 4(2) and limited to QIBs and Regulation S purchasers.

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