Practical Guidance

Top 10 Practice Tips: Liability Management Transactions

**A Practical Guidance® Practice Note by
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This Top 10 Practice Tips provides key practice tips for advising a client considering a liability management transaction. Given recurring periods of market volatility, issuers in a wide range of industry sectors from time to time evaluate 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 derive significant benefits from a liability management transaction including, but not limited to, evidencing a positive outlook for the issuer in an uncertain market environment, extending debt maturities, recording an accounting gain, deleveraging, obtaining potential regulatory capital benefits, increasing financing flexibility 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, as discussed below.

- **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 depends 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 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 depend on the issuer's business objectives, whether the issuer has sufficient cash on hand, and on 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, address its exposure to LIBOR-based indebtedness, or repurchase outstanding securities trading at a discount. Prior to considering any option, counsel must understand whether the transaction is opportunistic or whether the issuer faces financial challenges that need to be addressed as part of the transaction.

- **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 proceeds from a new issuance for other purposes. Therefore, the issuer's existing financing arrangements and other material agreements must be carefully reviewed. For example, an existing credit facility may prohibit 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. Moreover, debt securities may be redeemable by the issuer only after a certain period has elapsed or a certain market return has been achieved.

  Additionally, an indenture may contain financial covenants that restrict the issuer's 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. Often, the redemption price equals the face amount plus the present value of future interest payments. In certain situations, to permit a desired liability management transaction, an issuer may need to first or concurrently conduct a consent solicitation to amend or waive restrictive financial covenants or event of default provisions under an existing indenture that otherwise would limit its ability to engage in the liability management transaction. Because consent solicitations can increase flexibility under existing restrictive covenants they may serve as a useful tool when responding to challenges stemming from the COVID-19 pandemic.

  In connection with providing notice of redemption, a company typically issues a press release to announce its decision to redeem outstanding debt securities. This public disclosure should occur before contacting the company's debtholders if the broader impact of the transaction on the company's financial condition would be viewed as material.

- **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 transactions. The analysis of whether a particular offer constitutes a tender offer triggering requirements under the Securities Exchange Act of 1934, as amended, begins with the test set forth in Wellman v. Dickinson, 475 F. Supp. 783, 1979 U.S. Dist. LEXIS 11174, which provides that the following eight characteristics are typically indicative of a tender offer:

  - An active and widespread solicitation of public shareholders for the shares of an issuer.
  - A solicitation is made for a substantial percentage of the issuer's securities.
  - The offer to purchase is made at a premium over the prevailing market price.
  - The terms of the offer are firm rather than negotiable.
  - The offer is contingent on the tender of a fixed number of shares, often subject to a fixed maximum number to be purchased.
  - The offer is open only for a limited period of time.
  - The offeree is subjected to pressure to sell his or her security.
  - 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 offer. As a result, repurchase programs should be structured (i) for a limited number of securities; (ii) to a limited number of holders; (iii) over an extended period of time; (iv) at individually negotiated prices; and (v) with offers and acceptances not contingent on one another.

- **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 using cash to effect such a transaction as an inappropriate use of resources given market uncertainty. In that event, an issuer might instead consider a non-cash transaction, 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 offering or in an offering exempt from registration pursuant to Section 3(a)(9) (15 U.S.C. § 77c) of the Securities Act of 1933, as amended (Securities Act), or other exemption from registration, as discussed below. An exchange offer can be an especially useful mechanism for 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. Coupled with a consent solicitation, an exchange offer may be an attractive option for an issuer seeking to significantly amend or waive restrictive indenture provisions.

Conversely, issuers with sufficient cash may consider conducting privately negotiated repurchases, open market repurchases, or a cash tender offer. Repurchasing debt allows the issuer to obtain pricing based upon the current market price of securities that are likely trading at a discount. The issuer will often engage a financial intermediary to negotiate and effect the repurchase or to repurchase the debt securities on a principal basis. A debt repurchase is an efficient means of refinancing because it requires little preparation, limited or no documentation, and modest transaction costs, particularly when the issuer is seeking to repurchase only a small percentage of debt or if the debt is not widely held. An issuer also may consider a cash tender offer for all, or a significant portion, of a class of its outstanding securities.

- **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 to repurchase a small percentage of an outstanding series of debt securities held by a limited number of holders. A tender offer may be more appropriate if the security is widely held, and the issuer would like to retire all or a significant portion of the outstanding securities. Tender offers are the most common type of transaction and may be for "any and all" of the outstanding securities of one or more series or for a maximum principal or purchase amount. Because issuers in certain industries continue to face challenges as a result of the COVID-19 pandemic, tender offers have become even more relevant as they may be used to refinance outstanding debt at lower interest rates (and at a discount to the current applicable redemption price). 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, an issuer relying on the exemption of Section 4(a)(2) of the Securities Act (15 U.S.C. § 77d), or Regulation D thereunder, to conduct a private exchange offer will need to confirm the status of the participating holders to ensure that the offering requirements are satisfied.
- **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 several circumstances, including forgiveness of debt by the debt holder, repurchase of debt by the issuer at a discount, exchange of one debt instrument of the issuer for another, modification of debt, and 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.
- **Consider applicable stock exchange requirements and other securities law issues.** 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. The New York Stock Exchange and The Nasdaq Stock Market each require listed companies to obtain shareholder approval under certain circumstances for an issuance that will exceed more than 20% of the pre-transaction shares of common stock outstanding. The exchanges also require an issuer to obtain shareholder approval in advance of an issuance that would result in a change of control of the issuer.

may trigger disclosure obligations under SEC Regulation FD (disclosure of any material nonpublic information (MNPI) to certain market professionals or holders of its securities may require the issuer to inform the rest of the market). Issuers should also be aware that "testing the waters" for a transaction may also trigger this obligation. Therefore, issuers should disclose MNPI (e.g., unreleased earnings, potential changes to credit ratings) prior to engaging in such repurchases. Issuers should also be aware that repurchases may trigger Regulation M concerns. Regulation M makes it unlawful for an issuer to "bid for, purchase, or attempt to induce any person to bid for or purchase, a covered security during the applicable restricted period." Repurchases of convertible debt may be deemed a "forced conversion" and thus a distribution of the underlying equity security under Regulation M.

- **Determine if offering qualifies for abbreviated tender offer relief.** Historically, a tender or exchange offer of non-investment grade debt had to be held open for at least 20 business days (with 10-business day extensions for certain modifications). Investment grade debt was not subject to the 20-business day offer period and 10-business day extension requirements. However, in January 2015 the SEC Staff issued The Abbreviated Tender or Exchange Offers for Non-Convertible Debt Securities no-action letter 2015 SEC No-Act. LEXIS 22 that provided limited relief to certain tender and exchange offers (regardless of credit rating) to the extent specified conditions were met. In 2016, the SEC Staff issued Tender Offer and Schedules compliance and disclosure interpretations 162.01–162.05 clarifying the 2015 no-action letter. 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 include, among others, that (i) the offer to purchase must be made for any and all nonconvertible debt of a particular class or series (however, abbreviated offers can have minimum tender conditions); (ii) the offer must be open to all record and beneficial holders of that class or series of debt; (iii) 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; (iv) the offer must not be made in anticipation or response to other tender offers for the issuer's securities; and (v) 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-price or real-time fixed-price spread (only a fixed-price spread set two days prior to the expiration of the exchange offer is permitted for non-investment grade debt). The offer must be announced through a widely disseminated press release before 10:00 a.m. on the first business day of the five-business-day period, which, if the issuer or offeror is an SEC-reporting company, must be furnished to the SEC on a current report on Form 8-K (or Form 6-K for a foreign private issuer) before noon on the first business day of the offer. The abbreviated tender offer relief is not available if the offer is made in connection with a consent solicitation, if there is a default under the issuer's material debt agreements, if the offer is made concurrently with a tender offer for any other series of the issuer's securities made by the issuer, or in connection with a material acquisition or disposition.

- **Determine if the exchange offer will be registered or exempt**. An exchange offer involves the offer of new securities and, as a result, must comply with, or be exempt from, the registration requirements of the Securities Act. An issuer may rely on the private placement exemption provided by Section 4(a)(2) of the Securities Act or Regulation D thereunder. In addition, offers and sales outside the United States may qualify for the safe harbor exemption of Regulation S.

  Another option 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) exempts from the registration requirements "any securities exchanged by the issuer with its existing security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange." Section 3(a)(9) has the following five requirements: (i) the security being issued and the security for which it will be exchanged must be issued by the same issuer: (ii) the holders must not be asked to part with anything of value besides the outstanding security; (iii) the exchange must be offered exclusively to the issuer's existing security holders; (iv) the issuer must not pay any commission or remuneration for the solicitation of the exchange; and (v) 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 offer, 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 (or Form F-4 for foreign private issuers) and include descriptions of the securities being offered, the terms of the exchange offer, description of the issuer, risk factors, financial information and, if applicable, pro forma financial statements. 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 issuers. Additionally, the issuer and other offering participants in a registered exchange offer are subject to potential liability under Sections 11 (15 U.S.C. § 77k) and 12 (15 U.S.C. § 77l) of the Securities Act for material misrepresentations or omissions in the registration statement and prospectus.

- **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 (Trust Indenture Act), in connection with certain liability management transactions. Under most indentures, as well as Section 316(b) of the Trust Indenture Act (15 U.S.C. § 77ppp), consenting noteholders 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 deprive non-consenting noteholders of repayment on their securities.

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Anna Pinedo is a partner in Mayer Brown's New York office and co-leader of the Global Capital Markets 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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Anna regularly speaks at conferences and participates in panel discussions addressing securities law issues, as well as the securities issues arising in connection with derivatives and other financial products. She is the co-author of the leading capital markets treatise, *Corporate Finance and the Securities Laws*, published by Wolters Kluwer (6th Ed., updated 2020); co-author of *A Deep Dive Into Capital Raising Transactions*, published by the International Financial Law Review (2020); co-author of *JOBS Act Quick Start* (International Financial Law Review, 2013; updated 2014, 2016); contributor to *OTC Derivatives Regulation Under Dodd-Frank: A Guide to Registration, Reporting, Business Conduct, and Clearing* (Thomson Reuters, first ed. 2014, second ed. 2015, third ed. 2016, fourth ed. 2017); co-author of *Considerations for Foreign Banks Financing in the US* (International Financial Law Review, 2012; updated 2014, 2016); co-author of *Liability Management: An Overview* (International Financial Law Review, 2011, updated 2015); co-author of *Structuring Liability Management Transactions* (International Financial Law Review, 2018); co-author of *Covered Bonds Handbook*, published by Practising Law Institute (2010, updated 2012-2014); co-author of the treatise *Exempt and Hybrid Securities Offerings*, published by Practising Law Institute (2009, second ed. 2011, updated 2014, third ed. 2017); and co-author of *BNA Tax and Accounting Portfolio: SEC Reporting Issues for Foreign Private Issuers* (BNA Accounting Policy and Practice Series, 2009, second ed. 2012, third ed. 2016, fourth ed. 2020). Anna is also a contributing author to *Broker-Dealer Regulation* (2011, second ed. 2012, updated 2020), published by Practising Law Institute. She co-authored "The Approaches to Bank Resolution," a chapter in *Bank Resolution: The European Regime* (Oxford University Press, 2016). Anna contributed to *The Future of Bank Funding and Capital: Solutions for Issuers, Opportunities for Investors* (IFR Market Intelligence, 2009). Additionally, Anna co-authored "The Ties that Bind: The Prime-Brokerage Regulation," a chapter in *Global Financial Crisis* (Globe Law and Business, 2009); "The Law: Legal and Regulatory Framework," a chapter in (Bloomberg, 2006); and "The Impact Security: Reimagining the Nonprofit Capital Market," a chapter in *What Matters: Investing in Results to Build Strong, Vibrant Communities* (Federal Reserve Bank of San Francisco and Nonprofit Finance Fund, 2017). Anna is a contributor to Practising Law Institute's "BD/IA: Regulation in Focus" blog.

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Brian is a thought leader and frequently authors articles relating to capital markets trends and topics published by *Thomson Reuters'* Practical Law Company, the *Practicing Law Institute*, *Bloomberg* and *LexisNexis*. The *IFLR1000* 2022 guide ranks Brian as a "Rising Star Partner" in the United States for Capital Markets: Equity, and he is also a recommended lawyer by *The Legal 500 US*.

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