MAYER • BROWN

Capital/Liability Management

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Capital/Liability Management

- Purpose
- Techniques
- Legal Issues

Purpose

- Optimize capital structure
- Deleverage efficiently
- Strengthen balance sheet
- Eliminate undesirable securities (e.g., auction rate, floating rate, etc.)
- Reduce interest costs
- Enhance credit rating
- Eliminate burdensome financial covenants
- Capitalize on potential tax advantages under the American Recovery and Reinvestment Act of 2009

Techniques

- Overview
  - Stock buybacks
  - Debt repurchases
    - Redemptions
    - Open market and privately negotiated purchases
    - Tender or exchange offers
  - Consent solicitations
  - Other exchanges
    - Debt for equity exchanges

Stock Buybacks

- Purpose
  - Add upward pressure on stock
  - Increase earnings per share by decreasing shares outstanding
  - Return cash to stockholders without increasing dividends
  - Most efficient use of cash
  - Offset dilution from issuance under equity-linked incentive plans

Stock Buybacks

- Techniques
  - Open market repurchases
  - Privately negotiated transactions
  - Accelerated stock repurchase program
    - Company purchases shares of its own stock from an investment bank at a set price on a specific date
    - Investment bank borrows the shares and covers short position over a period of time
  - Tender offers
    - Modified Dutch auction tender offers (subject to minimum and maximum within 15%)
    - Price indexed to the daily volume weighted average trading price (VWAP) during a period of at least 10 consecutive trading days and ending on a date that is at least two business days prior to the expiration date

Stock Buybacks

- Legal Issues
  - State corporate law
    - Section 160 of the Delaware General Corporation Law generally provides that a corporation may not repurchase its shares when
      - the capital of the company is impaired or
      - the purchase would cause any capital impairment
    - Delaware case law provides that a company may not repurchase its own shares if the purchase diminishes the ability of the company to pay its debts or lessens the security of its creditors
  - Restrictive covenants
    - Confirm repurchase will not violate specific covenants (i.e., restricted payments covenants) or financial covenants

Stock Buybacks

- Legal Issues (cont.)
  - Insider trading and disclosure issues
    - An issuer can't repurchase stock on the basis of material non-public information
      - Issuers typically announce the authorization of a stock repurchase program
        - Issuers DO NOT announce when they enter or exit the market
      - Issuers typically have quarterly "blackout" periods before earnings releases
      - "Rule 10b5-1 plans" allow issuers to repurchase stock at any time
        - Pursuant to a binding contract, instruction or written plan entered into during a period in which the issuer did not have any material non-public information
        - Contract, instructions or plan must state
          - amount (specified number of shares or a specified dollar value of securities)
          - price (market price, limit price or dollar price)
          - date
        - Limited ability to modify plan other than to terminate

Stock Buybacks

- Legal Issues (cont.)
  - Market manipulation
    - Rule 10b-18 provides a non-exclusive “safe harbor” from anti-fraud and anti-manipulation provisions of the Exchange Act for open-market repurchases of equity securities
    - Does not apply to transactions outside of the United States
    - Substantive requirements
      - purchases may be made through only one broker on any single day
      - purchases cannot constitute the opening trade and cannot be made during the last 30 minutes (or 10 minutes in some cases) of trading
      - the purchase price cannot be higher than the current independent bid quotation or the last independent sale price, whichever is higher
      - purchases on any day generally may not exceed 25% of the average daily reported trading volume for the security for the preceding four calendar weeks

Stock Buybacks

- Legal Issues (cont.)
  - Tender offer rules
    - Filing, disclosure and substantive requirements are applicable if the stock repurchases constitute a "tender offer" under federal securities laws
    - SEC rules do not define what constitutes a tender offer, though normal open-market program complying with Rule 10b-18 should be OK
  - Repurchases during a distribution – Regulation M
    - "Distribution participants" and their respective affiliated purchasers may not bid for or purchase any security that is the subject of the "distribution" (e.g., registered securities offerings)
  - Going private regulations – Rule 13e-3
    - Additional disclosure requirements are applicable if the stock repurchases have either a reasonable likelihood or a purpose of causing (1) any class of registered equity securities to be held of record by less than 300 persons, or (2) any class of equity securities to be delisted from an exchange

Stock Buybacks

- Legal Issues (cont.)
  - Banking law issues
    - Federal Reserve Board
      - Under Section 225.4(b) of Regulation Y, a bank holding company must provide notice to the Federal Reserve Board prior to purchasing or redeeming its equity securities unless the gross consideration for the purchase, when aggregated with the net consideration paid by the company for all such purchases or redemptions within the preceding 12 months, is less than 10 % of the company's consolidated net worth
      - No prior notice is required if the bank holding company, among other things, will meet or exceed the "well capitalized" thresholds on a consolidated basis both before and after the repurchase, the bank holding company is considered "well managed" as such term is defined by the Federal Reserve Board, and the bank holding company is not the subject of any unresolved supervisory issues

Stock Buybacks

- Legal Issues (cont.)
  - Banking law issues
    - Federal Deposit Insurance Corporation
      - Under section 18(i)(1) of the Federal Deposit Insurance Act, insured nonmember banks must obtain the FDIC's prior consent to the retirement of any part of their common or preferred corporate stock
    - State law
      - State law may require a bank to obtain regulatory consent to the repurchase of capital stock
    - TARP
      - Financial institutions that have received funds under the TARP Capital Purchase Program agreed not to repurchase common stock, subject to limited exceptions
      - One bank holding company received the Treasury Department's approval in 2009 to reduce its dividend and to apply the savings to repurchases of its common stock

Debt Repurchases

- Redemptions
  - Purpose
    - Eliminate or retire all or a portion of outstanding series of debt
      - Refund with lower cost borrowing
      - Eliminate restrictive covenants
    - Advantages
      - Eliminates entire series
      - Minimal transaction costs
    - Disadvantages
      - May require premium
      - Requires cash
      - Other debt instruments such as credit agreements may limit a company's ability to redeem other outstanding debt

Debt Repurchases

- Redemptions (cont.)
  - Techniques
    - Mandatory call on securities if indenture/debt securities permit
    - Typically trustee gives 30 – 60 days notice
    - May require payment of fixed or make-whole premium
  - Legal Issues
    - Confirm indenture/debt securities permit redemption and/or refunding
    - No concern regarding insider trading because issuer has contractual right to redeem and bondholders have no investment decision
    - Financial institutions may require regulatory approval, especially for instruments qualifying for Tier 1 and Tier 2 capital treatment
    - Confirm redemption will not violate specific covenants (i.e., restricted payments covenants) or financial covenants

Debt Repurchases

- Open Market and Privately Negotiated Purchases
  - Purpose
    - Eliminate or retire outstanding debt
      - Refund with lower cost borrowing
      - Eliminate restrictive covenants
    - Advantages
      - May allow issuer to repurchase below par or without premium
      - Purchase when advantageous or when redemption not permitted
      - Allows for private negotiation if debt is held by few holders
    - Disadvantages
      - Requires willingness of bondholders to sell
      - Generally does not allow entire series to be retired
      - Requires cash
      - Higher transaction costs than redemption

Debt Repurchases

- Open Market and Privately Negotiated Purchases (cont.)
  - Techniques
    - Use one or more brokers to purchase from time to time in market at market prices
    - If significant holders can be identified, can privately negotiate price. May also be able to negotiate exchange for new security
  - Legal Issues
    - Issuer can’t repurchase securities on the basis of material non-public information
    - Filing, disclosure and substantive requirements are applicable if the repurchases constitute a “tender offer” under federal securities laws
    - Financial institutions may require regulatory approval

Debt Repurchases

- Tender/Exchange Offers
  - Purpose
    - Eliminate or retire outstanding substantial amount of debt quickly
      - Refund with lower cost borrowing
      - Eliminate restrictive covenants
    - Advantages
      - Allows for active and widespread solicitation of tenders
      - Can allow for retirement when redemption not permitted
      - Can offer new security rather than cash
      - Can be combined with consents to modify/eliminate covenants
    - Disadvantages
      - Subject to federal tender offer laws and regulations
      - Same price must be offered to all bondholders; typically premium over market price
      - Generally does not allow entire series to be retired
      - Tender offer requires cash

Debt Repurchases

- Tender/Exchange Offers (cont.)
  - Techniques
    - Fixed price
      - Fixed price specified at the beginning of the tender offer
      - May include early tender payment
    - Fixed-spread and real-time fixed spread
      - Price is based on a stated fixed spread over the current yield on a specified Treasury security determined as of the date of tender or the date immediately preceding such date or as of the exact time of the tender as reported by a designated quotation service
    - "Modified Dutch auction"
      - The issuer pays all security holders the same price ("clearing price"), but that price is the lowest price specified by tendering holders at which the issuer would purchase all the securities sought

Debt Repurchases

- Tender/Exchange Offers (cont.)
  - Legal Issues
    - Tender offer rules – Section 14(e)
      - Tender offer must be kept open for 20 business days from commencement and 10 business days from the date of a notice of an increase/decrease in the percentage of the securities to be acquired in the tender, the consideration offered or any dealer-manager fee is first published or sent to bondholders. Offer must remain open for a minimum of five business days after any other material change to the offer or waiver
      - SEC will allow tender offers to be held open for seven to 10 calendar days where:
        - Offer is for non-convertible, investment-grade debt securities
        - Offer must be for cash and be for any and all debt securities of the series
        - Offer is open to all record and beneficial holders of the series
        - Manner of offer affords holders reasonable opportunity to participate, including dissemination on expedited basis if offer is open less than 10 calendar days
        - Offer is not made in anticipation of or in response to other tender offers

Debt Repurchases

- Tender/Exchange Offers (cont.)
  - Legal Issues
    - Tender offer rules – Section 14(e)
      - Fixed-spread and real-time fixed spread tender offers are permitted if the tender offer
        - is for cash for any and all non-convertible, investment grade debt of a series
        - is open to all record and beneficial holders of the series
        - is based upon a benchmark Treasury security for which information is reported each day in a daily newspaper of national circulation
        - is conducted in a manner designed to afford all holders a reasonable opportunity to participate in the tender offer
        - provides that all tendering holders are paid promptly
        - is not made in anticipation of or in response to other tender offers
      - Additional requirements applicable to real-time fixed spread tender offers

Debt Repurchases

- Tender/Exchange Offers (cont.)
  - Legal issues
    - Tender offer rules – Section 14(e)
      - Anti-fraud rules
      - Partial tender offers
        - A tendering person must have a net long position in the subject security at the time of tendering and at the end of the proration period
    - Tender offer rules – Equity and convertible debt securities
      - SEC filing of Schedule TO (Rule 13e-4)
      - Offer must be made to all holders
      - Best price / no early tender premium
      - Publication of information in daily newspaper with national circulation
      - Restrictions on repurchases outside the tender offer
    - Regulation M
      - Certain restrictions apply to the issuer and its affiliates during a "distribution"

Debt Repurchases

- Tender/Exchange Offers

Key differences between investment grade debt and non-investment grade debt	
Investment Grade Debt	**Non-Investment Grade Debt**
• Offer must generally be open for 7-10 calendar days	• Offer must remain open for 20 business days
• Offer must be extended 5 calendar days for certain changes to terms	• Offer must be extended 10 business days for certain changes to terms
• All holders must have a reasonable opportunity to participate and be given the offer materials promptly	• Offer may be priced using a fixed-price spread set two days prior to expiration
• Offer may be priced using a fixed-price spread or a real-time fixed-price spread	

Debt Repurchases

- Tender/Exchange Offers
  - Securities Act considerations
    - Exchange offer involves the offering of a "new security" the offer and sale of which must either be registered or exempt from the registration requirements of the Securities Act
      - Section 3(a)(9) of the Securities Act exempts from registration "any security 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 five requirements:
        - The issuer of the old and new security must be the same
        - No additional consideration from the holder
        - Offer only to existing security holders
        - No remuneration for solicitation
        - Good faith – not used as a plan to avoid registration under the Securities Act
      - Some debt-for-debt exchange offers rely on Rule 144A
      - If debt securities are being offered in the exchange, the issuer must comply with applicable provisions of the Trust Indenture Act

Debt Repurchases

- Tender/Exchange Offers
  - Securities Act Considerations
    - Registered exchange offers
      - Filing of Form S-4
        - Must include a description of the securities being offered, the terms of the exchange offer, a description of the issuer and its business and risk factors
        - May also require pro-forma financial statements if the restructuring is significant
        - No automatic effectiveness (even for a WKSI)
      - Exchange offer may not be commenced until the S-4 is declared effective
      - Early commencement activities
        - Rule 162 under the Securities Act allows issuers to begin the offering period prior to effectiveness as long as no securities are exchanged or purchased until the S-4 has been declared effective and the offer has expired in accordance with the tender offer rules (this shortens the time after effectiveness that the tender offer must remain open)

Debt Repurchases

- Tender/Exchange Offers (cont.)
  - Securities Act considerations
    - Registered exchange offers
    - Early commencement of exchange offers involving debt securities
      - Rule 162 amendments allow early commencement, provided:
        - Same withdrawal rights are provided as if the offering were for equity securities
        - If a material change occurs in the information published, the offeror disseminates information to bondholders in compliance with Rule 13e-4
        - Offer must be held open for withdrawal rights for the minimum periods specified in Rule 13e-4 and Regulation 14D

Consent Solicitations

- Purpose
  - Eliminate restrictive covenants or change terms of debt securities
  - Advantages
    - Action of majority binds all bondholders
    - Does not require repurchase of bonds
  - Disadvantages
    - Some amendments require unanimity
    - Does not retire debt
    - Likely require consent fee
    - Some indentures require a consent payment to be paid to all bondholders consenting even after majority is obtained

Consent Solicitations

- Techniques
  - Solicit consents from bondholders
  - Supplemental indenture executed upon receipt of requisite holders
  - May require payment of consent fee
- Legal Issues
  - Amendment of "basic financial terms" of a security may result in the creation of a new security subjecting the consent solicitation to Securities Act registration
    - "Basic financial terms" include maturity date, interest rate, interest payment dates and redemption rights
    - Stripping of high yield covenants may or may not be an issue
    - Section 3(a)(9) exemption may be available
    - Trust Indenture Act filing (Form T-3) may still be necessary

Consent Solicitations

- Legal Issues (cont.)
  - If coupled with a tender offer, consents should be accepted and supplemental indenture signed (though not effective until closing of tender offer) before notes have been accepted for purchase in the tender offer so notes remaining "outstanding"
  - Need to coordinate with DTC and obtain "omnibus proxy" because DTC is only record holder
  - If convertible debt, consent solicitation may be subject to Exchange Act proxy rules

Other Exchanges

- Debt-for-Equity Exchanges
  - Purpose
    - Can be an effective way of negotiating with creditors and deleveraging
    - Potentially improve credit ratings
  - Technique
    - Exchange of outstanding debt for newly issued equity securities

Other Exchanges

- Debt-for-Equity Exchanges
  - Legal issues
    - Securities law considerations
      - Any exchange of securities must comply with the tender offer and exchange rules
      - New equity securities must be registered or exempt
        - May be able to rely on Section 3(a)(9) exchange offer exemption
    - General corporate matters
      - Must have sufficient authorized capital available or need shareholder approval to increase authorized capital
      - Generally an issuance of greater then 20% of the pre-transaction total shares outstanding will trigger NYSE/NASDAQ shareholder approval requirements