Top 10 Practice Tips: Liability Management Transactions

A Lexis Practice Advisor® Practice Note by
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This practice note provides 10 practice tips that can help you as counsel to an issuer seeking to engage in a liability management transaction. Given recent market volatility, issuers in a wide range of industry sectors may now be evaluating potential liability management transactions, including debt repurchases, tender or exchange offers, and consent solicitations. Liability management transactions allow an issuer to refinance or restructure its outstanding obligations and may, under certain circumstances, allow an issuer to achieve certain accounting, regulatory, or tax objectives.

Issuers may take advantage of significant benefits associated with a liability management transaction including, but not limited to, evidencing a positive outlook for the issuer in an uncertain market environment, deleveraging potential regulatory capital benefits, and potentially avoiding a more fundamental restructuring or bankruptcy. Choosing the most appropriate liability management transaction is critical and requires that the issuer and counsel consider a number of factors.

For additional information on various types of liability management transactions, see Top 10 Practice Tips: Debt Tender Offers, Debt Tender Offers, Debt Tender Offer Structuring Considerations, Market Trends 2018/19: Tender and Exchange Offers, Exchange Offers under Section 3(a)(9), Restructuring Outstanding Debt Securities Chart, and Debt Securities Restructuring Options.

1. **Consider whether the transaction is an opportunistic or a distressed transaction.** Choosing the right liability management alternative to restructure or retire outstanding debt securities or to manage risk and reduce funding costs may depend on a number of factors. Understanding an issuer's business objectives and financial health is critical when evaluating the feasibility of a given liability management transaction. Often, market participants assume that only issuers facing financial distress or issuers that are highly leveraged will engage in a liability management transaction. Of course, this is not the case, but the type of transaction and the terms will be highly dependent on the issuer's business objectives, whether the issuer has sufficient cash on hand, and market conditions. The transaction may be motivated by an accounting, regulatory, or tax objective or may

simply allow the issuer to refinance its outstanding indebtedness at attractive rates, extend its debt maturities in advance of an expected recession, address its exposure to LIBOR-based indebtedness, or repurchase its outstanding securities that are trading at a discount. Prior to considering any particular option, counsel must understand whether the transaction is opportunistic or whether the issuer faces particular financial challenges that need to be addressed as part of the transaction.

2. **Evaluate whether the issuer's contractual agreements prohibit repurchases, tenders, or exchanges of its outstanding securities.** An issuer's existing commitments may prevent the repurchase, tender, or exchange of an outstanding security or trigger repayment obligations or requirements to use the proceeds from such a transaction for other purposes. Therefore, a careful review of the issuer's existing financing arrangements and other material agreements must be undertaken by counsel. For example, an existing credit facility may prohibit the prepayment or redemption of the issuer's outstanding debt securities or the debt security itself may have call protection features (preventing or limiting a redemption) that should be analyzed and taken into consideration as part of the transaction. Moreover, certain debt securities may be redeemable by the issuer only after a certain period of time has elapsed or a certain market return has been achieved. Additionally, the issuer's indenture may contain financial covenants that restrict its ability to use available cash to pay down or retire other classes of outstanding debt securities. The indenture governing the securities to be redeemed will specify the redemption price and mechanics and typically requires notice of not less than 30 days nor more than 60 days be provided to holders. In certain situations, in order to permit a desired liability management transaction, an issuer may need to first or concurrently conduct a consent solicitation in order to amend or waive restrictive financial covenants or events of default provisions under an existing indenture that otherwise would limit its ability to engage in the transaction.

3. **Assess whether the tender offer rules apply.** An issuer repurchasing its securities, whether 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 by the Securities and Exchange Commission (SEC) to ensure that the issuer and other offering participants do not engage in manipulative practices. Because the term "tender offer" is not specifically defined by the SEC, courts have historically applied the tender offer rules to a broad range of transaction structures. The analysis of whether a particular offer constitutes a tender offer triggering Exchange Act requirements begins with the eight-factor test set forth in Wellman v. Dickinson, 475 F. Supp. 783 (SDNY 1979). The following eight characteristics are typically indicative of a tender offer:

   a) An active and widespread solicitation of public shareholders for the shares of an issuer.

   b) A solicitation is made for a substantial percentage of the issuer's securities.

   c) The offer to purchase is made at a premium over the prevailing market price.

   d) The terms of the offer are firm rather than negotiable.

   e) The offer is contingent on the tender of a fixed number of shares, often subject to a fixed maximum number to be purchased.

   f) The offer is open only for a limited period of time.

   g) The offeree is subjected to pressure to sell his or her security.

   h) Public announcements of a purchasing program precede or accompany a rapid accumulation of large amounts of the issuer's securities.

   These eight characteristics need not all be present for a transaction to be deemed a tender offer, and the weight given to each element varies with the individual facts and circumstances of the particular offer. As a result, repurchase programs should be structured (1) for a limited amount of securities, (2) to a limited number of holders, (3) over an extended period of time, (4) at prices that are individually negotiated, and (5) with offers and acceptances not contingent on one another.

4. **Assess whether the issuer has (or wants to use its) available cash to effect the transaction.** An issuer may not have sufficient cash to effect a redemption, repurchase, or tender offer, or the issuer's management may view the use of cash to effect such a transaction as an inappropriate use of resources given market uncertainty. In that event, an issuer

might instead consider a transaction that does not require deploying cash, such as an exchange offer or a consent solicitation (likely to require payment of a modest cash fee). In an exchange offer, the issuer offers to exchange a new debt or equity security for its outstanding debt or equity securities in a registered, private, or Section 3(a)(9) (15 U.S.C. § 77c) exempt exchange as described below. An exchange offer may enable an issuer to reduce its interest payments or cash interest expense, reduce the principal amount of its outstanding debt, manage its maturity dates, and reduce or eliminate onerous financial covenants. If an issuer would like to significantly amend or waive restrictive indenture provisions, an exchange offer coupled with a consent solicitation may be an attractive option. Conversely, issuers with sufficient cash may consider conducting privately negotiated repurchases, open market repurchases, or a cash tender offer. A debt repurchase allows the issuer to obtain pricing based upon the current market price of the securities that are likely trading at a discount. An issuer also may consider a cash tender offer for all or a significant portion of a class of its outstanding securities.

5. **Assess the composition of the holders of the issuer's securities.** The issuer should consider whether the securities that are the subject of the liability management transaction are widely held as well as the status (predominantly retail or institutional) and location of the holders of such securities (foreign or domestic holders). For example, privately negotiated repurchases are usually most effective if the issuer is seeking only to repurchase a small percentage of an outstanding series of debt securities and if the class of debt securities is held by a limited number of holders. A tender offer may be more appropriate if the security is held by numerous holders and the issuer would like to retire all or a significant portion of the outstanding securities. A tender offer allows an issuer to approach, or make an offer to, all of the holders of a series of its securities. The issuer may consider requiring, as a condition to the tender or exchange offer, that a substantial percentage of the outstanding securities be tendered as part of the transaction. Finally, if an issuer is relying on Section 4(a)(2) under the Securities Act (15 U.S.C. § 77d(a)(2)) for purposes of conducting a private exchange offer, the status of the participating holders will need to be confirmed in order to ensure that the offering restrictions are satisfied.

6. **Consult specialists to assess tax implications.** An issuer engaging in a liability management transaction must be aware of applicable tax consequences relating to cancellation-of-indebtedness (COD) income. Issuers with outstanding debt may be subject to tax on COD income when all or a portion of such debt has been effectively cancelled. COD income can arise in a number of circumstances, including forgiveness of debt by the debt holder, the repurchase of debt by the issuer at a discount, the exchange of one debt instrument of the issuer for another, the modification of debt, and the exchange of debt for the issuer's equity. Additionally, repurchases or exchanges by persons related to the issuer may inadvertently result in COD income. The Internal Revenue Code provides a number of exceptions to the inclusion of COD income, including exceptions related to insolvency and bankruptcy. Issuers and counsel are also advised to consider the tax and spending measures intended to benefit businesses and individuals under the recently passed Coronavirus Aid, Relief, and Economic Security Act.

7. **Consider applicable stock exchange requirements.** An issuer must review applicable securities exchange provisions if the security to be offered as part of a liability management transaction is the issuer's common stock or a security convertible or exercisable for the issuer's common stock. Each securities exchange has specific requirements applicable to listed companies that require the issuer to obtain shareholder approval to the extent that issuance will exceed more than 20% of the pre-transaction shares of common stock outstanding under certain circumstances. In addition, each securities exchange requires an issuer to obtain shareholder approval in advance of an issuance that would result in a change of control of the issuer.

8. **Determine if offering qualifies for abbreviated tender offer relief.** Historically, a tender or exchange offer of non-investment grade debt was required to be held open for at least 20 business days (offer must be extended 10 business days for certain modifications). However, in January 2015, the SEC staff issued a no-action letter that provides limited relief to certain tender and exchange offers (regardless of rating) to the extent specified conditions are met (offers that cannot comply with the relief remain subject to the prior no action letter guidance). This relief permits debt tender offers (including tender offers conducted in the context of certain exchange offers) to be held open for as

few as five business days with potential extensions as short as five business days following changes to the offered consideration or three business days following modifications to other material terms. Noteworthy conditions to the relief, among other conditions, include that (1) the offer to purchase must be made for any and all nonconvertible debt of a particular class or series, (2) the offer must be open to all record and beneficial holders of that class or series of debt, (3) the offer must be conducted and designed to provide all record and beneficial holders of that particular class or series of security a reasonable opportunity to participate, (4) the offer must not be made in anticipation or response to other tender offers for the issuer's securities, and (5) the offer must be made solely for cash or other qualified debt securities (certain nonconvertible debt securities with a longer maturity date) and the consideration must be fixed or based on a standard benchmark spread. The abbreviated tender offer relief is not available if the offer is made in connection with a consent solicitation or if there is a default under the issuer's material debt agreements.

9. **Determine if the exchange offer will be registered or exempt.** An exchange offer involves the offer of new securities and, as a result, it must comply with, or be exempt from, the registration requirements of the Securities Act. An issuer may rely on the private placement exemptions provided under Section 4(a)(2) of the Securities Act. In addition, an exemption pursuant to Regulation S for offers and sales to non-U.S. persons may be available to the issuer. Another option that is frequently used by issuers is an exchange offer exempt from registration pursuant to Section 3(a)(9) of the Securities Act. Section 3(a)(9) has the following five requirements: (1) the issuer of the old securities surrendered must be the same as the issuer trying to effectuate an exchange of the new securities, (2) the holder must not be asked to part with anything of value besides the outstanding security, (3) the exchange must be offered exclusively to the issuer's existing security holders, (4) the issuer must not pay any commission or remuneration for the solicitation of the exchange, and (5) the exchange must be in good faith and not as a plan to avoid the registration requirements of the Securities Act. Securities issued as part of a Section 3(a)(9) exchange remain subject to the same transfer restrictions as the original securities.

   If an issuer is unable to conduct a private exchange, or to rely on Section 3(a)(9), it may instead conduct a registered exchange offer. A registered exchange offer must be registered on a Form S-4 registration statement. The exchange offer may not be commenced until the registration statement is declared effective by the SEC. The SEC review process, cost to prepare the registration statement, and uncertainty concerning timing often make a registered exchange offer a less desirable option for an issuer.

10. **Consider recent Trust Indenture Act cases.** In recent years, debtholders have sought to invoke the protections of the Trust Indenture Act of 1939, as amended (the Trust Indenture Act), in connection with various liability management transactions. Under most indentures and under Section 316(b) of the Trust Indenture Act, noteholder consent 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-consenting noteholders. Several recent court cases have reinforced the significance of the Trust Indenture Act's protections and the need to avoid any coercive consent solicitation that would result in depriving non-consenting noteholders from any source of payment on their securities.

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Anna Pinedo is a partner in Mayer Brown's New York office and a member of the Corporate & Securities practice. She concentrates her practice on securities and derivatives. Anna represents issuers, investment banks/financial intermediaries and investors in financing transactions, including public offerings and private placements of equity and debt securities, as well as structured notes and other hybrid and structured products.

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In the derivatives area, Anna counsels a number of major financial institutions acting as dealers and participants in the commodities and derivatives markets. She advises on structuring issues as well as on regulatory issues, including those arising under the Dodd-Frank Act. Her work focuses on foreign exchange, equity and credit derivatives products, and structured derivatives transactions. Anna has experience with a wide range of transactions and structures, including collars, swaps, forward and accelerated repurchases, forward sales, hybrid preferred stock and off-balance sheet structures. She also has advised derivatives dealers regarding their Internet sites and other Internet and electronic signature/delivery issues, as well as on compliance matters.

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