Liability Management Handbook
2015 update
We first published the *Liability Management Handbook* in the midst of the financial crisis. As we then noted, during the early 2000s, corporate issuers issued debt in substantial amounts, with some companies becoming overleveraged in the process. Financial institutions also had relied significantly on regular issuances of hybrid securities such as trust preferred securities, mandatory convertibles, and REIT preferred securities. Financial institutions were not alone in relying on complex financing tools. Issuers in the US and globally offered a stunning diversity of new financial instruments, which were structured to achieve customised legal, tax, accounting and other goals.

What to do with these capital structures and how to do it falls under the rubric of liability management. In today’s world it requires an understanding not only of the law, but also of complex capital structures. To operate in this area, the team of professionals needs to know not only the relevant securities, tax, banking, bankruptcy and other laws, but also must have a keen appreciation for why structures were created, why structures worked, and why the structures may not serve today’s needs. While unprecedented in its severity, the financial crisis brought with it valuable lessons for practitioners in the area – whether through innovative debt-for-equity exchanges, the remarketing of outstanding securities, new approaches to tender offers, or new guidance from regulators. This learning will serve to inform us on how to approach any future wave of restructurings or liability management exercises.

We have compiled this handbook to help attorneys, investment bankers and corporate counsel navigate their way through the complex legal maze that has come to surround liability management transactions in the post-recession/crisis world. It is designed to pull together in one place not only the law relating to liability management, but also the modern practice of liability management. While the financial crisis may be viewed as part of a prior period in our financial history, each period brings with it new challenges, and hopefully, new opportunities. As of this writing, liability management issues for entities operating in the energy sector are the subject of increased focus. Next month, or next year, this focus likely will be elsewhere. The key point to be made is that understanding liability management approaches and techniques will not become irrelevant anytime soon.
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About the firm

We are Morrison & Foerster – a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology, and life science companies. We’ve been included on The American Lawyer’s A-List for eleven straight years, and Fortune named us one of the “100 Best Companies to Work For.” Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com

Morrison & Foerster attorneys represent issuers, dealer-managers, solicitation agents and other parties in connection with a variety of liability management transactions. Our attorneys have particular experience advising on, and structuring, debt tender offers, including tenders for investment grade and non-investment grade debt securities, and tenders involving hybrid securities, such as trust preferred securities. A liability management transaction may be an opportunistic or preventive transaction, or part of a more complete recapitalisation or restructuring. Our capital markets, corporate, bankruptcy & restructuring, and tax attorneys work closely together to structure multi-step transactions. Attorneys in our Tax Department have substantial expertise in the management of liabilities and the structuring of debt issuances, repurchases and exchanges. We have significant experience with the full panoply of transactions available to issuers restructuring their liabilities, including the use of securities like contingent convertible debt instruments, high-yield and zero coupon obligations, and other structured products. Our tax attorneys have the ability to address and manage the variety of tax and non-tax concerns an issuer might face, including the minimisation of cancellation of indebtedness income, the preservation of net operating losses, the conservation of cash and recapitalisations, or other reorganisations on a tax-free basis. We are comfortable advising both healthy companies revisiting their balance sheet or pursuing a leveraged acquisition and distressed companies approaching bankruptcy and non-bankruptcy workouts. Our ultimate goal is to provide concrete and practical solutions to the problems faced by issuers.
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Issuers should consider re-balancing their balance sheets under one or more of the following circumstances:

• **New business and market realities.** Many issuers are still recovering from the financial crisis and coming to terms with the new realities brought about by more stringent regulatory requirements and enhanced oversight and supervision. In certain instances, issuers have had to revisit their businesses and discontinue certain business lines or types of transactions, or consider dispositions of certain assets. These types of changes, together with continuing market volatility, declining stock prices, rating downgrades, write downs and modified earnings projections, often lead an issuer to evaluate a recalibration of its debt/equity mix.

• **Deleveraging efficiently.** Some debt securities, hybrid securities and converts are trading at discounts. An issuer may be able to affect an efficient repurchase/tender given market conditions—optimise its balance sheet, reduce its interest expense and the like.

• **US tax considerations.** Changes to the US federal tax laws in recent years 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.

This overview highlights a number of balance sheet restructuring approaches that issuers should consider and which are discussed in more detail in subsequent sections of this book.

Repurchases for cash include:

• **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. Exchange offers not involving cash include:

• **Private exchange offers** – unregistered debt for debt exchanges pursuant to section 4(a)(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-US 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.

• **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.

### General tax considerations

**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.
Debt holders
In part, the tax consequences to debt holders depend on whether the restructuring constitutes a recapitalisation within the meaning of section 368(a)(1)(E) of the Code. Generally, debt exchanges involving debt securities with terms longer than five years qualify as recapitalisations. On the other hand, a repurchase of debt securities will result in gain or loss to the debt holder 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 characterised as ordinary income.

How to choose an approach
Legal, accounting, ratings, regulatory capital and tax considerations should all be factored into determining the best approach to re-balancing:

- **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 offer.

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

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

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

- **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 financial or operating covenants as well as de-leveraging?

- **Part of a broader effort?** The issuer should consider whether a buy back is only a precursor to a restructuring or recapitalization, as well as 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 transaction carefully. Open market repurchases in contemplation of a tender offer may be problematic.

Benefits from a repurchase or exchange of debt securities
There can be a number of benefits to the issuer from a repurchase or exchange of debt securities, including:

- **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 earnings per share improvement**;

- **Potential regulatory capital and ratings benefit**; and

- **Alternative to more fundamental restructuring or potential bankruptcy**.

Repurchases and exchanges (debt for debt, hybrid or debt/equity) can be particularly important for financial institutions for the following reasons:

- **Many financial institutions are facing deadlines to comply with the regulatory capital requirements arising as a result of the implementation of the Basel III framework, and to address the “phase out” of the favourable regulatory capital treatment received in respect of certain outstanding hybrid securities. The interest rate environment and regulatory requirements may make this an opportune time to restructure a balance sheet**.

- **Rating agencies, analysts and commentators are focused on tangible common equity and similar measures. This may motivate financial institutions to restructure. Exchange offers may be used 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**.
• A restructuring may be a component of insurance company and bank reorganisations and/or good bank-bad bank or other split off transactions.

• May be used as a potential exit from government support.

Structuring challenges
In structuring a debt repurchase, particularly a tender offer, issuers face a number of challenges.

• Holdouts – The issuer and its financial and other 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 applicable 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 recapitalisation. 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.

General disclosure concerns
In addition to the disclosures to debt holders required in the repurchase transaction itself (as discussed below), issuers have ongoing disclosure obligations to all its security holders under the Securities Exchange Act 1934, as amended (the Exchange Act). In relation to the repurchase or tender offer, these obligations include requirements under Form 8-K to disclose entry into or termination of a material definitive agreement, creation of a direct financial obligation or an obligation under an off-balance sheet arrangement and unregistered sales of equity securities. An issuer may also need to file a Form 8-K for a cash tender if the tender may be considered an acceleration of a financial obligation.

Further, the issuer may also determine that before it can enter into a repurchase or redemption plan, it must disclose other material non-public information. 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 non-public information, whether or not related to the repurchase, the issuer should plan to disclose all material non-public 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 debt holder. This can be accomplished through the filing of 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 (see further below).

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 a redemption. A credit line may prohibit prepayment and 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 10 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.

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 terms governing 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 re-financings, permitted liens and restricted payments, as well as covenants regarding incurrence of indebtedness. An issuer should carefully review its existing debt instruments to ensure that redemption is permitted and that it would not trigger repayment obligations. There also may be other, non-financial agreements, such as lease agreements or even acquisition agreements, which 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 terms of the debt securities, which were negotiated at the time of issuance, usually specify the redemption price. The redemption price typically will reflect the
holders’ yield to maturity on the outstanding debt securities and debt holders will be made whole. The price will typically 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 an issuer generally is required to provide at least 30 days’ prior notice of redemption, if it announces a redemption on fixed rate debt securities, it runs the risk that the cost of the proceeds it intends to use for the redemption, which at the time the notice was issued were available at a lower cost, may have increased, and may even increase above the redemption cost.

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 for a redemption usually is determined by the trustee or by the trustee working with the depository.

In connection with delivery of the redemption 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 debt holders. During the financial crisis, there were a few notable instances in which the failure by issuers to disclose their intention to redeem certain securities gave rise to allegations of selective disclosure (violating the issuer’s Regulation FD [Fair Disclosure] obligations) and bondholder claims.¹

In connection with any redemption of outstanding debt securities, an issuer must also ensure that it has complied with securities law antifraud provisions. In particular, if the issuer has not, in the original offering documents, 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 Exchange Act, for material misstatements or omissions in the prospectus as they relate to the redemption.²

Privately negotiated and open market debt repurchases
An issuer that has cash on hand, 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 will also 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 security holders in order to achieve the best possible pricing.

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 are usually 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 or other terms directly with security holders; 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 for resale to the issuer; 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 regulatory 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 or initial purchaser 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 security holders in connection with debt repurchases.

Private negotiations with creditors, including debt holders, 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 non-public 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 non-public 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, would likely be viewed as material. Disclosure of the repurchases to a debt holder 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 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, debt holders 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 also 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 debt holders that may rise to the level of an “offer” under the US securities laws. If this occurs, the offer must either: 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).

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 debt securities 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 the 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 with 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 securities. 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 a 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 carefully review the impact of the eight factors and structure the transaction to avoid the tender offer rules. Courts have found the following eight characteristics indicative 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.

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. 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.

**Regulation 14E**

In 1968, Congress amended the Exchange Act to add provisions relating to tender offers. The statutory amendments together with the SEC’s rules adopted in 1968 are typically referred to collectively as the Williams Act. The rules were significantly amended in 1999. Regulation 14E and Rules 14e-1, 14e-2 and 14e-3 under the Exchange Act apply to all tender offers – both equity and debt. However, 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 and more recently to tenders of non-investment grade debt securities that meet specified conditions. 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.

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. The offer must also stay open for at least 10 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. By analogy to the requirements of Rule 14d-4, 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.

- **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 9:00am 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.

- **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.

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 its position with respect to the bidder’s tender to its security holders- 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, similar to Rule 10b-5. If such person is in possession of material non-public information that he knows or has reason to know is non-public 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 non-public information. This information may include unreleased earnings, a potential change in an issuer’s credit ratings or an unannounced merger. To avoid any issues, the issuer should disclose this information prior to commencing a tender offer.

Debt tenders for cash
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 debt holders 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.

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.

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, 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 10 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 gain greater visibility regarding the success of the tender offer. An issuer needs to be mindful that the falling away of the premium may, under in certain circumstances, constitute a change in consideration that may require that the tender stay open for an additional 10 days as discussed above.

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 for 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). Usually the permitted price range is very narrow — often no more than 15% of the minimum price.

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.

Since 1986, based in large measure on the belief 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, the SEC staff consistently granted relief to issuers of investment grade debt in the context of tenders for their debt securities. Based on those no-action letters, which have, to an extent, been superseded by the issuance in January 2015 of a more recent no-action letter (discussed below), an issuer need not keep the tender open for 20 business days, provided the following conditions are met:

- 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 period of less than 10 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 the series of no-action letters issued since 1986, investment grade debt issuers were no longer subject to the 10- and 20-business day requirements. In 1990, the SEC staff expanded this no-action relief for investment grade debt. Salomon Brothers 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 US 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).

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 US 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.12

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 10- and 20-business day requirements.13

**Treatment of investment grade versus non-investment grade debt**

Until relatively recently, tender offers for investment grade debt were subject to the more lenient process outlined above, while similar relief remained unavailable for tender offers for non-investment grade debt. In January 2015, the SEC staff issued a no-action letter (which supersedes the prior letters discussed above in most respects) that effectively eliminates the distinction between investment grade and other debt securities, and 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 if certain specified conditions are satisfied. The significant conditions include:

- The offer must be made available to all holders of the debt securities and for all of the outstanding securities.
- The offer must be made by the issuer of the debt securities or a parent or subsidiary of the issuer.
- The offer must be made solely for cash or other so-called qualified debt securities, which is defined as securities that are materially identical to the securities that are the subject of the tender offer.
- The consideration offered in the tender offer must be fixed or based on a benchmark spread.
- The offer cannot be combined with an exit consent to amend or eliminate covenants or otherwise to amend the provisions of the indenture or the debt securities.

The no-action letter is significant in that it may offer some issuers more flexibility to tender for their outstanding debt securities; however, not all issuers will be able to comply with the specified conditions summarised above and the additional disclosure related conditions. We discuss the letter in greater detail in Chapter 4.

**Cash tender offers for convertible debt securities**

Certain provisions of the Williams Act 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 these provisions, including Rule 13e-4, which regulates tender offers by issuers. 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.

**Requirements of tenders subject to Rule 13e-4**

The principal additional requirements for a tender subject to Rule 13e-4 are:

- **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 security holders. Schedule TOs are subject to review by the SEC,14 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.15 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 security holder for securities tendered in the tender offer must be the highest consideration paid to any other security holder for securities tendered in the tender 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 security holder is paid to any other security holder 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.\(^\text{16}\)

• **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 10 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.\(^\text{17}\)

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.\(^\text{18}\) 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, an issuer may have 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 US registered securities into the European Union (EU) 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 security holders.

**Regulation M**

Although, as discussed above, 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 will generally recognise 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.

A debt holder whose debt security is repurchased by the issuer will recognise 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 characterised 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). 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.

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 will 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. If an issuer engages a financial intermediary to assist with the solicitation of tenders, the intermediary may be subject to statutory underwriter liability and will conduct its own diligence review of the issuer, including 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(a)(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-US persons may be available on a standalone basis or combined with other applicable securities exemptions.

Regulation M
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(a)(2), it may not engage in a general solicitation of its security holders. In addition, any offerees must be sophisticated investors. Typically, if an issuer is relying on section 4(a)(2) for its exchange, it will limit its offer only to qualified institutional investors, or 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, the intermediary will identify debt holders and contact them in advance. Often, the financial intermediary will have certifications on file for the debt holder 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 the 2007 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” (emphasis added).

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 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:
• **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 security holder must not be asked to part with anything of value besides the outstanding security;

• **Offer only to existing holders** – the exchange must be offered exclusively to the issuer’s existing security holders;

• **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 security holders. 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 straightforward, 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. 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.”

In another no-action letter, an issuer transferred its common stock to a trust. 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).

**No additional consideration from the holder**

The term “exclusively” in Section 3(a)(9) refers to the consideration that security holders 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 than old securities. Conversely, an issuer relying on section 3(a)(9) is free to include cash in what it gives to the security holders.

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

**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. 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 subject to certain restrictions. The services provided by the third party must be “ministerial” or “mechanical.” 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.” An issuer needs to be particularly mindful of firms, such as investor relations firms, that communicate with security holders. Hiring a firm to communicate with security holders 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 security holders regarding the exchange offer, 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.

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. An issuer also needs to be cautious of having its exchange offer integrated with other securities offerings conducted in close proximity to the exchange. In making a determination regarding integration, an issuer must apply the SEC’s five factor integration test.

Registered exchange offers

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. As with a tender offer, additional Exchange Act rules will apply to exchanges of debt with equity characteristics, such as convertible debt.

The registration statement

A registered exchange offer must be registered on a Form S-4 registration statement (Form F-4 for foreign private issuers). 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 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 restructuring, the issuer may be required to provide pro forma financial information statements reflecting the effects 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. 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.

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 debt holders, the offeror disseminates information about the material change to the debt holders 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.

**Tax considerations**

An issuer that exchanges new debt for old debt, or that modifies old debt, may recognize ordinary COD income if it results in a taxable exchange. In the event of a taxable exchange, the issuer 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 or a debt-for-debt exchange will be treated as a taxable exchange if the modification to the old debt 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 (for example, 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.

Assuming the exchange or modification constituted a recapitalisation, such exchange or modification generally should not result in gain or loss to the debt holder. 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 exceeded that of the old debt, certain tax consequences could follow. For example, if the principal amount of the new debt 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. Depending on prevailing economic conditions, debt exchanges or modifications will result in COD income if the market prices of existing debt securities are discounted from their adjusted issue prices.

**Consent solicitations**

Often, an issuer may wish to solicit consents from its debt holders, 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 that would have to be registered under the Securities Act or be subject to an exemption from registration. 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 debt holders. 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 holders from any source of payment on their securities.

**Standalone consents**

In certain situations, in order for example to permit a potential transaction, such as an acquisition, reorganisation 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 10 business days, although a supplemental indenture giving effect to the amendments or waivers sought may be executed and delivered as soon as the requisite consents from security-holders are obtained.

**Exit consents**

If an issuer would like to significantly change 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 debt holders (who are about to give up the old securities) as opposed to continuing holders of the old debt securities. The tendering debt holders 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. 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 debt holders 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. US courts have viewed exit consents as permissible contract amendments governed by basic contract law principles. 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 10 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.

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 authorised capital available prior to commencing the exchange. If the issuer lacks sufficient authorised 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, 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 debt holder 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.

Tax considerations
An issuer that engages in a debt equity swap will recognise ordinary COD income to the extent the adjusted issue price of the debt exceeds the market value of the equity it issues. 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 recapitalisation. 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 securities when it is in possession of material non-public 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 non-public 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 security holders 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 authorised 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.

### Incentives and disincentives

There are a number of structural considerations that may create incentives to tender or to tender early. An issuer should consider some or all the following depending on the structure and legal requirements of the tender or exchange:

- **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 penalise 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 debt holders will be in a better position if bankruptcy is avoided. This involves a delicate balancing act.

### 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). Financial intermediaries in particular may be subject to liability as statutory underwriters in connection with solicitations of participation in the exchange offer. It is therefore customary for a dealer-manager, in order to avail itself of a due diligence defence 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 the value of these securities or the 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 2008 Delaware court case crystallises some of the challenges associated with debt restructurings. In the Realogy case, Realogy Corporation 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, 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 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.
Exchange requirements
The securities exchanges, the New York Stock Exchange (NYSE), the Nasdaq Stock Market (Nasdaq) and the NYSE MKT (NYSE MKT and collectively, the exchanges), require shareholder approval for the issuance of equity securities by their listed issuers in various situations. 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 categorised as a public offering.

Under Nasdaq Rule 5635 and NYSE MKT 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 security holder 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.

Each exchange also requires shareholder approval when an issuance will result in a change of control of the issuer. None of the exchanges however, has 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.

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 NYSE MKT 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; (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 NYSE MKT has indicated 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. NYSE MKT 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 categorised as a public
offering, exchange offers may be structured with a cap (in
other words, the exchange is capped at 19.9% and the
remaining percentage above 20% is subject to shareholder
approval).49

**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 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 NYSE MKT;
or the issuer qualifies to register an offering on Forms S-3,
F-3, or F-10 under the Securities Act.50 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 many circumstances, involvement of an
affiliate may preclude reliance on the section 3(a)(9)
exemption for an exchange offer.
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 security holders, 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 debt holders, their organisation and sophistication and whether the issuer has information about, and any contact with, its debt holders. 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 specialised 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 debt holders 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 debt holders 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 debt holders 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 debt holder 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 debt holders 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-manager 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 debt holders, 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. 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; and
only provide debt holders 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 debt holders 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 security holders of the exchange offer. 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 the holders. The permitted activities are limited to contacting security holders to confirm that the issuer's mailings were received, that the security holder understands the mechanical requirements necessary to participate in the exchange, and to determine whether the security holder intends to participate in the exchange offer. Under this arrangement, however, payment would have to be made on a flat, per-contact basis, and communications with security holders may not include any recommendation regarding the decision to accept or reject the exchange offer. 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 as dealer-manager (which includes soliciting holders if the exchange offer is coupled with a consent solicitation). The dealer-manager for a registered exchange offer (or a 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 of securities. In addition, the dealer-manager may require delivery of legal opinions, a 10b-5 negative assurance letter with respect to disclosure, and a comfort letter or agreed upon procedures letter. The dealer-manager must keep in mind all rules relating to pre-filing or pre-launch communications with debt holders in order to avoid gun-jumping issues and Regulation FD issues.
ENDNOTES


4. 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 security holders; (2) all six of those security holders were highly sophisticated; (3) the purchasers did not pressure the security holders in any way that the tender offer rules were designed to prevent; (4) the purchasers did not publicise 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).

5. 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.


7. If the securities are registered on one or more national securities exchanges, the announcement must be made by the first opening of any one of such exchanges on the business day following expiration.


13. 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. (December 23 2005).

14. The SEC, aware of the length of the offer period, will typically provide any comments within the first 10 days.

15. Issuers must 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.

16. The tender offer rules have not been revised or amended to take into account greater reliance on the Internet.

17. 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.


19. Qualified institutional investor is defined in Rule 144A under the Securities Act.

20. “Accredited investor” is defined in Rule 501 of Regulation D under the Securities Act.


22. 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.


28 See SEC No-Action Letter, Exxon Mobil Corp. (June 28 2002).


33 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 (November 6 1962).

34 Forms S-3 and F-3 are available only for offerings for cash; they are not available for an exchange offer.

35 This is a particular issue for well known seasoned issuers or WKSIs, who may be used to automatic effectiveness of their registration statements.

36 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.

37 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).

38 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.


40 Discussed further in Appendix A.

41 Cash tender offers are not registered under the Securities Act. Therefore, none of the participants, including financial intermediaries, will have Securities Act liabilities.

42 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.”


44 See example, Nasdaq Marketplace Rule 5635 (the Nasdaq rules) and related publicly available interpretive guidance; NYSE Issuer Manual Sections 312.00 – 312.07 (the NYSE rules); and NYSE MKT LLC Company Guide Sections 710-713 (the NYSE MKT Rules).

45 Nasdaq Rule 5635(e)(1) 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. NYSE MKT does not have a similar rule.

46 See Nasdaq Rule 5635(b), NYSE MKT Rule 713(b) and NYSE Rule 312.03(d).

47 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 5635-3; Commentary to NYSE MKT Section 713.

48 Telephone conversations between this firm and each of the exchanges.

49 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.

50 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).

51 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.

52 Other permitted activities involve confirming debt holder contact details, confirming their receipt of all requisite materials and reminding debt holders of approaching deadlines.


54 This second requirement applies to any of the issuer’s agents who contact the security holders, and not only to dedicated sales departments.

55 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.
## Liability management: summary of options

<table>
<thead>
<tr>
<th></th>
<th><strong>ADVANTAGES</strong></th>
<th><strong>DISADVANTAGES</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Redemptions</strong></td>
<td>• Speed (no registration required, no documentation needed)</td>
<td>• Requires cash on hand</td>
</tr>
<tr>
<td></td>
<td>• Flexible (may redeem all or part of an outstanding class)</td>
<td>• Expensive (redemption price usually preserves yield to maturity)</td>
</tr>
<tr>
<td></td>
<td>• Notice must be outstanding between 30 and 60 days (rates may fluctuate)</td>
<td></td>
</tr>
<tr>
<td><strong>Repurchases</strong></td>
<td>• Speed (no registration required and no documentation needed)</td>
<td>• Requires cash on hand</td>
</tr>
<tr>
<td></td>
<td>• Privately negotiated. Pricing takes advantage of market fluctuations</td>
<td>• May only retire a small percentage of securities from a limited number of holders</td>
</tr>
<tr>
<td></td>
<td>• Less visibility to the market</td>
<td>• May trigger disclosure obligations</td>
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<td></td>
<td>• For financial institutions, may help improve Tier 1 regulatory capital position</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• May be part of an ongoing repurchase program</td>
<td>• May trigger tender offer rules</td>
</tr>
<tr>
<td></td>
<td>• May engage investment bank to assist</td>
<td></td>
</tr>
<tr>
<td><strong>Debt tenders</strong></td>
<td>• Speed (no registration required and not subject to SEC review, unless convertible debt)</td>
<td>• Requires cash on hand</td>
</tr>
<tr>
<td></td>
<td>• Flexible (able to retire an entire series or class of debt securities)</td>
<td>• If subject to the tender offer rules, debt tenders must be held open for a specified time period, which may vary depending upon the rating ascribed to the debt securities and the ability to comply with certain conditions specified in SEC guidance</td>
</tr>
<tr>
<td></td>
<td>• Able to approach all holders (subject to compliance with the tender offer rules)</td>
<td>• Holdout issue</td>
</tr>
<tr>
<td></td>
<td>• May engage investment bank to solicit</td>
<td>• Convertible debt tenders are subject to the tender rules for equity securities</td>
</tr>
<tr>
<td></td>
<td>• Can pair with a consent solicitation</td>
<td>• Must pay all investors of the same class the same price (if subject to the tender offer rules regarding any equity derivative)</td>
</tr>
</tbody>
</table>

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### ADVANTAGES
- Speed (no registration required, no documentation needed)
- Flexible (may redeem all or part of an outstanding class)
- Notice must be outstanding between 30 and 60 days (rates may fluctuate)

### DISADVANTAGES
- Requires cash on hand
- Expensive (redemption price usually preserves yield to maturity)
- May trigger disclosure obligations
- May trigger tender offer rules
<table>
<thead>
<tr>
<th></th>
<th><strong>ADVANTAGES</strong></th>
<th><strong>DISADVANTAGES</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Private exchange offer</td>
<td>• Speed (no registration required and not subject to SEC review, unless convertible debt)</td>
<td>• Generally limited to QIBs and non-US investors</td>
</tr>
<tr>
<td></td>
<td>• Does not require cash on hand (only minimal costs)</td>
<td>• No general solicitation permitted</td>
</tr>
<tr>
<td></td>
<td>• Flexible (able to retire an entire series or class of debt securities)</td>
<td>• Holdout issue</td>
</tr>
<tr>
<td></td>
<td>• May engage investment bank to solicit</td>
<td>• New securities may be restricted (but holder may be able to tack its holding period)</td>
</tr>
<tr>
<td></td>
<td>• Able to pre-certify investor status</td>
<td>• Holders may request registration of the new securities</td>
</tr>
<tr>
<td></td>
<td>• No section 11 liability in respect of offering memorandum</td>
<td></td>
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<tr>
<td></td>
<td>• Can pair with a consent solicitation</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Often can be accomplished largely tax-free for debt holders</td>
<td></td>
</tr>
<tr>
<td>3(a)(9) exchange offer</td>
<td>• Speed (no registration required and not subject to SEC review)</td>
<td>• New securities may be restricted (but holder may be able to tack its holding period)</td>
</tr>
<tr>
<td></td>
<td>• Flexible (able to retire an entire series or class of debt securities)</td>
<td>• Limited ability to engage and compensate investment bank</td>
</tr>
<tr>
<td></td>
<td>• Does not require cash on hand (only minimal costs)</td>
<td>• Holdout issue</td>
</tr>
<tr>
<td></td>
<td>• Able to approach all holders (subject to compliance with the tender offer rules)</td>
<td>• May be integrated with offers made in close proximity</td>
</tr>
<tr>
<td></td>
<td>• No section 11 liability with regard to offering memorandum</td>
<td>• Must pay all investors of the same class the same price (if subject to the tender offer rules)</td>
</tr>
<tr>
<td></td>
<td>• Can pair with a consent solicitation</td>
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</tr>
<tr>
<td></td>
<td>• Often can be accomplished largely tax-free for debt holders</td>
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<tr>
<td>ADVANTAGES</td>
<td>DISADVANTAGES</td>
<td></td>
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<tr>
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</tr>
</tbody>
</table>
| Registered exchange offer | • Flexible (able to retire an entire series or class of debt securities)  
• Does not require cash on hand  
• New securities are freely transferable  
• May engage an investment bank to solicit (no restrictions on compensation)  
• Able to approach all holders (subject to compliance with the tender offer rules)  
• Can pair with a consent solicitation  
• Often can be accomplished largely tax-free for debt holders | • Time consuming (subject to SEC review and filing requirements)  
• Must remain open for 20 business days (if subject to the tender offer rules)  
• Section 11 liability  
• More expensive than an unregistered exchange offer or repurchase  
• Holdout issue  
• Must pay all investors of the same class the same price (if subject to the tender offer rules) |
| Debt for equity exchanges | • Used by issuers as an alternative to bankruptcy because of upside potential for investors  
• Improves debt/equity ratio, potentially improving credit ratings  
• Does not require cash on hand (only minimal costs)  
• Can pair with a consent solicitation  
• Often can be accomplished largely tax-free for debt holders | • If registered, can be time consuming (subject to SEC review and filing requirements)  
• Must remain open for a specified time period (if subject to the tender offer rules)  
• Equity issuance may trigger securities exchange issuance limitations  
• If insufficient share capital, issuer may be required to obtain shareholder approval  
• Terms of equity securities may be onerous  
• Must pay all investors of the same class the same price (if subject to the tender offer rules) |
<table>
<thead>
<tr>
<th>ADVANTAGES</th>
<th>DISADVANTAGES</th>
</tr>
</thead>
</table>
| Equity for equity exchanges | • Does not require cash on hand (only minimal costs)  
• Terms of new securities may be less onerous  
• Generally a tax free transaction  
• Able to approach all holders (subject to compliance with the tender offer rules) | • Must be permitted under state law  
• If registered, can be time consuming (subject to SEC review and filing requirements)  
• Must remain open for a specified time period (if subject to the tender offer rules)  
• No balance sheet impact  
• Must pay all investors of the same class the same price (if subject to the tender offer rules) |
| Consent solicitation | • May be undertaken alone or with a tender or exchange offer  
• Able to modify onerous or restrictive covenants  
• Not subject to SEC review or tender offer rules  
• No section 11 liability  
• Does not require cash on hand (only minimal costs)  
• Generally tax-free unless considered a significant modification of the debt | • May require a supermajority to enact modifications  
• TIA does not permit modification of interest, principal, maturity and other provisions without 100% approval; TIA provisions may serve to limit certain amendments that deprive holders of a right to a source of payment  
• Modifications may result in the remaining securities being considered new for Securities Act purposes  
• Holdout issue |
CHAPTER 3

Liability management continuum

Least documentation → Most documentation

Redemptions → Debt tenders → 3(a)(9) exchange offers → Debt for equity swaps

Least time consuming → Most time consuming

Repurchases → Private exchange offers → Registered exchange offers → Equity for equity exchanges
An issuer considering debt repurchases faces a series of important decisions regarding the scope of the repurchases, terms, and other related matters. For example, an issuer may purchase debt securities consensually in open market transactions or, conversely, in a non-consensual redemption according to the terms of the applicable indenture or note purchase agreement. Alternatively, the issuer may exchange outstanding securities for a new series of securities.1

Depending on the path taken, issuers will have to be mindful of various requirements and obligations. Some, such as the anti-fraud provisions of the securities laws, apply regardless of the route taken. Others, such as the conditions relating to reliance on the section 3(a)(9) exemption from registration under the Securities Act of 1933, as amended (the Securities Act), affect only certain exchanges.

Redemptions

Complying with the terms of the governing indenture

Depending on the terms of the governing indenture, an issuer may be able to redeem its debt securities at a predetermined price without the holder’s consent. The redemption price is likely to be based on the holder’s yield to maturity. Some indentures, typically those governing zero-coupon obligations or debt with a relatively short maturity, have absolute call protection and do not permit redemption. Other indentures include restrictions on the time period during which issuers can redeem the securities.

An issuer may have the most difficulty with indenture provisions that restrict the source of funds the issuer can use to redeem the securities. These types of provisions typically prohibit an issuer from financing the redemption of its securities with the proceeds of offerings of lower-cost debt securities. In addition, an issuer should consider the provisions of its credit agreements or bank facilities, which may contain prohibitions on redemptions of debt securities.

Fortunately, courts permit an issuer to demonstrate that, despite a concurrent lower-cost offering of securities, the direct source of the funds used to repurchase the old debt originated elsewhere.2 One court allowed an issuer to make a tender offer for its own debt securities using the proceeds of the tainted, lower-cost securities, while simultaneously redeeming those not tendered with clean cash raised through other means.3 Nevertheless, these cases hinge on the contractual terms of the relevant indenture. An issuer redeeming its securities should not mistake favourable judicial precedent for a guarantee that its own indenture permits a particular strategy. At the very least, an issuer must be very careful to segregate the clean funds used to redeem securities from the proceeds of any other lower-cost securities offerings. Even if an issuer takes such precautions, however, it is possible the market will perceive the issuer as having breached the terms of the indenture. The boundaries of activity contractually permissible do not always overlap with the boundaries of activity conducive to good reputation.

Providing adequate disclosure

An issuer that redeems its securities must comply with the anti-fraud provisions of the securities laws. Though the terms of the relevant indenture may permit various activities, no private contract can waive the anti-fraud protections afforded by the Securities Act and the Securities Exchange Act of 1934, as amended (the Exchange Act). For example, one court found that, despite the issuer’s compliance with the terms of the indenture, its failure to disclose all relevant facts regarding the redemption violated Rule 10b-5(b).4 An issuer must comply with the terms set forth in the indenture as well as with the anti-fraud prohibitions of the securities laws.

Repurchasing debt securities in the open market

Unlike a redemption, where an issuer repurchases its securities without the consent of the holders, an open-market purchase is a voluntary transaction between the issuer and a willing debt holder. The primary challenge for an issuer undertaking an open market purchase is to lessen the possibility that the transaction will be regarded by the SEC as a tender offer. Tender offer or not, however, an issuer repurchasing securities in the open market must be mindful of the SEC’s disclosure requirements.
Avoiding the definition of tender offer

Section 14(d) of the Exchange Act requires certain filings and disclosures when any person or group makes a tender offer, resulting in the ownership of greater than 5% of a given class of securities. Section 14(e) of the Exchange Act is an anti-fraud provision that forbids misstatements, omissions and fraudulent or misleading acts in connection with any tender offer. These two sections, and the rules promulgated under these sections, apply only when a transaction constitutes a tender offer.

Congress, in adopting the William Act and section 14(d), did not define tender offer in order to give the courts and the SEC flexibility. In its rules under section 14(d) and 14(e), the SEC also has not defined tender offer to give itself flexibility in applying the rules. Courts have filled this gap, providing a set of factors useful in differentiating between tender offers and other public solicitations. The test used by a majority of courts lists eight characteristics that are typical of a tender offer:

1. Active and widespread solicitation of public shareholders for the shares of an issuer.
2. Solicitation made for a substantial percentage of the issuer’s stock.
3. Offer to purchase made at a premium over the prevailing market price.
4. Terms of the offer are firm rather than negotiable.
5. Offer is dependent on the tender of a fixed number of shares, often subject to a fixed maximum number to be purchased.
6. Offer is open for only a limited period of time.
7. Offeree is subjected to pressure to sell his or her stock.
8. Public announcements of a purchasing program concerning the target company precede or accompany rapid accumulation of large amounts of the target company’s securities.

Not all of these elements need to be present for a transaction to constitute a tender offer, and the weight given to each element varies with the circumstances. For example, an open-market purchase of 25% of a corporation’s stock was not considered to constitute a tender offer for various reasons. The purchaser contacted only six of the 22,800 security holders, all six of those security holders were highly sophisticated and the purchaser did not pressure the security holders in any way that the tender offer rules were designed to prevent. Additionally, the purchaser did not publicise the offer, the purchasers did not pay a significant premium — nor did they require a minimum number of shares or percentage of stock, and the purchasers did not set a time limit for the offer. In determining whether a tender offer has occurred, this Court noted that courts should be guided by the statutory purpose to protect the “ill-informed solicitee”.

The eight-part test and above case implementing it both involved equity securities. Congress and the SEC have acknowledged that tender offers for non-convertible debt securities are usually less problematic from both a tender offer and public policy perspective. However, any discussion of an acquisition of debt securities should begin with consideration of the eight characteristics listed above. An issuer considering an open-market repurchase of its debt securities should therefore be mindful of the eight factors if it wishes to avoid the strictures of the tender offer rules.

Disclosure requirements for open-market transactions

An issuer that repurchases securities in the open market must comply with the anti-fraud provisions of the securities laws. For repurchase programs, the primary concern is adequate disclosure. Before repurchasing securities, an issuer must consider whether it is in possession of material, non-public information that the securities laws require it to disclose. Both Rule 10b-5 and Regulation FD place disclosure obligations on parties who possess material non-public information about the securities they purchase. Examples of material information include unreleased earnings or an unannounced merger — both of which would need to be disclosed before purchasing securities from a bondholder.

It is possible that the repurchase program itself constitutes material, non-public information. For example, an issuer that drastically reduces the total amount of its outstanding debt through a repurchase program should consider disclosing the program as material. This would also be true if the repurchase program is likely to significantly reduce the issuer’s cash reserves. Generally speaking, an issuer’s plans to repurchase some of its debt will not constitute a material event, so long as a significant principal amount of debt remains outstanding after the repurchase. This is also the case if the public float of a given series remains constant (that is, if the issuer repurchases bonds only from insiders). An issuer should consult with counsel if it is concerned about the materiality of a planned transaction.

An issuer has at least two options should it decide it must disclose its plan to repurchase debt securities. The issuer may announce the debt repurchase program with a press release and file the release as an exhibit to a Current Report on Form 8-K. A more subtle approach would be for the issuer to disclose its intentions in a periodic report, such as in the liquidity discussion in the MD&A section of an Annual Report on Form 10-K, or a Quarterly Report.
on Form 10-Q. Debt repurchase programs likely will proceed more smoothly when the program has been planned for and the marketplace has been informed of it in the issuer’s MD&A section. This is not always possible, however, and a Form 8-K filing is an acceptable alternative.

**Structuring a debt tender offer in light of no-action letter guidance**

It may not be possible for an issuer to ensure that the SEC will not regard an open-market repurchase program as a tender offer. In that case, the issuer/buyer and any dealer manager will need to comply with the requirements of Rules 14e-1, 14e-2, and 14e-3 of the Exchange Act – each of which is applicable to all tender offers (Rule 13e-4 applies only to tender offers for equity securities). The most problematic requirement associated with these rules has traditionally been that the offer remain open for 20 business days, and that following any change in consideration or in the amount of securities sought, the offer must remain open for 10 business days. The reason these requirements have been troubling is that most debt tender offers occur when interest rates are low – the issuer is trying to retire its higher-interest debt using proceeds from current, lower-interest bonds. If the interest rates decline during the offer period, the issuer will not retire as much debt as hoped for. If rates increase, the debt to be retired by the issuer will come at a higher price. Longer offer periods translate into increased uncertainty for debt tender offers, which in turn leads to fewer debt tender offers.

In the past, the SEC staff (the staff) has consistently granted relief from the requirement that non-convertible debt tender offers be held open for 20 business days, provided certain conditions are met. The SEC staff has also provided additional relief from other provisions of paragraphs (a) and (b) of Rule 14e-1, as issuers and their dealer managers have proposed new methodologies for tender offers. In many of the no-action letters (particularly the earlier ones establishing the general relief) the staff has stated an often unelaborated belief. This is that issuer debt tender offers for any and all non-convertible debt securities of a particular class or series, may present considerations different from any and all issuer tender offers, for a class or series of equity securities or non-investment grade debt.

With the assistance of counsel, an issuer should be able to structure a tender to fit within existing no-action guidance and avoid the need to file for its own no-action relief. Structuring within the existing guidance will spare the issuer from the 10 and 20-business day requirements. As we discuss below, based upon recently issued no-action letter guidance, in any and all tenders that meet certain requirements, the time period may be shortened to five business days.

The following discussion addresses the different methodologies for debt tender offers in light of existing SEC no-action letter guidance.

**Non-convertible Debt Tender for Cash: background and basic conditions**

In its no-action relief, the staff has consistently required the following four basic conditions. These were established in a series of nearly identical 1986 no-action letters from investment banks, following amendments to sections 14(d) and 14(e) of the Exchange Act requiring that all tender offers remain open for 20 business days:

- Offers to purchase are made for any and all nonconvertible debt of a particular class or series.
- The offers are open to all record and beneficial holders of that class or series of debt.
- The offers are conducted in a manner designed to provide all record and beneficial holders of that class or series of debt with a reasonable opportunity to participate in the tender offer. This includes dissemination of the offer on an expedited basis in situations where the tender offer is open for a period of less than 10 calendar days.
- The offers are not made in anticipation of or in response to other tender offers for the issuer’s securities.

In many of the no-action letters, the proposed debt tender offers are open for 10 calendar days (or seven calendar days if the expedited procedure indicated above is used), and any extension following a change in number of securities sought or consideration offered can be less than 10 business days. However, not all of these no-action letters requested relief from the 20-business day requirement.

The no-action letters that established these basic conditions did not indicate whether the debt was investment grade. However, in a 1990 no-action letter response, the staff advised Salomon Brothers that its 1986 response letters were limited to investment grade debt securities only.

**Investment grade debt: fixed spread pricing**

As discussed earlier, the principal concern when conducting a debt tender offer is that prevailing market interest rates will change, so that holders will not tender or any tender will become more expensive. In addition to
shortening the time period for the tender offer in order to limit exposure to interest rate fluctuations, another protective measure is to price the tender using fixed spread pricing.

Fixed spread pricing permits an issuer/offeror to choose a specific yield spread between the debt being tendered for and a benchmark US Treasury security (benchmark treasury security), which matures at or near the earliest redemption date for such debt security. The purchase price is calculated as the present value of the security subject to the tender offer, discounted at an interest rate equal to the applicable spread. While the actual price to be paid in the tender offer is not fixed, the formula for determining the price is. The greater the spread, the higher the discount rate, resulting in a lower present value and purchase price.

The no-action letter guidance has focused on the timing of the fixed spread calculation and has required additional conditions for these kinds of tenders. All of these no-action letters involve investment grade securities.

1. Date of, or date immediately preceding date of, tender – Salomon Brothers (October 1 1990)

Salomon Brothers suggested the issuer would offer to purchase its debt securities from tendering holders at a price determined on each day during the tender period. This would be by reference to a fixed spread over the then-current yield on a specified benchmark US Treasury security, determined as of the date, or date preceding the date, of tender.

The staff, in granting no-action relief, required the following additional conditions:

- Information regarding such benchmark treasury security will be reported each day in a daily newspaper of national circulation.
- All tendering holders of that class or series of debt are paid promptly for their tendered securities after such securities are accepted for payment (in this no-action letter, daily settlement was contemplated).

2. Real-time fixed spread offer – Merrill Lynch, Pierce, Fenner & Smith Incorporated (July 19 1993)

Merrill Lynch refined the fixed spread pricing initially created by Salomon Brothers. Merrill Lynch proposed to use a fixed spread pricing methodology in connection with issuer tender offers. However, the nominal purchase price in the offer would be calculated by reference to a stated fixed spread over the most current yield on a benchmark treasury security, determined at the time that the holder of the debt security tenders the security. This is rather than by reference to the yield on a benchmark treasury security as of the date, or date preceding the date, of tender. Merrill Lynch called this a real-time fixed spread offer.

The staff said it would not recommend enforcement action in respect of a real-time fixed spread offer, subject to the following additional conditions:

- The offer identifies the specific benchmark treasury security and specifies the fixed spread to be added to the yield on the benchmark treasury security.
- States the nominal purchase price that would have been payable under the offer be based on the applicable reference yield immediately preceding commencement of the offer.
- Indicates the daily newspaper of national circulation that will provide the closing yield of the benchmark treasury security on each day of the offer.
- Indicates the reference source to be used during the offer, establishing current yield information on the benchmark treasury security.
- Describes the methodology to be used to calculate the purchase price paid for the tendered securities.
- Indicates that the current yield on the benchmark treasury security and the resulting nominal purchase price of the debt securities will be accessible on a real-time basis – either by calling the dealer-manager collect or through an 800 telephone number established for each offer.
- Provides that all tendering holders of that class or series of debt will be paid promptly for their tendered securities after such securities are accepted for payment, within the standard settlement time frame for broker-dealer trades (then five and now three business days from the date of tender).
- In addition to these conditions, the dealer-manager must make and maintain records showing at least the following information in connection with any real-time fixed spread offer:

  - The date and time of the tender.
  - The current yield on the benchmark treasury security at the time of the tender.
The purchase price of the tendered securities based on that yield.

No later than the next business day, send a confirmation to the tendering debt holder providing the specifics of the tender offer transaction, including, upon request, the time of the tender.

3. Continuously priced fixed spread tender offer / single simultaneous settlement – Goldman Sachs (December 3, 1993)

Goldman Sachs created its own version of Merrill Lynch’s real-time fixed spread offer and named it a continuously priced fixed spread tender offer. It was described as being similar to the real-time fixed spread offer described above, but with a provision for simultaneous settlement. Although the target securities would be irrevocably accepted for payment on a continuous basis throughout the tender offer period, the issuer would pay for validly tendered securities on a single simultaneous settlement date promptly after the termination of the tender offer, if the holder were to make such election.

The benefit to the holder of making the election is that the target securities would continue to accrue interest to the settlement date. The staff indicated it would not recommend enforcement action in respect of a continuously priced fixed spread tender offer, subject to the same conditions required in the Merrill Lynch 1993 letter. However, the staff also required the following slightly different conditions with respect to the dealer manager’s obligations:

- Records must be maintained showing at least the following information:
  - The date and time of the tender.
  - The current yield on the benchmark treasury security at the time of the tender.
  - The purchase price of the tendered securities based on that yield.
  - The date the simultaneous settlement procedure is made available, whether or not the holder tendering securities elected to receive payment on a single settlement date rather than within the standard time frame.
  - No later than the next business day, send a confirmation to the tendering debt holder providing the specifics of the tender offer transaction, including the date and (upon request), the time of the tender, price to be paid for the tendered securities, and the settlement date.

4. Indirect obligor – Embassy Suites (April 15, 1992)

Embassy Suites requested confirmation that the staff would not recommend any enforcement action be taken under Rule 14e-1(b) in regard to a cash tender offer for certain non-convertible investment grade debt securities. Embassy Suites was not the direct obligor on the debt securities. The existing structure for the debt securities involved a direct pay letter of credit from a bank, and following a series of spin-off and merger transactions Embassy Suites became one of the obligors party to a reimbursement agreement – although Holiday Inn was still the nominal obligor.

The proposed transaction involved an offer to purchase any and all of the series of notes, which Embassy Suites would then submit to the trustee for cancellation. The tender offer would be a fixed spread issuer tender offer for non-convertible investment grade debt. The request letter stated that “from an economic standpoint, Embassy and [its parent] have assumed the primary repayment liability on the Notes through assumption of the Reimbursement Agreement and the indemnification obligations.”

Embassy Suites described the requirements of the Salomon Brothers no-action letter, dated October 1, 1990, and indicated that it would comply with those requirements. The staff indicated it would not recommend enforcement action pursuant to Rule 14e-1(b), and emphasised the following factors in addition to the ones already described in earlier no-action letters:

- The offer will be held open for at least 20 business days from the date the offer is first published or sent or given to note holders.
- Since the pre-offer agreements between the issuer and the bidder eliminate any risk that the bidder could use the notes acquired in the offer to influence the issuer, there are no control implications to the offer.
- The bidder has the same economic interests in the pricing and completion of the offer and retirement of the notes as an issuer of debt securities would have in an issuer debt tender offer.

Issuers also have recently adjusted pricing mechanisms to more fully reflect market conditions and fluctuations. They have also asked the staff for no-action letter relief for such pricing mechanisms under Rule 14e-1(b). In Citizens Republic Bancorp Inc, the staff provided no-action letter relief for an exchange offer of non-convertible subordinated notes and trust preferred securities for common shares. This was where the pricing mechanism included an averaging period, which was the five trading days ending on the second day before the expiration date of the offer.

As part of the exchange, the issuer would issue common shares having a value (based on their Average VWAP) equal to a fixed dollar amount specified in the related prospectus at the time of the offer’s launch. Average VWAP was defined as the arithmetic average of the daily volume-weighted average price (VWAP), over an averaging period of five trading days ending on the day of expiration. In addition, the related prospectus included a link to a webpage that would show:

- Indicative Average VWAP and resulting indicative exchange ratios calculated as if that day were the last of the exchange offer. This was done by 4.30pm (New York time) on each trading day before the first day of the averaging period.

- Indicative Average VWAP and resulting indicative exchange ratios using actual cumulative trading day during the VWAP averaging period, updated every three hours starting at 10.30 am (New York time) on each trading day.

- The last closing price for the common shares each time the webpage was updated.

The issuer argued the pricing mechanism should be permitted under Rule 14e-1(b) by citing free and ready access to updated indicative exchange ratios, which would enable informed decisions about whether or not to tender. The issuer also pointed out that the pricing mechanism would result in a fixed, constant dollar value exchange, provide greater certainty about the ultimate return to investors, and allow investors to better predict the value they would receive in the exchange offer compared to a fixed exchange ratio.

In Lloyds Banking Group plc, the staff provided no-action letter relief for an exchange offer of non-convertible notes for ordinary shares, where the pricing formula included as a data input the US dollar/UK pound exchange rate. More specifically, the exchange ratio was specified as a stated dollar amount divided by the Dollar VWAP, which was defined as the product of the average daily VWAP in British pounds sterling (UK pound), for the securities tendered. These were reported by Bloomberg for each LSE trading day in the 10-LSE trading period, prior to the expiration date. It was also defined as the product of the US dollar/UK pound spot exchange rate as reported by Bloomberg at or about 4.00pm (London time) on the expiration date.

Additionally, the pricing formula operated, and the final pricing was disclosed, on the expiration date of the offer. The maximum amount of securities that would be accepted in the offer, and the possible application of proration to securities tendered, depended on the results of the pricing formula’s operation on the expiration date of the offer. The issuer said the pricing formula was important to holders because the tendered securities were US dollar-denominated, and the offer enabled holders to receive an amount of consideration with a value that reflected the most recent exchange rate for the US dollar.

Corporate Restructurings, multiple series of debt securities

The staff has also provided no-action letter guidance for debt tender offers in the context of corporate mergers, acquisitions and divestitures – particularly when the issuer is tendering for more than one series of debt, or there are other factors involved. These include consent solicitations and exchange offers (rather than solely cash tender offers). Because of the potential complexity of these transactions, the staff imposes additional conditions.

1. Multiple Transactions – Playtex FP (November 22 1988)

In connection with certain acquisitions, divestitures and mergers pertaining to the Playtex group of companies, four Playtex entities sought an exemption from Rule 10b-6. This was with respect to concurrent cash tender offers for three series of existing debt securities, an exemption under Rule 10b-6 with respect to a public offer of a new series of notes, which would include change of control provisions and confirmation that the staff would not recommend enforcement action under Rule 14e-1(b).

The staff said it would not recommend enforcement action under Rule 14e-1(b) if Playtex complied with the following tender offer features that Playtex described:
• Notice of the offering and tender offer will be given to all holders of the pertinent class of existing debt securities. The tender offer will be made to all holders of such class.

• The tender offers will remain open for at least 20 business days.

• Existing debt securities tendered pursuant to a tender offer may be withdrawn at any time until the expiration of such offer.

• If, for any reason, the price to be offered to holders in a tender offer is increased after such offer is made, the increased price will be paid to all holders tendering pursuant to the tender offer.


The Times Mirror Company had entered into a merger agreement to dispose of its cable television business to Cox Cable. As part of the merger, The Times Mirror Company was to turn New Times Mirror into a spin-off. In connection with this spin-off, The Times Mirror Company proposed to conduct a cash tender offer for a series of notes, a separate exchange offer for a different series of notes and a related exit consent solicitation.

The cash tender offer would be priced as a stated fixed spread over the yield on a specified benchmark treasury security, as of 2.00pm New York time on the business day immediately preceding the expiration date of the offer. As a condition to accepting the tender offer, tendering noteholders would be required to give their consent to certain indenture amendments. In the exchange offer, notes of an old series would be exchanged for new notes issued by the New Times Mirror. Exchanging noteholders would be required to give the same consent to certain indenture amendments as in the cash tender offer. Notes not repurchased or exchanged would remain outstanding obligations of The Times Mirror Company.

The exit consent solicitation was intended to avoid the situation where both Cox Cable and New Times Mirror would become co-obligors with respect to the notes that remained outstanding after completion of the cash tender offer and exchange offer. The Times Mirror Company indicated that previous no-action letters had not specifically allowed for tender offer structures, where a debtholder’s right to tender is conditioned on such holder giving an exit consent.

The staff indicated it would not recommend enforcement action under Rule 14e-1(b) if Times Mirror conducted a cash tender offer for the notes at a price determined as described above. This was subject to the conditions applicable for a fixed price spread offering (as described above), plus an additional requirement that withdrawal of the tendered notes shall be deemed a withdrawal of the exit consent solicitation.

Debt-like securities

The staff has also provided no action guidance for securities not denominated as debt, but with debt-like characteristics – such as certain kinds of preference shares.


BBVA and Banco Bilbao proposed to make a cash tender offer for all of the outstanding non-cumulative guaranteed preference shares, series D of BBVA Privanza International (Gibraltar), including preference shares represented by American Depositary Shares. It was a condition to the tender that all such shares be validly tendered and not withdrawn. The intention was to price the tender offer based on a stated fixed spread over the yield on a specified benchmark treasury security. This was to be from 2.00pm New York time, on the second business day immediately preceding the expiration date of the offer (the 18th business day of the offer period).

BBVA and Banco Bilbao said the tender offer would be made consistent with the principles established in prior no-action letters, as relating to formula pricing in issuer tender offers for equity securities. Additionally, the offer would be substantially similar to the tender offers covered by no-action letters relating to the use of fixed spread pricing methodologies for non-convertible, investment grade debt tender offers.

The staff stated that it would not recommend enforcement action under Rule 14e-1(b) against BBVA or Banco Bilbao if the tender offer used the pricing mechanism described, and if the tender offer was otherwise conducted in the manner represented.

In granting the requested relief, the staff noted, in addition to the typical conditions for fixed spread transactions, that:

• The subject securities are represented as being valued by investors on the basis of their yield. This is taking into account the issuer’s credit spread, compared to a benchmark yield. The yield of the subject securities fluctuates in response to changes in prevailing interest rates.
• The final offer price will be set at least two trading days prior to the scheduled expiration of the offer.

• The offering party will issue a press release to publically announce the final offer price prior to the close of business on the pricing date.

2. Trust preferred securities

The staff has also provided informal oral advice to say that trust preferred securities are sufficiently debt-like. This means that tender offers for trust preferred securities would be subject to the requirements applicable to debt tender offers or exchange offers, and not the more restrictive requirements applicable to equity tender offers under Rule 13e-4. The staff’s position is predicated on the applicable instruments being qualified under the Trust Indenture Act.25

Non-investment grade debt

Until the issuance of a no-action letter in January 2015, the SEC had not issued written no-action relief for tender offers for non-investment grade debt securities.

Prior to the recent no-action letter guidance, the SEC staff’s informal advice had been premised on the notion that fixed spread tender offers for non-investment grade debt securities had different characteristics than those for investment grade securities and less flexible pricing terms. The pricing must be fixed on a pricing date, which should be no later than the second business day preceding the offer’s expiration.26 This results in all holders receiving the same purchase price. While not providing real time pricing, as with investment grade tenders, this pricing mechanism does mitigate the interest rate risks faced by both the issuer/purchaser and the holder. In addition to this pricing mechanism the staff requires the following conditions, which the issuer/purchaser must agree in writing to undertake:

The securities:

• Trade on a basis of a spread over the US treasury market.

• Are liquid based on trading volume and the number of market makers.

• Are widely followed (evidence for which includes a rating by at least one nationally recognised statistical rating organisation).

• The offer to purchase, and each press release regarding the tender, will provide a toll-free number to allow holders to ask questions about the offer.

• The offer must be open for at least 20 business days.

• A press release announcing the purchase price will be issued no later than the business day immediately following the pricing date.

The SEC has also required additional conditions if a consent solicitation is part of the non-investment grade debt tender offer, including the following:

• Withdrawals of tenders and consents are allowed until the consents from holders of the required amount of securities are obtained.

• If consent to deletion of indenture covenants is sought, the issuer or purchaser must prove that the changes to the covenants should not have a material effect on the trading value of the securities not tendered in the offering.

• If a consent fee is paid and the consent period ends prior to expiration of the tender itself, the tender offer will remain open for five business days following the end of the consent solicitation period.

• If the consent solicitation period expires on the 10th business day of the tender, but the tender price is not fixed until later (day 18), the offering materials state when the consent payment will be made.

• A press release announcing that the requisite number of consents has been received must be issued no later than the opening of business on the day immediately following the date the threshold is reached.

• If an exit consent is required in order to tender, the offer must specify that the withdrawal of the tendered securities will be deemed a withdrawal of the consent.

• If the consent fee is payable only until a specified date (the consent expiration date) or the date that a majority of consents is obtained, the majority must be obtained by the consent date. If not, withdrawal rights for tendered securities and consents must be extended until at least 6.00pm on the business day following the issuer’s public announcement (in a press release) that the issuer has received consents from holders representing a majority in principal amount of the outstanding securities tendered for.

• That the revised covenant terms (typically set forth in a supplemental indenture), will not become effective until the tender offer is consummated.
• If the consent solicitation is amended resulting in material adverse change to the rights of security holders, the solicitation period will be extended for 10 business days to allow holders to revoke their consents.

Recent SEC no-action letter guidance applicable to non-convertible debt securities

As noted above, historically, the SEC staff drew a clear distinction between tender and exchange offers for investment grade debt securities and those for non-investment grade debt securities. In structuring tender and exchange offers, market participants relied on existing no-action letter guidance and on informal guidance sought from the SEC staff. In January 2015, the SEC staff issued a new no-action letter that addresses certain tender and exchange offers to the extent that these meet specified conditions and, for the first time, provides relief comparable to that available for investment grade securities to offers for non-investment grade securities. It is important to keep in mind that this guidance, which may provide additional flexibility, especially for addressing outstanding non-investment grade securities, is not available in each and every case. Many tender and exchange offers will continue to be made in reliance on the pre-existing guidance and approaches.

Summary of new guidance

On January 23 2015, the SEC responded to a request submitted by a consortium representing a group of issuers, investment banks, investors and their counsel, and issued a no-action letter indicating that it would not recommend SEC enforcement action in connection with a tender offer or exchange offer for non-convertible debt securities that is held open for as few as five business days, to the extent that the offer is conducted in accordance with certain specified conditions outlined in the letter.27

This no-action letter (which supersedes the prior letters) eliminates the distinction between investment-grade and other debt securities. It also 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, to the extent that the offer is conducted in accordance with certain specified conditions outlined in the letter.27

The offer must be made available to all holders of the debt securities and for all of the outstanding securities (in other words, the offer must be structured as an any and all offer).

• The offer must be made by the issuer of the debt securities or a parent or a wholly owned subsidiary of the issuer. Consequently, third parties tendering for debt securities of an issuer will not be permitted to avail themselves of the shortened tender period.

• The offer must be open to all record and beneficial holders of the targeted debt securities. It is still possible to restrict an exchange offer to QIBs or non-US persons provided that other holders of the targeted debt securities have the option to receive cash in an amount equal to the approximate value of the exchange offer consideration.

• The offer must be made solely for cash or other qualified debt securities, which is defined as securities that are materially identical to the securities that are the subject of the tender offer.

• The consideration offered in the tender offer must be fixed or based on a benchmark spread, which may include US Treasury rates, LIBOR, or swap rates.

• The offer cannot be combined with an exit consent to amend or eliminate covenants or with any other consent solicitation to amend the provisions of the indenture or the debt securities.

• Holders must be entitled to withdrawal rights until the earlier of the expiration date and, if the offer is extended, the tenth business day following the launch. Holders also must be allowed to withdraw tenders after the 60th business day following the launch if the offer has not been consummated by such time.

As outlined above, the consideration must consist solely of cash or non-convertible debt securities that are (i) identical in all material respects to the targeted debt securities (including as to obligors, collateral, lien priority, covenants and other terms) except for payment-related dates, redemption provisions and interest rate; (ii) have interest terms payable only in cash; and (iii) a weighted average life to maturity that is longer than that of the targeted debt securities.

The offer must be announced no later than 10:00 am, Eastern time, on the first business day of the five business day period, through a widely disseminated press release, which in the case of an offer by an SEC reporting company must also be furnished almost immediately under a Current Report on Form 8-K. The press release must include all of the basic terms of the offer and contain a hyperlink to the offer to purchase and letter of transmittal as well as any other relevant documents or instructions. Changes in the offered consideration or other material terms of the offer may result in the requirement to extend
the offer period, such that at least five business days remain from and including the announcement of any change in the offered consideration, and at least three business days remain from and including the announcement of any other material change in the offer. In a manner similar to the announcement of these expedited offers, issuers must notify investors of these material changes by a widely disseminated press release, and SEC reporting issuers must describe changes to the offered consideration almost immediately in a Form 8-K. The results of the offer also must be announced through a press release.

As noted above, the no-action letter is not available for partial tenders. The letter also is not available for tenders or exchanges with exit consents. In addition, the relief is not available:

- at a time when the issuer is the subject of bankruptcy or insolvency proceedings, or otherwise has commenced activity geared toward accomplishing an out-of-court restructuring or pre-packaged bankruptcy;

- in anticipation of or in response to, or concurrently with, a change of control or other extraordinary transaction involving the issuer;

- in anticipation of or in response to a competing tender offer;

- concurrently with a tender offer for any other series of the issuer’s securities made by the issuer or certain affiliates of the issuer if the effect of such offer would result in a change to the capital structure of the issuer (e.g., addition of obligors or collateral, increased priority of liens or shortened weighted average life to maturity of such other series); or

- in connection with a material acquisition or disposition.

There are a number of instances where issuers will be relegated to continuing to rely on the prior no-action letter guidance and structure their offers to remain open for 20 business days.
APPENDIX A

Rule 14e-1 – Unlawful tender offer practices

As a means reasonably designed to prevent fraudulent, deceptive or manipulative acts or practices within the meaning of section 14(e) of the Act, no person who makes a tender offer shall:

a. Hold such tender offer open for less than 20 business days from the date such tender offer is first published or sent to security holders; provided, however, that if the tender offer involves a roll-up transaction as defined in Item 901(c) of Regulation S-K and the securities being offered are registered (or authorised to be registered) on Form S-4 or Form F-4, the offer shall not be open for less than 60 calendar days from the date the tender offer is first published or sent to security holders;

b. Increase or decrease the percentage of the class of securities being sought or the consideration offered or the dealer’s soliciting fee to be given in a tender offer unless such tender offer remains open for at least 10 business days from the date that notice of such increase or decrease is first published or sent or given to security holders;

Provided, however, that, for purposes of this paragraph, the acceptance for payment of an additional amount of securities not to exceed two percent of the class of securities that is subject the tender offer shall not be deemed to be an increase. For purposes of this paragraph, the percentage of a class of securities shall be calculated in accordance with section 14(d)(3) of the Act.

c. Fail to pay the consideration offered or return the securities deposited by or on behalf of security holders promptly after the termination or withdrawal of a tender offer. This paragraph does not prohibit a bidder electing to offer a subsequent offering period under Rule 14d-11 from paying for securities during the subsequent offering period in accordance with that section.

d. Extend the length of a tender offer without issuing a notice of such extension by press release or other public announcement, which notice shall include disclosure of the approximate number of securities deposited to date and shall be issued no later than the earlier of:
   i. 9.00am Eastern time, on the next business day after the scheduled expiration date of the offer or
   ii. If the class of securities which is the subject of the tender offer is registered on one or more national securities exchanges, the first opening of any one of such exchanges on the next business day after the scheduled expiration date of the offer.

e. The periods of time required by paragraphs (a) and (b) of this section shall be tolled for any period during which the bidder has failed to file in electronic format, absent a hardship exemption (Rules 232.201 and 232.202 of this chapter), the Schedule TO Tender Offer Statement (Rule 240.14d-100), any tender offer material required to be filed by Item 12 of that Schedule pursuant to paragraph (a) of Item 1016 of Regulation M-A, and any amendments thereto.

If such documents were filed in paper pursuant to a hardship exemption (see Rule 232.201 and Rule 232.202(d)), the minimum offering periods shall be tolled for any period during which a required confirming electronic copy of such Schedule and tender offer material is delinquent.
RULE 14E-2 – POSITION OF SUBJECT COMPANY WITH RESPECT TO A TENDER OFFER

a. Position of subject company. As a means reasonably designed to prevent fraudulent, deceptive or manipulative acts or practices within the meaning of section 14(e) of the Act, the subject company, no later than 10 business days from the date the tender offer is first published or sent or given, shall publish, send or give to security holders a statement disclosing that the subject company:

1. Recommends acceptance or rejection of the bidder’s tender offer;
2. Expresses no opinion and is remaining neutral toward the bidder’s tender offer; or
3. Is unable to take a position with respect to the bidder’s tender offer.

Such statement shall also include the reason(s) for the position (including the inability to take a position) disclosed therein.

b. Material change. If any material change occurs in the disclosure required by paragraph (a) of this section, the subject company shall promptly publish, send or give a statement disclosing such material change to security holders.

c. Any issuer, a class of the securities of which is the subject of a tender offer filed with the Commission on Schedule 14D-1F and conducted in reliance upon and in conformity with Rule 14d-1(b) under the Act, and any director or officer of such issuer where so required by the laws, regulations and policies of Canada and/or any of its provinces or territories, in lieu of the statements called for by paragraph (a) of this section and Rule 14d-9 under the Act, shall file with the Commission on Schedule 14D-9F the entire disclosure document(s) required to be furnished to holders of securities of the subject issuer by the laws, regulations and policies of Canada and/or any of its provinces or territories governing the conduct of the tender offer, and shall disseminate such document(s) in the United States in accordance with such laws, regulations and policies.

d. Exemption for cross-border tender offers. The subject company shall be exempt from this section with respect to a tender offer conducted under Rule 14d-1(c).
3. Any officer, director, partner, employee or any other person acting on behalf of the offering person or such issuer, to purchase or sell or cause to be purchased or sold any of such securities or any securities convertible into or exchangeable for any such securities or any option or right to obtain or to dispose of any of the foregoing securities, unless within a reasonable time prior to any purchase or sale such information and its source are publically disclosed by press release or otherwise.

b. A person other than a natural person shall not violate paragraph (a) of this section if such person shows that:

1. The individual(s) making the investment decision on behalf of such person to purchase or sell any security described in paragraph (a) or to cause any such security to be purchased or sold by or on behalf of others did not know the material, nonpublic information; and

2. Such person had implemented one or a combination of policies and procedures, reasonable under the circumstances, taking into consideration the nature of the person's business, to ensure that individual(s) making investment decision(s) would not violate paragraph (a), which policies and procedures may include, but are not limited to:
   i. Those which restrict any purchase, sale and causing any purchase and sale of any such security; or
   ii. Those which prevent such individual(s) from knowing such information.

c. Notwithstanding anything in paragraph (a) to contrary, the following transactions shall not be violations of paragraph (a) of this section:
   1. Purchase(s) of any security described in paragraph (a) by a broker or by another agent on behalf of an offering person; or
   2. Sale(s) by any person of any security described in paragraph (a) to the offering person.

d. 1. As a means reasonably designed to prevent fraudulent, deceptive or manipulative acts or practices within the meaning of section 14(e) of the Act, it shall be unlawful for any person described in paragraph (d)(2) of this section to communicate material, nonpublic information relating to a tender offer to any other person under circumstances in which it is reasonably foreseeable that such communication is likely to result in a violation of this rule except that this paragraph shall not apply to a communication made in good faith,
   i. To the officers, directors, partners or employees of the offering person, to its advisors or to other persons, involved in the planning, financing, preparation or execution of such tender offer;
   ii. To the issuer whose securities are sought or to be sought by such tender offer. Also to its officers, directors, partners, employees or advisors or to other persons, involved in the planning, financing, preparation or execution of the activities of the issuer with respect to such tender offer; or
   iii. To any person pursuant to a requirement of any statute or rule or regulation announced thereunder.

2. The persons referred to in paragraph (d)(1) of this section are:
   i. The offering person or its officers, directors, partners, employees or advisors;
   ii. The issuer of the securities sought or to be sought by such tender offer or its officers, directors, partners, employees or advisors;
   iii. Anyone acting on behalf of the persons in paragraph (d)(2)(i) or the issuer or persons in paragraph (d)(2)(ii); and
   iv. Any person in possession of material information relating to a tender offer which information he knows or has reason to know is non-public and which he knows or has reason to know has been acquired directly or indirectly from any of the above.
1 See section 3(a)(9) exchange offers.


3 *Mutual Savings Life Insurance Co v. James River Corp of Virginia*, 716 So. 2d 1172, 1178 (Ala. 1998). See also, Part II.

4 *Harris v. Union Electric Co*, 787 F. 2d 355, 370 (8th Cir. 1986). Harris provides a lesson in the need for careful drafting of the original offering document, although the tone in Harris is so harsh that there is an inference there was more to the Court’s decision than merely failure to disclose material information (an earlier Missouri Court of Appeals decision in the matter had held that the redemption process complied with the indenture). See *Harris v. Union Electric Co*, 622 S.W.2d 239 (Mo.Ct.App. 1981).

5 *Hanson Trust PLC v. SMC Corp*, 774 F. 2d 47, 56 (2d. Cir. 1985). The Hanson Court noted Congressional concern that a “rigid definition would be evaded.”

6 *Wellman v. Dickinson*, 475 F. Supp. 783, 823–24 (S.D.N.Y. 1979); see also Hanson Trust, supra note 5.

7 Hanson Trust, supra note 5 at 57–59.

8 Id. at 57.

9 While both equity and debt tender offers are subject to sections 14(d) and 14(e) and the rules thereunder, equity tender offers are also subject to the requirements of Rule 13e-4. See also Part III and infra note 13.

10 See Appendix A for the texts of Rules 14e-1, 14e-2 and 14e-3.

11 The staff acknowledged these concerns in response to a series of no-action letter requests in 1986. See infra note 15.

12 Tender offers for debt securities that are convertible into equity securities, such as common stock, are treated as equity tender offers, which raise different concerns and are not discussed in this memorandum.

13 See example, SEC No-Action Letter, Merrill Lynch, Pierce, Fenner & Smith Inc (July 2 1986) (“For example, because of the modest premiums typically offered in an Issuer Debt Tender Offer, it is not clear that participation in the tender offer by individual non-institutional debtholders would be materially increased by requiring that tender offer be held open for twenty business days.”)

14 The following discussion highlights the most significant no-action letters concerning structuring debt tender offers, and is not exhaustive of all the no-action guidance.

15 SEC No-Action Letters, Salomon Brothers Inc (March 12 1986); Goldman Sachs & Co. (March 26 1986); First Boston Corporation (April 17 1986); Kidder, Peabody, & Co Inc (May 5 1986); and Merrill Lynch, Pierce, Fenner & Smith Inc (July 2 1986).

16 See SEC No-Action Letter, Salomon Brothers Inc (October 1 1990).

17 See id. The total purchase price for a debt security would be the sum of (1) the present value as of the payment date of (a) the interest payments on the debt from the payment date until maturity or the earliest call date and (b) any principal payments to and redemption premium at the earliest call date or maturity, plus (2) any accrued and unpaid interest to the purchase date.

18 It is interesting to note that in the first of the fixed price spread requests, SEC No-Action Letter, Salomon Brothers Inc (October 1 1990), Salomon did not refer to “investment grade” but the staff’s response was specifically limited to “investment grade” debt securities.

19 Now this methodology should also include access to a website with such information.

20 In a direct pay letter of credit transaction, the letter of credit bank makes the payments on the securities and then seeks reimbursement from the ultimate obligor. This credit-enhancing structure results in the debt security taking on the credit rating of the bank and not of the ultimate obligor.


22 SEC No-Action Letter, Lloyds Banking Group plc (May 28 2010).
23 The staff has previously permitted a formula pricing method in which
the pricing formula operated, and the final pricing was disclosed, on the
expiration date of the relevant offer. See, e.g. SEC No-Action Letter,
Lazard Frères & Co (August 11 1995), SEC No-Action Letter, AB Volvo
(May 16 1997), SEC No-Action Letter, Epicor Software Corporation
(May 13 2004), SEC No-Action Letter, TXU Corp (September 13
2004), SEC No-Action Letter McDonald's Corporation (September 27
2006), SEC No-Action Letter, Weyerhaeuser Company (February 23
2007), SEC No-Action Letter, Halliburton Company (March 23 2007),
SEC No-Action Letter, Kraft Foods Inc (July 1 2008), SEC No-Action
Letter, Citizens Republic Bancorp, Inc, supra note 21, SEC No-Action
Letter, Thermo Fisher Scientific (November 13 2009), and SEC No-

24 Prior to the repeal of Rule 10b-6 and the adoption of Regulation M, it
was necessary to obtain an exemption under Rule 10b-6 if an issuer
engaged in a “distribution” of new debt securities at or about the same
time as it made a tender offer for outstanding debt securities of the same
class and series. See Johnson and McLaughlin, Corporate Finance and
the Securities Laws, section 13.02 (2009). The restrictions of Rules 101
and 102 announced under Regulation M apply only to securities that are
identical in all of their terms to the securities being distributed. The staff
granted no-action relief in Playtex with respect to Rule 10b-6.

25 The staff has previously indicated that “[the Trust Indenture] Act
generally would apply… to preferred securities issued by a trust that
represent an interest in debt issued by a single obligor”. See SEC
Division of Corporation Finance, Compliance and Disclosure
Interpretations: Trust Indenture Act of 1939 (Question 101.04) (March
30 2007), available at

26 The staff has allowed some alternatives to this second business day
pricing models, but its goal appears to be to ensure that holders of non-
investment grade debt have information early in the process regarding
the final expected price, rather than a price to be calculated based on
yield. This reflects the staff’s concern that the market for non-
investment grade (or high yield) debt securities is less liquid and may be
more susceptible to manipulation.

27 See SEC No-Action Letter, Abbreviated Tender or Exchange Offer for
Non-Convertible Debt Securities (January 23 2015).
Liability management is attractive for many issuers as there are a wide array of transactions and restructuring options available for issuers. These include: redemptions; repurchases; debt tenders; private exchange offers; section 3(a)(9) exchange offers; registered exchange offers; debt for equity swaps; equity for equity exchanges; and consent solicitations.

Background
In an exchange offer, the issuer offers to exchange new debt or equity securities for its outstanding debt or equity securities. An exchange offer often is used as an alternative to a cash tender offer if an issuer does not have or want to use its available cash resources to repurchase outstanding debt or equity securities. For distressed companies, an exchange offer may be the best non-bankruptcy restructuring option. An exchange offer enables an issuer to, among other things:

- reduce interest payments or cash interest expense (by exchanging debt securities with a high rate for debt securities with a lower rate);
- reduce the principal amount of outstanding debt (in the case of a debt-equity swap);
- manage the maturity dates of outstanding debt (by exchanging debt securities that are coming due for debt securities with an extended maturity);
- modify the terms of securities (for example, interest payment dates, conversion ratios and redemption provisions); or
- reduce or eliminate onerous covenants (if coupled with an exit consent).

An issuer may need to comply with the tender offer rules in connection with an exchange offer, depending on the facts and circumstances. Because an exchange offer also involves the offer of new securities, it must comply with, or satisfy an exemption from, the registration requirements of the Securities Act. An issuer may rely on the private placement exemption provided under section 4(a)(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-US persons may be available on a stand-alone basis or combined with other applicable exemptions from registration. An issuer also must be mindful of Regulation M’s prohibitions on bidding for, or purchasing, its securities when it is engaged in an exchange offer.

Section 3(a)(9) exchange offers present a number of advantages compared to other types of exchange offers and restructuring options, including the following:

- can be completed quickly, as there is no registration required and, therefore, no SEC staff review (however, if the exchange offer is subject to the tender offer rules, then it is likely that the Schedule TO would be reviewed);
- are flexible (an issuer can retire an entire series or class of debt securities);
- do not require cash on hand (there are only minimal costs);
- there is no section 11 liability with regard to an offer to exchange, as there is no registration statement required;
- can be paired with a consent solicitation; and
- often can be accomplished largely tax-free for debt holders.

However, section 3(a)(9) exchange offers also have a number of disadvantages compared to other exchange offers and restructuring options, including the following:

- the new securities issued in the exchange offer may be restricted securities, depending on the status of the securities surrendered for exchange;
• there is a limited ability to engage and compensate an investment bank or other third parties in connection with the exchange offer;

• there may be holdout issues;

• the exchange offer may be integrated with other offers made by the issuer in close proximity;

• if the exchange offer is subject to the tender offer rules, the offer must be made to all existing security holders; and

• if the exchange offer is subject to the tender offer rules, all investors of the same class must be paid the same price.

Requirements under section 3(a)(9)
Section 3(a)(9) of the Securities Act applies to “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”. The exemption from registration provided by section 3(a)(9) is a transactional exemption only. This means that the new securities issued are subject to the same restrictions on transferability, if any, of the old securities, and any subsequent transfer of the newly issued securities will require registration or another exemption from registration. For example, if the old securities were issued without registration in a section 4(a)(2) private placement and then were exchanged by a holder for new securities, the holder could only sell or transfer the new securities without registration pursuant to Rule 144, pursuant to section 4(a)(1), or, with respect to securities held by affiliates, in a section 4(a)(1-1/2) private placement.

The four main requirements of section 3(a)(9) are as follows:

• Same issuer. The issuer of the old securities being surrendered is the same as the issuer trying to exchange into the new securities.

• No additional consideration from the security holder. The security holder must not be asked to part with anything of value besides the outstanding securities.

• Offer only to existing security holders. The exchange must be offered exclusively to the issuer’s existing security holders.

• No remuneration for the solicitation. The issuer must not pay any commission or remuneration for the solicitation of the exchange.

In addition, as a general matter and similar to other exempt offerings, any exchange offer under section 3(a)(9) must be made in good faith and not as part of 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 security holders. This means that the new securities being issued and the securities that are being surrendered must originate from a single issuer. Although this concept seems relatively straightforward, there are a number of scenarios that can complicate the identity of issuer analysis. In fact, over the years the SEC staff has granted no-action relief in response to facts and circumstances that do not fit neatly within the “single issuer” requirement. For example, in Echo Bay Resources, the SEC granted no-action relief under section 3(a)(9) for an exchange of guaranteed debt securities of a finance subsidiary for the securities of the parent-issuer guarantor. The incoming letter in Echo Bay Resources emphasised the economic reality of the transaction. This included the relationship between the parent issuer and the subsidiary; the SEC noted that the subsidiary was established by the parent-issuer to issue securities and finance the activities of the parent-issuer and the subsidiary had minimal assets and liabilities that were tied to the issuance of securities.

It should be noted that the SEC staff takes the view that there is no 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 that would not be guaranteed by its parent in exchange for the guaranteed debenture. However, the SEC staff has provided no-action relief in the case where there is an exchange of a new parent security for an outstanding parent security that has one or more upstream guarantees from the parent’s wholly-owned subsidiaries.

In Suntrust Banks, the SEC staff provided no-action relief in connection with the same issuer requirement under section 3(a)(9), in a situation where the trust preferred trust securities of an existing trust and the substantially similar trust preferred securities of a newly formed trust were deemed to constitute securities of their parent, given that the trusts had limited purposes and the obligations of the trusts were guaranteed under back-up arrangements between the parent and the trusts.

In Grupo TMM, an issuer transferred its common stock to a trust in order to facilitate the exchange of old securities
for new ones. The issue in the no-action request was whether the issuance by the trust, which was ostensibly a different issuer, would preclude the issuer from relying on the section 3(a)(9) exemption. The SEC staff, without agreeing with counsel's analysis (and noting “policy considerations”), provided no-action relief from Securities Act registration requirements. The incoming letter noted that the trust was a special purpose entity established for the sole purpose of allowing investors to obtain the economic right in a security and the trust did not engage in any activities unrelated to this purpose and has no independent financial or economic activity. More significantly, the SEC staff’s approach, along with the approach taken in Echo Bay Resources, Suntrust Banks and similar no-action letters, indicates that the SEC will often focus on the underlying economic reality of the exchange for the purposes of the identity of issuer analysis.14

Consistent with these precedents, issuers have relied on section 3(a)(9) to exchange common or preferred stock for trust preferred securities. For example, on June 3 2009, KeyCorp announced an offer to exchange, in reliance on section 3(a)(9), its common shares for any and all trust preferred securities of KeyCorp Capital I, KeyCorp Capital II, KeyCorp Capital III and KeyCorp Capital IV, and on June 30 2005, Foster Wheeler announced an offer to exchange, in reliance on section 3(a)(9), its common shares for all outstanding shares of its 9% trust preferred securities.16

Another frequent concern with the identity of an issuer arises when, through a merger, acquisition or other transaction, an issuer has unconditionally assumed the obligations of the securities of another issuer. The SEC staff is of the view that the section 3(a)(9) exemption is available for the exchange of the securities of one issuer for the debt securities of another issuer when the obligations on those debt securities have been fully and unconditionally assumed by the issuer of the new security. However, the SEC staff has indicated that a US parent may not rely on section 3(a)(9) to exempt the conversion of shares of a Canadian subsidiary into US parent shares, even though holders of the Canadian subsidiary shares indirectly share the same dividend, liquidation and voting rights held by common stockholders of the US parent.18

In summary, the SEC staff has recognised that a lack of complete identity of the issuer in certain contexts would not preclude reliance on the Section 3(a)(9) exemption to the extent that the securities involved offer a similar investment—that is the investor looked to the creditworthiness and overall financial condition of the parent, as guarantor or otherwise, or where two entities comprise a single indivisible business. For example, the SEC staff has issued no-action letter guidance in proposed exchanges where: an issuer is relying on a depositary (technically, the “issuer”) that performs a ministerial role in facilitating an exchange of “unit” American Depositary Shares; in the case of parent guarantees which are exchangeable for new parent securities where although two or more issuers are involved, the investor can be assumed to have regarded the exchange of the outstanding parent securities for a new parent security as the substance of the exchange; in reorganizations, where an issuer reorganizes to create a holding company and the new parent guarantees the outstanding securities of the issuer, which are thereafter exchangeable for a parent security; and in the case of “paired securities” of a parent and a subsidiary which were deemed to represent the same economic risk in the parent company as did the parent company for which they were to be exchanged.20

No additional consideration from the security holder
Under section 3(a)(9), the consideration that security holders exchange must consist only of the old securities. However, there are two limited exceptions to this requirement. First, under Rule 150 under the Securities Act, an issuer can make payments to its security holders “in connection with an exchange of securities for outstanding securities, when such payments are part of the terms of the offer of the exchange”. The SEC staff has provided no-action relief where these payments included cash or a cash equivalent and even when paid by an affiliate of the issuer. Second, under Rule 149 under the Securities Act, a security holder can make any cash payments that may be necessary “to effect an equitable adjustment, in respect of dividends or interest paid or payable on the securities involved in the exchange, as between such security holder and other security holders of the same class accepting the offer of exchange”. For example, an equitable adjustment may be necessary when, due to the timing of interest payments and sales between security holders, one security holder receives the benefit of an interest payment due to another security holder. In this case, the issuer can require the unjustly enriched security holder to reimburse the issuer for the extra interest payment. In addition, an issuer can also require the security holders to waive the right to receive an interest payment or other consideration accruing from a security.22

Offer only to existing security holders
Any exchange offer conducted in reliance on section 3(a)(9) may be made only to existing security holders. Although this requirement also appears straightforward, it may not be satisfied if an issuer is conducting an offering of new securities for cash at the same time as the exchange
offer. In this case, the issuer must take care to keep the two offerings separate and avoid their integration, which would require the registration of the combined offerings or the application of another exemption from registration. The determination regarding integration is fact specific, and the issuer must apply the SEC’s five-factor test.

Further, if any part of the issue in the same transaction as the exchange is sold for cash, or intended to be sold for cash, or provided to creditors (as opposed to security holders), even if those portions of the transaction are exempt pursuant to another exemption or are registered, then section 3(a)(9) would not be available.

There is no requirement, however, that a section 3(a)(9) offering be made to all members of a given class of security holders (assuming that tender offer rules do not apply to the transaction). As a result, an issuer may choose to rely on section 3(a)(9) to exchange with securities with one or a limited group of investors.

No remuneration for solicitation
Section 3(a)(9) expressly prohibits an issuer from paying a person or entity a commission or other remuneration either directly or indirectly for soliciting the exchange. When determining what activity and/or commission or other remuneration is permissible under section 3(a)(9), an issuer or a third party involved in the exchange should consider the following factors:

• the relationship between the issuer and the person or entity furnishing the services;

• the nature of the services performed; and

• the method of compensation for the services.

Issuer’s activities
As a general rule, an issuer may solicit holders of target securities without jeopardising the use of the section 3(a)(9) exemption. An issuer soliciting holders of target securities should adhere to the following guidelines:

• the personnel chosen to contact the security holders, which may include the issuer’s directors, officers, and key employees (the “corporate solicitors”), should have significant responsibilities with the issuer other than the solicitation of the exchange and should not be hired for the purpose of soliciting the exchange;

• no special bonus, commission, fee, or any other type of remuneration should be paid to the corporate solicitors for their solicitation activities, which means they should be paid no more than their regular salary; and

• the corporate solicitors should attend to their regular duties, with their solicitation efforts only being additional assignments.

Third party activities
An issuer also may engage third parties, such as financial advisers, investment banks, and investor relations firms, to assist in the exchange offer, subject to certain limitations. Whether an issuer should engage a third party for assisting with an exchange offer and the services that the third party will provide depends on the issuer’s particular situation and the type of transaction contemplated. Generally, the more complex and significant a restructuring (for example, a restructuring for a distressed company), the more helpful it may be for an issuer to engage a financial intermediary, such as an investment bank. The type of transaction will dictate an investment bank’s role (including any limitations on its activities), which ranges from merely an advisory role to responsibilities as an agent or principal.

However, an issuer merely interested in taking advantage of declining secondary market prices for debt securities also may benefit from engaging an investment bank to locate, contact, and negotiate with security holders to retire (or exchange) their securities on favorable terms. In either case, an investment bank, which typically has a liability management, restructuring or workout team specialising in debt restructurings, will help create a restructuring plan, structure the transaction, solicit participation, and manage the marketing efforts to achieve a successful restructuring. Some important factors to consider in determining whether to engage a third party include the number of security holders and their organisation and sophistication and whether the issuer has information about, or any contact with, its security holders.

Impermissible activities. Services may be provided by persons or entities other than the issuer in a section 3(a)(9) exchange, subject to the following limitations:

• cannot make any recommendation regarding the exchange to any security holder, or to any adviser or other representative of any such security holder;

• when communicating with security holders, can provide only that information which is included in the various communications sent by the issuer to the security holders; and

• should limit its activities to performing functionary services or administrative assistance in the distribution of exchange materials and providing information about the mechanics of the exchange.
If any security holder or any adviser or other representative to any security holder asks for a third party’s opinion on an investment-related attribute of the exchange, the third party should direct the holder of the target securities to contact the appropriate officer or employee of the issuer. The third party may respond to questions from security holders regarding substantive elements of the exchange that are addressed in the exchange materials by directing the security holder to the pertinent portion of the exchange materials; however, the third party must not convey management’s views or recommendations on the exchange, even if those views or recommendations or both are contained in the exchange materials.

**Permissible activities.** Permissible activities can be grouped into two broad categories: (1) advice to the issuer with respect to the terms and mechanics of the exchange; and (2) services that are administrative, ministerial, or mechanical in nature in furtherance of the exchange. Any services not deemed administrative, ministerial, or mechanical must be ancillary to the effective mechanical operation of the process of formulating a restructuring proposal.

For example, in *Seaman Furniture*, the SEC granted no-action letter relief in connection with a proposed exchange offer for which the issuer hired investment bankers from Merrill Lynch to act as its financial advisers. The issuer characterised the services and activities provided by its financial advisers as follows:

Since their engagement by the Company in July 1989, the investment bankers from Merrill Lynch Capital Markets who have acted as the Company’s financial advisors have performed the following services for the Company: (1) performed financial analyses; (2) assisted the Company in formulating a restructuring proposal; (3) advised the Company with respect to the terms of the new securities to be issued in connection with the restructuring and the new capital structure of the Company; (4) participated in meetings between representatives of the Company, on the one hand, and the banks, on the other hand; (5) participated in meetings between representatives of the Company, on the one hand, and the legal and financial advisors to the Committee, on the other hand; and (6) conversed by telephone with representatives of the banks and the legal and financial advisors to the Committee. Merrill Lynch Capital Markets will not: (1) be named as a dealer manager of the Exchange Offer; (2) deliver a fairness opinion with respect to the Exchange Offer; or (3) communicate directly with any holder of Existing Sub Debt with respect to substantive matters relating to the restructuring or the Exchange Offer. The Company understands that during the aforementioned telephone conversations and meetings its financial advisors have: (1) outlined the current status of negotiations between the Company and the other creditors of the Company; (2) discussed the Company’s financial statements and projections; (3) presented the Company's current proposals with respect to the terms of the Exchange Offer and the restructuring to the banks and the legal and financial advisors to the Committee; and (4) received and discussed the counterproposals of the banks and the legal and financial advisors to the Committee and relayed such counterproposals to the Company. We understand that the Company’s financial advisors have not: (1) expressed to the banks or the legal or financial advisors to the Committee their views as to (a) the fairness of the proposed restructuring or the Exchange Offer or (b) the value of the securities to be issued in connection with the Exchange Offer or (2) made any recommendation to the banks or the legal and financial advisors to the Committee with respect to the restructuring or the Exchange Offer.

The argument made by the issuer that such services and activities were permitted under section 3(a)(9) was that there was no direct contact between the issuer’s financial advisers and any debt holder with respect to substantive matters relating to the exchange offer. In addition, the issuer stated that the activities of the issuer’s financial advisers constituted activities “effecting” rather than “promoting” an exchange because (1) the exchange offer had not been made, (2) the issuer’s financial advisers had not and would not make any recommendation to the debt holders or their advisers with respect to the proposed exchange offer, and (3) it is customary for an issuer involved in a complex financial transaction to engage an investment banker to act as an intermediary among the parties to a negotiation, especially when the other parties are professional legal and financial advisers. A financial advisor may advise the issuer with respect to virtually all aspects of developing and executing the exchange. The SEC has taken a no-action position with respect to each of the following advisory services:

- performance of financial analysis for the issuer;
- formulation or assistance in the formulation of a restructuring proposal for the issuer’s approval;
- advice on the issuer’s capital structure following the restructuring;
• advice on the timing and organisation of the restructuring proposal;

• advice on the proposed terms and mechanical procedures for the exchange;

• advice on the proposed terms of the new securities;

• assistance in the preparation of the various exchange materials to be sent by the issuer to the security holders;

• advice to employees of the issuer on the procedures to be used in conversations with security holders concerning the exchange;

• engaging in pre-launch discussions or negotiations with legal and financial representatives of debt holder committees;

• providing a fairness opinion regarding the exchange; and

• consulting with institutional investors as to what they would consider to be an acceptable exchange offer.

A third party can engage in administrative, ministerial, or mechanical services designed to convey the information in the exchange materials to security holders. These activities can be divided into two groups: (1) those in which the third party merely services as a functionary in disseminating information; and (2) those in which the third party communicates directly with security holders or their advisers or other representatives. However, the latter group of services should be conducted with great care. The SEC staff has acknowledged in no-action letters that third parties may provide each of the following functionary services in disseminating information to security holders:

• obtain a list of the issuer’s security holders from the issuer, and confirm the accuracy of the addresses of the security holders;

• mail or otherwise assist in the distribution of exchange materials;

• maintain records on the exchange;

• be named as a financial intermediary in the exchange materials;

• contact nominees holding target securities and ascertain the number of the exchange materials needed by each brokerage house for transmittal to beneficial holders;

• deliver sufficient quantities of the exchange materials to brokerage houses, trust officers, other banks, and other nominees for distribution to beneficial holders of the target securities; and

• mail duplicate copies of exchange materials to security holders who appear to have lost or mislaid those originally sent to them.

The issuer may rely on a third party, such as an investor relations firm or other sales force or an information agent, to inform security holders of the exchange offer. A third party can contact security holders directly for the following administrative, mechanical, or ministerial purposes, subject in all instances to the requirement that no solicitation take place as a result of any such contacts:

• to determine whether the security holders received the exchange materials;

• to determine whether the security holders understand the procedures for participating in the exchange (for example, expiration dates and to whom to forward documents);

• to answer questions or resolve any confusion about the procedures for participating in the exchange;

• to contact back-office personnel of nominees who hold securities for the benefit of others to make sure that they promptly forward exchange materials to the nominees;

• to urge back-office personnel to check with the beneficial holders of the target securities about whether such holders have received the exchange materials, understand procedurally how to participate in the exchange, and are generally aware of the relevant dates and deadlines;

• to determine whether the security holders intend to participate in the exchange and to communicate their responses to the issuer;

• to remind the security holders of all appropriate deadlines; and
• to respond to the questions of security holders that do not concern the mechanical aspects of the exchange by directing the security holders to the relevant portions of the exchange materials.

Fees paid to third parties
Section 3(a)(9) does not specify the types of fees that third parties can receive in an exchange. However, the SEC staff has indicated through various no-action letters that a financial adviser may receive a fixed fee for its services, not contingent upon the success of the exchange, plus reasonable expenses related to the exchange. A fixed fee arrangement eliminates one factor which might otherwise support the inference that the financial adviser had an incentive to engage in a solicitation of security holders. Therefore, whenever paid third parties are contacting security holders within permissible guidelines, it is advisable that their fees be a fixed amount not tied to the success of the exchange. Nevertheless, determining whether a paid solicitation has occurred is a fact-specific analysis that will turn on the facts present in a particular transaction. Note that this determination is not necessarily based upon the method of payment of fees to the third party. In addition, if the issuer relies on an investor relations firm, sales force, information agent or others to inform security holders of the exchange, then the issuer can only pay a fee on a flat, per-contact basis to that financial intermediary.38

Redemption standby agreement
A redemption standby agreement between an issuer and an investment bank can be combined with an exchange of securities under section 3(a)(9). An issuer engages an investment bank as a standby purchaser when it plans to force the conversion of convertible debentures (or other similar instruments) by calling the debentures for redemption. But it is also when the issuer would like to protect itself from having to make substantial cash outlays in the event that the issuer’s stock price declines in the period between the redemption notice and the redemption date and the holders elect for redemption.

A standby agreement between an issuer and an investment bank is similar to an underwriting agreement for a primary distribution of securities. The investment bank agrees, for a fee, to purchase at a price slightly above the redemption price all of the debt securities that are offered to it before the redemption date, and then to convert those debt securities into common stock. The issuer can rely on section 3(a)(9) to exempt the exchange of its common stock for the debt securities acquired by the investment bank.39

Open market purchases
An investment bank also can itself effect open market purchases of an issuer’s securities as a principal and then later exchange those securities with the issuer for new securities in reliance on section 3(a)(9). However, all of the conditions under section 3(a)(9) must be satisfied, which means that the investment bank cannot receive any commission or remuneration in connection with the open market purchases.

Other considerations
Involvement of affiliates
In some circumstances, affiliates of an issuer may seek to exchange the issuer’s debt or equity securities. This may occur on the corporate level, such as when a parent exchanges securities of its subsidiaries or when subsidiaries exchange securities of their parent or other subsidiaries, or if officers, directors or significant shareholders seek to exchange the issuer’s securities. In these instances, the affiliates would generally be considered insiders of the issuer and subject to the same disclosure obligations as the issuer. In many circumstances, the involvement of an affiliate may preclude reliance on the section 3(a)(9) exemption for an exchange offer.

Qualification under the Trust Indenture Act
Exchange offers of debt securities that are exempt from registration under sections 3(a)(9) are not exempt from qualification under the Trust Indenture Act.40 Unless an indenture for a debt security is qualified under section 305 of the Trust Indenture Act, which covers registered offerings, or is exempt from qualification under section 304 (which does not include an exemption for section 3(a)(9) exchange offers), the sale of a debt security pursuant to a section 3(a)(9) exchange would generally violate section 306 of the Trust Indenture Act unless an application for qualification of the related indenture has been filed with the SEC.41 Qualification under the Trust Indenture Act is accomplished by filing a Form T-3 with the SEC, which is subject to review by the SEC staff. The solicitation of the exchange offer may not commence until the Form T-3 is filed, and no sales may be made until the Form T-3 is declared effective by the SEC staff.

Securities exchange requirements
The securities exchanges, including the New York Stock Exchange (NYSE), the Nasdaq Stock Market and the NYSE MKT, require shareholder approval for the issuance of equity securities by 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. For example, the requirement for shareholder approval for issuances of common stock in an amount more than 20% of the current outstanding common stock, at a price below the greater of book or market value, has resulted in many section 3(a)(9) exchange offers structured with a price floor for the common stock, a volume weighted average price (VWAP) or a maximum amount of common stock issued just below the appropriate threshold. An issuer also must carefully review the securities exchange rules if the security to be exchanged is either actual equity or convertible or exchangeable debt, or if the exchange offer cannot be categorised as a “public offering.” In addition, the securities exchanges require shareholder approval when an issuance will result in a “change of control” of the issuer.43

**Tax considerations**

An issuer that exchanges new debt for old debt in an exchange offer may recognise ordinary cancellation of indebtedness (COD) if it results in a taxable exchange. In the event of a taxable exchange, the issuer will recognise 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, as part of an exchange offer, also will be treated as a taxable exchange if the modification to the old debt is significant. Generally, modifications are significant if, among other things: (1) the yield changes by the greater of 25 basis points or 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 (for example, from debt to equity or from recourse to nonrecourse).

Assuming the exchange or modification constituted a recapitalisation, the exchange or modification generally should not result in gain or loss to the debt holder. 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 exceeded that of the old debt, the holder could recognise gain equal to the fair market value of the excess. Exchanges and modifications also can create OID or, conversely, an amortisable premium, due to differences in the issue price of the new debt and the stated redemption price at maturity.44

**Liability considerations**

Restructuring transactions, including exchange offers, involve the purchase and sale of securities. Therefore, these transactions are subject to the general antifraud provisions of section 10(b) of the Exchange Act and Rule 10b-5 under the Exchange Act. Section 10(b) provides 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 things, 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 third parties retained by the issuer, may be held liable. Exchange offers may also be subject to section 14(e) of the Exchange Act, which, in addition to specific procedural requirements, contains prohibitions regarding material misstatements and omissions similar to those in section 10(b) and Rule 10b-5.

For this reason, the documentation for an exchange offer (including the offer to exchange) must be more detailed than that for a cash tender offer; for example, the offering materials must describe the terms of the new securities.

If the securities being exchanged are debt securities convertible into equity securities, under certain circumstances, repurchases of the convertible debt securities could be deemed a forced conversion and, therefore, a distribution of the underlying equity securities for Regulation M purposes.

When debt securities are offered, an indenture may need to be qualified under the Trust Indenture Act and the Form T-3 filed for the purpose of qualifying the indenture may be subject to SEC staff review.

The exemption does not apply with respect to a security exchanged under Chapter 11 of the US Bankruptcy Code. Other exemptions, such as Section 1145 of the US Bankruptcy Code, may apply with respect to securities exchanged pursuant to a plan of reorganisation. If an issuer relies on section 3(a)(9) for a solicitation of security holders prior to a bankruptcy filing, and then, following the bankruptcy filing, completes the exchange pursuant to section 1145 of the US Bankruptcy Code, then the issuer would need to file a Form T-3 before commencing the pre-bankruptcy filing solicitation. See SEC Division of Corporation Finance, Compliance and Disclosure Interpretations: Securities Act Sections (Question 125.11) (June 4 2010), available at http://www.sec.gov/divisions/corpfin/guidance/sasinterp.htm.

The incoming letter stated: “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.”


17 See SEC Division of Corporation Finance, Compliance and Disclosure Interpretations: Securities Act Sections (Question 125.02) (November 26 2008).

18 See SEC Division of Corporation Finance, Compliance and Disclosure Interpretations: Securities Act Sections (Question 125.10) (August 14 2010). The offering structure in this instance was designed to take advantage of a Canadian tax exemption for the disposition of shares in a Canadian enterprise through a business combination where the consideration is paid in securities of another Canadian issuer.


24 The five-factor test requires that an issuer consider: (1) whether the offerings are part of a single plan of financing; (2) whether the offerings involve issuances of the same class of securities; (3) whether the offerings are made at or about the same time; (4) whether the same type of consideration is received; and (5) whether the offerings are made for the same general purposes. See SEC Release No. 33-4552 (November 6 1962).


29 See SEC No-Action Letter, Seaman Furniture Co., Inc. (October 10 1989). An issuer also needs to be particularly mindful of those third parties, such as investor relations firms, that communicate with security holders. Hiring a firm to communicate with security holders could be construed as payment for solicitation. The SEC, however, allows investor relations firms to participate in exchange offers in a limited capacity.

30 See id.

31 See id.

32 See id.

33 See, for example, SEC No-Action Letter, Seaman Furniture Co., Inc. (October 10 1989); SEC No-Action Letter, Mortgage Investors of Washington (September 8 1980); SEC No-Action Letter, Hamilton Brothers Petroleum Corp. (August 14 1978); SEC No-Action Letter, Valhi, Inc. (September 15 1976); and SEC No-Action Letter, Dean Witter & Co., Inc. (January 22 1975).

34 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 (Question 125.07) (November 26 2008), available at http://www.sec.gov/divisions/corpfin/guidance/sasinterp.htm.


37 Relying on an investment bank in this instance may be efficient as the firm that initially sold the securities may be in the best position to contact its former customers.

38 See supra note 29.

39 See SEC No-Action Letter, TransTechnology Corp. (February 23 1983); SEC No-Action Letter, Foster Wheeler Corp. (July 2 1973); SEC No-Action Letter, Kewanee Oil Co. (February 5 1973); and SEC No-Action Letter, Squibb Corp. (June 23 1971).

41 Section 306 of the Trust Indenture Act does not apply to exchange offers that are exempt under Section 3(a)(9) where the offering does not exceed $5 million and Section 304(a)(8) and Rule 4a-1 under the Trust Indenture Act otherwise are available. See SEC Division of Corporation Finance, Compliance and Disclosure Interpretations: Trust Indenture Act of 1939 (Interpretation 207.01) (March 30 2007), available at http://www.sec.gov/divisions/corpfin/guidance/tiainterp.htm.

42 See example, Nasdaq Marketplace Rule 5635(a)-(f), and related publicly available interpretive guidance; NYSE Issuer Manual Sections 312.00 – 312.07; and NYSE MKT Company Guide Sections 710-713.

43 See Nasdaq Rule 5635(b); NYSE Rule 312.03(d); and NYSE MKT LLC Company Guide Section 713(b).

44 In each case, particular attention must be paid to terms of art, including 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 existing debt is deemed the current market price. 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.
A key consideration in developing any liability management strategy is the extent to which the SEC's tender offer rules apply to any contemplated transactions, given that these rules can substantially affect the manner in which a transaction is conducted, the timing of the transaction, as well as the issuer's ability to conduct other transactions in its securities around the time of the tender offer. The tender offer rules can apply when a company is offering securities and/or cash for its outstanding securities, and the level of regulation of the offer (in terms of timing and mandated procedural protections) varies depending on the type of security that is the subject of the offer. In the case of exchange offers, the tender offer rules may apply in addition to the requirement that the issuer must either register the transaction or meet the conditions for an exemption from registration under the Securities Act.

Tender Offer Requirements

Defining the tender offer
The comprehensive regulation of tender offers came about with the enactment of the Williams Act in 1968. The Williams Act and the SEC’s implementing regulations are designed to require the dissemination of material information about a tender offer, while providing sufficient procedural protections so that security holders get the opportunity to consider the disclosure when making a decision about whether to tender their securities in the offer. The tender offer rules apply in the case of a third-party tender offer for the securities of another issuer, as well as to a tender offer by an issuer for its own securities.

The term tender offer is not specifically defined in the statute or in the SEC’s regulations. The lack of a specific definition has permitted the SEC and the courts to apply the tender offer rules to a broad range of transaction structures. The analysis of whether an offer constitutes a tender offer begins with the often-cited “eight factor” test in the case of Wellman v. Dickinson:

1. An active and widespread solicitation of public shareholders for the shares of an issuer;
2. A solicitation is made for a substantial percentage of the issuer’s securities;
3. The offer to purchase is made at a premium over the prevailing market price;
4. The terms of the offer are firm rather than negotiable;
5. The offer is contingent on the tender of a fixed number of shares, often subject to a fixed maximum number to be purchased;
6. The offer is open only for a limited period of time;
7. The offeree is subjected to pressure to sell his or her security; 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.

These eight factors 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. While these factors were cited in the context of an offer for equity securities, the principles would equally apply to tender offers involving debt securities or equity securities other than common stock. The eight-factor test may be applied in the context of both third-party offers, as well as offers by an issuer for its own securities.

Courts have also applied a totality-of-the-circumstances test in determining whether a transaction involves a tender offer that should be subject to the statutory requirements and the SEC’s rules. In this context, the courts have examined whether, in the absence of disclosure and procedures required under the tender offer rules, there will be a substantial risk that the offeree will lack the information needed to make an investment decision with respect to the
The SEC staff has historically focused on whether a tender offer involves an investment decision on the part of the offeree, particularly where the protections afforded by the tender offer requirements would appear to be necessary based on the nature of the transaction.

Requirements applicable to all tender offers
Section 14(e) of the Securities Exchange Act of 1934 (the Exchange Act) is an antifraud provision that establishes the baseline for tender offer regulation. Section 14(e) prohibits an offeror from making any untrue statement of a material fact, or omitting to state any material fact necessary in order to make the statements made, in light of the circumstances in which they were made, not misleading. Section 14(e) also prohibits any fraudulent, deceptive or manipulative acts in connection with a tender offer. Section 14(e) applies to cash tender offers, as well as to exchange offers subject to the tender offer requirements.

Pursuant to the authority specified in section 14(e), the SEC has adopted Regulation 14E. Regulation 14E specifies requirements applicable to all tender offers, and for those tender offers where additional requirements apply (such as tender offers for equity securities), the requirements of Regulation 14E must still be satisfied. Regulation 14E applies to cash tender offers, as well as to exchange offers subject to the tender offer requirements. In addition, Regulation 14E applies to both third-party tender offers as well as issuer tender offers.

What is required by Regulation 14E?
Regulation 14E sets forth certain requirements for tender offers that must be carefully followed throughout the course of an offer. These requirements seek to prevent practises that would be deemed fraudulent, deceptive or manipulative acts in connection with a tender offer. Regulation 14E requires that:

- A tender offer must be held open for at least 20 business days;
- The percentage of the class of securities being sought or the consideration being offered may not be increased or decreased unless the tender offer remains open for at least 10 business days from the date that the notice of such increase or decrease is first published or sent or given to security holders;
- The offeror promptly pay the consideration, or return tendered securities, upon termination or withdrawal of the tender offer;
- Public notice be provided in connection with the extension of a tender offer, and such notice must include disclosure of the amount of securities already tendered;
- The issuer subject to a tender offer disclose to its security holders its position with respect to the offeror’s tender offer;
- Certain trading be avoided when a person is in possession of material nonpublic information relating to the tender offer;
- 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 in connection with partial tender offers (and not engage in short-tendering and hedged tendering in connection with their tenders); and
- No covered person directly or indirectly purchase or arrange to purchase any subject securities or any related securities except as part of the tender offer, from the time of public announcement of the tender offer until the tender offer expires.

Each of these requirements is described in more detail below.

Minimum offer period
Rule 14e-1(a) provides that a tender offer must remain open for at least 20 business days from the date the tender offer commences. Rule 14e-1(b) provides that the offer must also stay open for at least 10 business days from the date of a notice is first published or sent or given to the holders of the subject securities of an increase or decrease in: (i) the percentage of securities to be acquired pursuant to the tender offer (if the change exceeds 2% of the original amount); (ii) the consideration offered, without any de minimis exception; or (iii) any dealer-manager’s solicitation fee. The SEC has stated that 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.

Prompt payment
Rule 14e-1(c) provides that the offeror must either pay the consideration offered or return the securities tendered promptly after termination or withdrawal, respectively, of the tender offer.

The SEC staff has generally taken the view that “prompt payment” under Rule 14e-1(c) requires the payment of consideration or the return of tendered securities no later than three business days after the conclusion of the tender offer.
Extension of offering period
Rule 14e-1(d) provides that any extension of the offer period must be made by a press release or other public announcement by 9:00am, 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. 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 next business day following the scheduled expiration date of the tender offer.

Disclosure of position regarding the offer
Rule 14e-2 requires that an issuer that has securities subject to a tender offer disclose to its security holders its position with respect to the offeror's tender offer, in other words, whether the issuer recommends the offer, expresses no opinion with respect to the offer or is unable to take a position. The disclosure must be provided no later than 10 business days after the tender offer is first disseminated to security holders. In the event of any material change in the disclosure, the subject company must promptly disseminate a statement to security holders noting the material change. Given that Rule 14e-2 is not expressly limited to third party tender offers, it is common for an issuer conducting an issuer tender offer to include in its tender offer materials a statement that the issuer makes no recommendation as to the tender.

Prohibited transactions in connection with partial tender offers
Partial tender offers typically involve the risk to security holders that not all of the securities that the security holder tenders will be accepted in the tender offer (commonly referred to as proration risk). Rule 14e-4 prohibits security holders from engaging in the practice of short tendering, which occurs when the security holder tenders more shares than they own in order to avoid or mitigate the proration risk, or hedged tendering, which occurs when a security holder tenders securities but then sells a portion of their shares before the proration deadline to a person that could then tender those shares. Under Rule 14e-4, 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.

Prohibited purchases outside of a tender offer
Rule 14e-5 provides that, subject to certain exceptions, no covered person may directly or indirectly purchase or arrange to purchase any subject securities or any related securities except as part of the tender offer. The prohibition in Rule 14e-5 applies from the time of public announcement of the tender offer until the tender offer expires, but does not apply to any purchases or arrangements to purchase made during the time of any subsequent offering period as provided for in Rule 14d-11, as long as the consideration paid or to be paid for the purchases or arrangements to purchase is the same in form and amount as the consideration offered in the tender offer.

For the purposes of Rule 14e-5, covered person is defined broadly to include: (i) the offeror and its affiliates; (ii) the offeror’s dealer-manager and its affiliates; (iii) any advisor to any of the persons specified in (i) and (ii) above, whose compensation is dependent on the completion of the offer; and (iv) any person acting, directly or indirectly, in concert with any of these persons in connection with any purchase or arrangement to purchase, any subject securities or any related securities. Subject securities are defined for the purposes of Rule 14e-5 to include the securities or class of securities that are sought to be acquired in the transaction or that are otherwise the subject of the transaction.

The period during which purchases outside of the tender offer are prohibited runs from the potentially earlier date of public announcement as compared to commencement of the tender offer. Public announcement is defined for the purposes of Rule 14e-5 as “any oral or written communication by the offeror or any person authorised to act on the offeror's behalf that is reasonably designed to, or has the effect of, informing the public or security holders...
in general about the tender offer”. Given the potentially broad reach of this definition, offerors must be very careful about what is stated in advance of any potential cash tender offer or exchange offer, particular when it is contemplated that purchases of subject securities or any related securities may occur in advance of commencement of the offer.

Exceptions to the Rule 14e-5 prohibition on purchases outside of the tender offer include:

- The exercise, conversion or exchange of related securities into subject securities, as long as the related securities were held prior to public announcement of the tender offer;
- Purchases or arrangements to purchase by or for a plan that are made by an agent independent of the issuer;
- Purchases during odd-lot offers;
- Purchases by or through a dealer-manager or its affiliates that are made in the ordinary course of business and made either on an agency basis not for a covered person; or as principal for its own account if the dealer-manager or its affiliate is not a market maker, and the purchase is made to offset a contemporaneous sale after having received an unsolicited order to buy from a customer who is not a covered person;
- Purchases or arrangements to purchase a basket of securities containing a subject security or a related security under specified conditions;
- Purchases or arrangements to purchase to cover a short sale or the exercise of an option by a non-covered person, if: (i) the short sale or option transaction was made in the ordinary course of business and not to facilitate the offer; (ii) the short sale was entered into before public announcement of the tender offer; and (iii) the covered person wrote the option before public announcement of the tender offer;
- Purchases or arrangements to purchase pursuant to a contract, if an unconditional and binding contract was entered into before public announcement of the tender offer, and the existence of the contract and all material terms including quantity, price and parties are disclosed in the offering materials;
- Purchases or arrangements to purchase by an affiliate of a dealer-manager under specified conditions;
- Purchases by connected exempt market makers or connected exempt principal traders under certain conditions; and
- Purchases made during cross-border tender offers under specified circumstances.

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

Regulation 14E does not specifically require that an offeror provide withdrawal rights to offerees. Similarly, the proration, best price, all holders and other provisions set forth in section 14(d) and Rule 13e-4 of the Exchange Act are only applicable to tender offers conducted pursuant to Regulation 14D and Rule 13e-4, and do not apply to tender offers subject only to Regulation 14E.

Requirements applicable to issuer tender offers for equity securities
Pursuant to Rule 13e-4 under the Exchange Act, an issuer with equity securities registered under section 12 or that is required to file periodic reports with the SEC pursuant to section 15(d) is required, in connection with any tender offer for its own equity securities, to file a tender offer statement (on schedule TO) to make certain disclosures to offerees. Rule 13e-4 is intended to prevent fraudulent, deceptive or manipulative acts in connection with issuer tender offers.

In general, Rule 13e-4 imposes disclosure, filing, and procedural requirements on issuers and their affiliates in connection with issuer tender offers. For the purposes of this rule, issuer tender offer is defined as a tender offer for, or a request or invitation for tenders of, any class of equity security made by the issuer of that class of security or by an affiliate of that issuer. An soon as practicable on the commencement date of the issuer tender offer, the issuer or affiliate making the offer must comply with the filing, disclosure and dissemination requirements specified in the rule.

Applicability of Rule 13e-4 to equity securities
Equity securities used in Rule 13e-4 is not defined in the rule. Section 3(a)(11) of the Exchange Act provides a general definition of the term equity security, which includes “any stock or similar security; or any security
future on any such security; or any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any other security which the Commission shall deem to be of a similar nature and consider necessary or appropriate, by such rules and regulations as it may prescribe in the public interest or for the protection of investors, to treat as an equity security.” Under the statute, the SEC has discretion to evaluate the nature of a security and to consider public policy implications in determining the characterisation of the security. Based on this definition, the term equity securities for the purposes of the applicability of Rule 13e-4 includes debt securities convertible or exchangeable for equity securities.

In the past, the staff has provided limited no-action letter relief in respect of offers that should be excluded from the application of Rules 13e-3 and 13e-4 based on whether the subject securities were deemed “equity securities” for the purposes of those rules. In a no-action letter to American Financial Corporation,7 the staff concluded it would not recommend enforcement action if, in reliance on an opinion of counsel, the issuer proceeded with an exchange offer relating to non-voting, non-participating, mandatorily redeemable preferred stock without compliance with either Rule 13e-3 or Rule 13e-4. Counsel to the issuer had concluded that in economic substance the preferred stock was equivalent to a debt security. The staff later affirmed this view in a subsequent no-action letter issued to American Financial Corporation.8 In between these two letters, the staff issued no-action letter guidance to Republic New York Corporation.9 In Republic New York Corporation, the staff concluded that it could not assure enforcement action if the issuer were to undertake purchases of shares of its cumulative preferred stock without compliance with Rule 13e-3. The staff will not necessarily take the same view today with respect to preferred stock, particularly in situations where preferred stock which has debt-like characteristics has not been treated as debt for the purposes of matters such as compliance with the Trust Indenture Act of 1939 and legality opinions.

On the other hand, the staff has provided informal, oral advice that trust preferred securities are sufficiently “debt-like” so that tender offers for trust preferred securities would be subject to the requirements applicable to debt tender offers or exchange offers, and not the more restrictive requirements applicable to equity tender offers or exchange offers under Rule 13e-4. The staff’s position is predicated on the applicable instruments being qualified under the Trust Indenture Act.10 The staff also has focused on the nature of the legality opinions issued by counsel in connection with the original registration of the trust preferred securities.

Further, in a no-action letter for BBVA Privanza International Limited and Banco Bilbao Vizcaya Argentaria,11 BBVA and Banco Bilbao proposed to make a cash tender offer for all of the outstanding non-cumulative guaranteed preference shares, series D of BBVA Privanza International (Gibraltar), including preference shares represented by American depositary shares. It was a condition to the tender that all such shares be validly tendered and not withdrawn. The intention was to price the tender offer based on a stated fixed spread over the yield on a specified benchmark US Treasury security as of 2.00pm New York time, on the second business day immediately preceding the expiration date of the tender offer (the 18th business day of the offer period).

BBVA and Banco Bilbao described that the tender offer would be made consistent with the principles established in prior no-action letters relating to formula pricing in issuer tender offers for equity securities, and that the offer would be substantially similar to the tender offers covered by no-action letters relating to the use of fixed spread pricing methodologies for non-convertible, investment grade debt tender offers.

The staff stated that it would not recommend enforcement action under Rule 14e-1(b) against BBVA or Banco Bilbao if the tender offer uses the pricing mechanism described and if the tender offer was otherwise conducted in the manner represented.

In granting the requested relief, the staff noted, in addition to the typical conditions for fixed spread transactions, that:

- the subject securities are represented as being valued by investors on the basis of their yield, taking into account the issuer’s credit spread, compared to a benchmark yield, and the yield of the subject securities fluctuates in response to changes in prevailing interest rates;
- the final offer price will be set at least two trading days prior to the scheduled expiration of the offer; and
- the offerors will issue a press release to publicly announce the final offer price prior to the close of business on the pricing date.

Filing requirements

Unlike under Regulation 14E, Rule 13e-4 requires that an issuer12 engaged in an issuer tender offer must file a tender offer statement on schedule TO with the SEC as soon as practicable on the commencement date of the offer.13 In addition, the issuer is required to file:
• Any of its written communications relating to the issuer tender offer, from and including the first public announcement, as soon as practicable on the date of the communication;

• An amendment to the schedule TO reporting promptly any material changes in the information disclosed in the previously filed schedule TO and amendments thereto;¹⁴ and

• A final amendment to the schedule TO reporting promptly the results of the issuer tender offer.

A significant amount of disclosure is required to be filed under cover of schedule TO.¹⁵ Most of the specific line item requirements are satisfied by reference to a separate offer to purchase or offer to exchange document that is filed as an exhibit to the schedule TO. The information required by schedule TO includes:

• A summary term sheet;

• Information about the issuer;

• The identity and background of filing persons;

• The terms of the transaction;

• Any past contacts, transactions and negotiations;

• The purposes of the transactions and plans or proposals;

• The source and amount of funds or other consideration for the tender offer;

• Interests in subject securities;

• Persons/assets retained, employed, compensated or used;

• Financial statements, if material;

• Additional information;

• Exhibits; and

• To the extent applicable, information required by Schedule 13E-3.

In addition to the schedule TO filing, an issuer conducting an issuer tender offer must file any pre-commencement written communications under cover of schedule TO, marking the box on the cover page to note the status of the materials as pre-commencement communications.¹⁶ Pursuant to instruction 3 to Rule 13e-4(c), each pre-commencement written communication must include a prominent legend in clear, plain language advising shareholders to read the tender offer statement when it becomes available because it contains important information.

If pre-commencement communications are made in connection with an exchange offer that is registered under the Securities Act, then the issuer can file the communications solely under Rule 425 under the Securities Act, and such communications will be deemed filed for the purposes of Rule 13e-4.

Disclosure requirements
An issuer making an issuer tender offer under Rule 13e-4 must publish, send, or give to shareholders:

• the summary term sheet required by Item 1 of schedule TO; and

• the information required by the remaining schedule TO items for issuer tender offers, except for Item 12 (exhibits), or a fair and adequate summary of the information.

To the extent that there are any material changes to the information previously disclosed to shareholders, paragraphs (d)(2) and (e)(3) of Rule 13e-4 require that the issuer disclose those changes promptly to shareholders in a manner reasonably calculated to inform them of the change.

In the event that an the issuer disseminates the issuer tender offer by means of summary publication as discussed below, any summary advertisement used by the issuer must not include a letter of transmittal that would permit shareholders to tender securities, and the advertisement must disclose at least the following information:

• the identity of the issuer (or affiliate);

• the material terms and purposes of the transaction, as specified in Items 1004(a)(1) and 1006(a) of Regulation M-A;

• instructions as to how shareholders can promptly obtain a copy of the disclosure statement required by Rule 13e-4(d)(1), at the issuer’s expense; and

• a statement that the information contained in the disclosure statement discussed above is incorporated by reference.
**Dissemination requirements**

With respect to issuer tender offers in which the consideration offered consists solely of cash and or securities exempt from registration under section 3 of the Securities Act, an issuer must disseminate the required disclosure to security holder by on or more of these methods: long form publication of the information, the use of security holder lists or through summary publication.

Rule 13e-4(e)(1)(i) provides that dissemination may occur by making adequate long form publication of the tender offer in a newspaper or newspapers on the commencement date of the issuer tender offer. For this purpose, the instruction to paragraph (e)(1) specifies that adequate publication may require publication in a newspaper with a national circulation, a newspaper with a metropolitan or regional circulation, or a combination of the two, depending on the specific facts and circumstances.

Alternatively, Rule 13e-4(e)(1)(iii) permits publication of a summary advertisement in a newspaper or newspapers on the commencement date including the disclosures referenced above, and by mailing or otherwise furnishing promptly the Rule 13e-4(d)(1) disclosure statement and a transmittal letter to any security holder upon request.

Tender offer materials may also be disseminated by using security holder lists and security position listings. Under the procedures specified in 13e-4(e)(1)(ii), the materials may be distributed by:

- Mailing or otherwise furnishing promptly the disclosure required by Rule 13e-4(d)(1) to each security holder whose name appears on the issuer’s most recent security holder list;
- Contacting each participant on the most recent security position listing of any clearing agency within the possession or access of the issuer, and inquiring of each participant as to the approximate number of beneficial owners of the subject securities held by the participant;
- Furnishing to each participant a sufficient number of copies of the Rule 13e-4(d)(1) disclosure statement for transmittal to the beneficial owners; and
- Agreeing to reimburse each participant promptly for its reasonable expenses incurred in forwarding the statement to beneficial owners.

In an exchange offer where the consideration consists solely or partly of securities that are registered under the Securities Act, then Rule 13e-4(e)(2) provides that the issuer must:

- File a registration statement containing all of the required information, including pricing information; and
- Deliver to shareholders a preliminary prospectus or a prospectus that meets the requirement of section 10(a) of the Securities Act, along with a letter of transmittal.

**Material changes**

Rule 13e-4(e)(3) specifies that when a material change occurs in the information that the issuer has published, sent or given to security holders, then the issuer must promptly disseminate disclosure of the material change “in a manner reasonably calculated to inform security holders of the change”.

In the case of a registered exchange offer, special timing provisions govern the dissemination of material changes when the issuer has disseminated a preliminary prospectus in accordance with Rule 13e-4(d)(2). Rule 13e-4(e)(3) specifies that the offer must remain open from the date on which the issuer disseminates material changes to the tender offer materials to shareholders, as follows:

- Five business days for a prospectus supplement containing a material change other than price or share levels;
- 10 business days for a prospectus supplement containing a change in price, the amount of securities sought, the dealer’s soliciting fee, or other similarly significant change;
- 10 business days for a prospectus supplement included as part of a post-effective amendment to the registration statement; and
- 20 business days for a revised prospectus when the initial prospectus was “materially deficient.”

**Procedural requirements**

Rule 13e-4(f) prescribes the manner in which issuers may conduct an issuer tender offer, including specific requirements with respect to the period during which the tender offer must remain open; the availability of withdrawal rights, pro rata acceptance, any increases in consideration, prompt payment for or return of securities tendered, purchases outside of the tender offer and the all holders and best price protections.

**Offering period**

Rule 13e-4(f)(1)(i) specifies that, unless withdrawn, an issuer tender offer must remain open until expiration of:
• At least 20 business days from commencement of the issuer tender offer; and

• At least 10 business days from the date that notice of an increase or decrease in one of the following is first published, sent or given to security holders:

• The percentage of the class of securities being sought; 18

• The consideration being offered (subject to no de minimis exception); or

• The dealer’s soliciting fee to be given.

Withdrawal rights
Rule 13e-4(f)(2) provides that the issuer making an issuer tender offer must permit shareholders to withdraw securities tendered pursuant to the issuer tender offer:

• At any time during the period when the issuer tender offer remains open; and

• If tendered securities have not yet been accepted for payment, after the expiration of 40 business days from the commencement of the tender offer.

Pro rata acceptance
Rule 13e-4(f)(3) requires that the tender offer by the issuer or affiliate is for fewer than all of the outstanding equity securities of a class, and the number of securities tendered exceeds the number that the issuer is bound or willing to take up and pay for, the issuer or affiliate must accept and pay for the securities as nearly as may be pro rata, disregarding fractions, according to the number of securities tendered by each shareholder during the period that the offer remains open.

Rule 13e-4(f)(3) does not prohibit the issuer making an issuer tender offer from:

• Accepting all securities tendered by shareholders who own no more than a specified number of shares less than 100 and who tender all of their securities, before pro rata rating securities tendered by others; or

• Accepting by lot securities tendered by shareholders who tender all of their shares and who elect to have all or none (or at least a minimum amount and none) accepted, if the issuer or affiliate first accepts the securities tendered by persons who have not made such an election.

Increase in consideration
Rule 13e-4(f)(4) requires equal treatment of security holders in the event of an increase in the consideration offered. If the issuer increases the consideration offered after the tender offer has commenced, then issuer must pay that increased consideration to all shareholders whose tendered securities are accepted for payment.

Prompt payment or return
Under Rule 13e-4(f)(5), an issuer must either pay the consideration offered, or return the tendered securities, promptly after the termination or withdrawal of the tender offer.

Purchases outside the tender offer
Rule 13e-4(f)(6) prohibits purchases outside of the tender offer. Until at least 10 business days after the termination of the tender offer, the issuer and its affiliates cannot purchase (other than pursuant to the tender offer) any subject security, any security of the same class and series, or any right to purchase such securities. With respect to exchange offers, this prohibition applies to the purchases of any security being offered in the exchange offer, any securities of the same class and series, and any right to purchase such a security.

All holders requirement
Rule 13e-4(f)(8)(i) provides that the tender offer must be open to all security holders of the class of securities subject to the tender offer. 20 This all-holders provision would not prohibit an issuer or affiliate from excluding all security holders in a state where the tender offer is prohibited by administrative or judicial action under a state statute after a good faith effort to comply with the statute.

Best price requirement
Rule 13e-4(f)(8)(ii) requires that the consideration paid to any security holder for securities tendered in the tender offer is the highest consideration paid to any other security holder for securities tendered in the tender offer.

Rule 13e-4(f)(10) specifies that the best price requirement does not prohibit more than one type of consideration being offered in a tender offer, provided that: (i) security holders have an equal right to elect among each of the types of consideration offered; and (ii) the highest consideration of each type paid to any shareholder is paid to any other shareholder receiving that type of consideration.

Under Rule 13e-4(f)(11), if the offer and sale of securities constitute consideration offered in the tender offer, and the issuer or affiliate has made a good faith effort
to register or qualify the offer and sale in a particular state, but is prohibited by the appropriate authority of that state, the issuer or affiliate may offer shareholders in that state an alternative form of consideration. The alternative form of consideration need not be offered or paid to shareholders in any other state.

**Antifraud provisions**

Rule 13e-4(j) specifies antifraud requirements applicable to issuer tender offers, prohibiting issuers and affiliates, in connection with an issuer tender offer, from:

- Employing any device, scheme or artifice to defraud any person;

- Making any false statement of material fact or omission of material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading; or

- Engaging in any act, practice, or course of business that operates or would operate as a fraud or deceit on any person.

Rule 13e-4(j) also states that, as a means reasonably designed to prevent fraudulent, deceptive, or manipulative practices in connection with an issuer tender offer, it is unlawful for an issuer or affiliate to make an issuer tender offer unless it complies with the requirements of Rule 13e-4(b), (c), (d), (e), (f ), and (j). In addition, the other antifraud and anti-manipulation provisions of the Exchange Act would apply to an issuer tender offer, including section 10(b) and Rule 10b-5 thereunder, as well as section 14(e).

**Exemptions**

Certain transactions are exempt from the application of the rule under Rule 13e-4(h) from the issuer tender offer provisions. Specifically, Rule 13e-4 does not apply to:

- Calls or redemptions pursuant to the governing instrument;

- Offers to purchase evidenced by a scrip certificate, order form, or similar document that represents a fractional interest in a share of stock;

- Offers to purchase shares of dissenting shareholders in accordance with a statutory procedure;

- Tender offers subject to Exchange Act section 14(d);

- Offers to purchase from owners of up to a specified number of shares less than 100, provided that the offer satisfies the all holder provisions of the rule with respect to shareholders who own a number of shares equal to or less than the specified number of shares (except that the issuer can exclude participants in certain plans for employees or security holders, and can exclude security holders who do not own their shares as of a specified date); and the equal consideration provisions of rule are satisfied or consideration paid is determined on the basis of a uniformly applied formula based on the subject security’s market price;

- Issuer tender offers made solely to effect a rescission offer, provided that: (1) the offer is registered under the Securities Act; and (2) the consideration equals the price paid by each security holder, plus legal interest if the issuer elects or is required to pay legal interest;

- Offers by closed-end management investment companies to repurchase equity securities under Investment Company Act Rule 23c-3;

- Issuer tender offers by a foreign private issuer under certain conditions relating to: (1) the maximum percentage of US holders of the subject class of securities; (2) the equal treatment of US holders and other holders; and (3) dissemination of informational documents; and

- Transactions exempted by the SEC, on written request or on its own motion, either unconditionally or subject to conditions.

An offer may qualify for the Tier I exemption from the tender offer rules if it can be established that 10% or less of the securities are held by US resident holders, looking through to the beneficial owners. For the purpose of this exemption, holders of notes held in bearer form may be presumed to be outside the United States unless the issuer “knows or has reason to know that these securities are held by US residents”. Under recently adopted amendments to the Tier I exemption, an offeror may calculate ownership by US resident holders as of any date no more than 60 days before, and no more than 30 days after, the public announcement of the transaction, rather than as of the date that is 30 days prior to the publication of the offer document as was previously required. In situations where the offeror is unable to conduct the necessary analysis of beneficial holders within the 90-day period, the SEC now permits the use of a date not more than 120 days before the public announcement. Under the recently effective
amendments, individual holders of more than 10% of the subject securities are no longer excluded for the purposes of calculating the level of US ownership.

**SEC staff review**

When a schedule TO is filed, the SEC staff may review and comment on the disclosure in the schedule TO, the offer to purchase or offer to exchange, and any other related documents, as well as compliance with Rule 13e-4 and Regulation 14E. The staff Office of Mergers & Acquisitions in the Division of Corporation Finance reviews the schedule TO. Typically, the staff tries to issue comment quickly (within five to seven business days), because the tender offer is only required to be open for 20 business days. The staff’s comments may require that the issuer file amendments to the schedule TO and disseminate changes in order to address the staff’s concerns.

**Considerations for liability management transactions**

**Debt versus equity tender offers**

The requirements of Rule 13e-4 result in significantly less flexibility for tender offers or exchange offers for convertible or exchangeable debt securities, common stock and preferred stock, when compared to tender offers or exchange offer for straight debt securities. For example, it is not possible for issuers to sweeten a tender offer or exchange offer for convertible or exchangeable debt securities, preferred stock or common stock with an early tender premium as is sometimes the case in tender offers or exchange offers for straight debt securities. Holders that tender early in the offering period, typically within the first 10 business days, may receive the total consideration. Under this approach, 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 may, under certain circumstances, constitute a change in consideration that may require that the tender stay open for an additional 10 days, as discussed above.

Moreover, in a straight debt tender offer, an issuer has the flexibility to choose to accept tenders of securities on a first come, first served basis, or offer limited or no withdrawal rights, or conduct a Dutch auction or modified Dutch auction for pricing purposes.

**SEC staff relief for investment grade debt securities**

The requirements of Regulation 14E may still be limiting for an issuer conducting a tender offer for straight debt securities. 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. We discuss this relief in Chapter 4.

**Modified Dutch auctions**

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 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 staff has permitted tender offers to proceed without the issuer disclosing the range of prices 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). Usually, the permitted price range is very narrow: often no more than 15% of the minimum price. In this regard, modified issuer Dutch auction tender offers have been permitted under Rule 13e-4, subject to several additional conditions:

- Disclosure in the tender offer materials reflects the minimum and maximum consideration to be paid;
• Pro rata acceptance occurs throughout the offer with all securities purchased participating equally in pro-
rationing;

• Withdrawal rights are available throughout the offer;

• The issuer makes a prompt announcement of the purchase price, if determined prior to the expiration of
the offer; and

• The purchase of all accepted securities is made at the highest price paid to any security holder under the
offer.23

In prior no-action letter guidance, the staff had noted its belief that issuers conducting modified Dutch auction
tender offers could not satisfy the requirements of (then) Schedule 13e-4 by stating a range of shares to be sought in
the tender offer. In this regard, the staff appeared to be concerned that an issuer would have discretion to select a
number from within that range that might be purchased in the tender offer.24

More recently, in a recent no-action letter to Alliance Semiconductor Corporation,25 the staff considered a
modified Dutch auction tender offer where the issuer suggested that the total number of securities may be
disclosed in terms of the maximum number that can be purchased, subject to the number of shares tendered and at
which price those shares are tendered. In the proposed tender offer, the offer to purchase was to state that the
maximum number of shares is 10,909,090, and that if the offer was fully subscribed, the issuer would buy an
amount of shares between 10,000,000 and 10,909,090, with exact number dependent on the terms of the offer, not a decision
on the part of the issuer. As a result of this structure, the amount that would be purchased in the tender offer is
determined as a function of the prices at which shares are validly tendered and the number of shares tendered.
Alliance Semiconductor argued that Rule 13e-3(f)(1)(ii) would not require extending the offer for 10 days after the
purchase price (and hence exact number of shares to be purchased) was determined, and that the disclosure of the
range of shares presented would satisfy the requirement of Item 1004(a)(1)(i) of Regulation M-A to disclose the “total
number and class of securities”.

In providing its response that no enforcement action
would be recommended if the offer was conducted as
described in the letter, the staff particularly noted that:

• The total number and dollar value of securities being
sought in the offer is disclosed in the offer materials as
required by Item 1004(a)(1)(i) of Regulation M-A;

• The maximum number of shares that may be purchased
in the offer is stated on the cover page of the offer to
purchase;

• The offer to purchase discloses the range of shares that
will be purchased if the offer is fully subscribed; and

• The exact number of shares to be purchased in the offer
will be based on the purchase price established by the
shareholders determined in accordance with the terms of
the offer as disclosed in the offer to purchase.

Other pricing mechanisms
Issuers also have adjusted pricing mechanisms to more
fully reflect market conditions and fluctuations, and have
asked the staff for no-action letter relief for such pricing
mechanisms under Rules 13e-4(d)(1), 13e-4(f )(1)(ii) and
14e-1(b). In Thermo Fisher Scientific Inc., the staff
provided no action relief in the context of a cash tender
offer for convertible notes when the issuer proposed to
offer to pay cash for the tendered securities in an amount
determined by reference to the average VWAP (defined as
the simple arithmetic average of the daily VWAP over an
averaging period of 21 consecutive trading days ending on
the expiration date of the tender offer).26 In granting the
relief, the staff particularly noted that:

• the offer to purchase would disclose the pricing
mechanism for determining the final purchase price per
subject security that is equal to the sum of the parity
value (defined as the number of shares of common stock
into which a subject security is currently convertible)
plus a fixed amount of cash (together with any accrued
and unpaid interest);

• the offer to purchase would include an illustrative table
showing calculations of the purchase price;

• the offer to purchase would disclose a fixed minimum
purchase price that will be paid by the company for each
subject security tendered and purchased;

• the pricing mechanism and the minimum price would
remain fixed throughout the duration of the offer; and, if
there was a change in the pricing mechanism or the
minimum price, the offer would remain open for at least
10 business days;

• the common stock used as the reference security in the
pricing mechanism was listed on the New York Stock
Exchange;
the company’s belief that the value of the subject securities was directly correlated to the trading price of the common stock;

the company would publish the daily indicative calculated purchase prices per subject security on a webpage maintained for the offer and provided a toll-free number that holders of the subject securities could use to obtain pricing related information;

the company would publish the final purchase price on the offer webpage and in a press release no later than 4.30pm, New York time, on the expiration date of the offer, and electronically file that information on an amended schedule TO;

the company would make available forms of VOI and notice of withdrawal in its printed offering materials and on the offer webpage, will permit tenders and withdrawals to be made until midnight on the expiration date, and will disclose the procedures for making tenders and withdrawals in the offering materials;

the offer to purchase would include disclosure informing beneficial holders of the subject securities that they must make arrangements with their brokers or similar institutions for such brokers or similar institutions to fax a VOI or notice of withdrawal (as applicable) to the Depositary on such beneficial holders’ behalf prior to midnight, New York time, on the expiration date; and

the offer to purchase disclosed that the company was seeking to buy any and all of the subject securities.

Following the *Thermo Fischer Scientific Inc.* letter, the SEC staff has provided similar relief in the context of cash tender offers and combined cash and common stock offers wherein the offers involved similar formula-based pricing mechanisms. See for example the letters issued to: Textron, Inc. (Oct 7 2011), CNO Financial Group, Inc. (Feb 11 2013), Group 1 Automotive, Inc. (May 16 2014), Sonic Automotive, Inc. (July 24 2012) and American Equity Investment Life Holding Company (Aug 23 2013). In each case, there were structural protections incorporated in the tender offers, such as a determinable and fixed pricing formula, daily publication of indicative purchase prices on a webpage available to holders, final pricing based on readily observable trading prices for securities listed on a national securities exchange, and dissemination of pricing and related information by the issuer. The time periods incorporated in the VWAP averaging pricing formulae in each case may have varied in order to address the particular market factors affecting the subject security. The SEC staff appears to have focused principally on certainty related to the pricing formula, and information transparency as it relates to the indicative pricing.

**Concerns with creeping tender offers and purchases outside of the offer**

In certain circumstances, purchases of securities in the market or through negotiated transactions could be deemed to constitute a tender offer that is not in compliance with the rules described above. Further, when a tender offer commences around the time of open market or negotiated purchases, security holders could potentially object to the terms of the transactions outside of the tender offer.

Courts that have addressed the issue of tender offer integration have taken disparate approaches. Most claims have arisen in connection with claims of violations of the best price and all holders provisions applicable to tender offers, or violations of the prohibitions on purchases outside of a tender offer. Some courts have strictly construed the time frame of the tender offer to start with public announcement or commencement and end with withdrawal or termination, while others have adopted an approach of determining whether the questioned transaction was an integral part of the tender offer. More specifically, several courts have held that share purchases by the acquirer made in advance of a tender offer are not improper, because the tender offer rules are only applicable upon announcement or commencement of the tender offer. Some courts, however, have taken a broader view in interpreting whether transactions occurring before or after the precise technical commencement and termination or withdraw of the tender offer were considered part of the tender offer.

Issuers must carefully structure any ongoing market purchases or negotiated acquisitions of securities so as to comply with the prohibitions on purchases outside of the tender offer in Rules 13e-4 and 14e-5. In this regard, it is often important to analyse whether the targeted securities in the outside purchases are of a separate class from the class of securities that are the subject of a tender offer. Class is not defined specifically for the purposes of Rule 13e-4 and Regulation 14E, however, the term has been defined for other purposes under the Exchange Act. In section 12(g)(5), it is defined to include “all securities of an issuer which are of substantially similar character and the holders of which enjoy substantially similar rights and privileges”. Further, the SEC has provided guidance regarding the determination of whether different series of preferred stock are the same class for the purposes of Rule 144A, stating
that the test under Rule 144A to determine whether securities would be of the same class would be the same test as under section 12(g)(5) of the Exchange Act and would be interpreted in the same manner.

Regulation M

While 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. If debt being exchanged in an exchange offer 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.

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 US registered securities into the European Union or other foreign jurisdictions. For these tenders, an issuer must not only focus on the various considerations described above, but also must be cautious that its tender does not violate any rules in the home country of its security holders.

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 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.

On April 16 2014, a revamped version of MAD was formally adopted by the Council of the European Union, taking the form of a Market Abuse Regulation (MAR) which shall apply automatically in all EU states when it becomes effective in July 2016. While the existing MAD regulates financial instruments traded on regulated exchanges, as discussed above, MAR will also cover instruments traded on other markets known as Multilateral Trading Facilities (MTFs) and Organized Trading Facilities (OTF). Other changes made by MAR include extending the scope of the existing MAD by regulating market soundings (discussions with investors prior to commencement of a transaction to gauge interest and determine pricing) and the introduction of a new offence of attempted insider dealing and market manipulation.


3 Regulation 14E applies to tender offers for any securities other than “exempt securities” as defined by section 3(a)(12) of the Exchange Act. As a result, the rules that comprise Regulation 14E apply to tender offers for debt securities, equity securities, and the securities of companies that do not have a class of securities registered under section 12 of the Exchange Act or are otherwise required to file reports under the Exchange Act.

4 Rule 14d-1(g) states that when “computing any time period under section 14(d)(5) or section 14(d)(6) of the Act or under Regulation 14D or Regulation 14E, the date of the event which begins the running of such time period shall be included.” Therefore, the date on which the tender offer is first published or sent to holders of the subject securities is counted as the first day of the 20 business day period.


6 In tender offers for straight debt securities, it is standard practice to provide holders with withdrawal rights. These withdrawal rights typically expire after an initial period, often after the first 10 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.

7 SEC No Action Letter, American Financial Corporation (December 20 1982).


9 SEC No Action Letter, Republic New York Corporation (March 5 1985).

10 The Staff has previously indicated that “[the Trust Indenture] Act generally would apply...to preferred securities issued by a trust that represent an interest in debt issued by a single obligor”. See SEC Division of Corporation Finance, Compliance and Disclosure Interpretations: Trust Indenture Act of 1939 (#101.04) (March 30 2007), available at http://www.sec.gov/divisions/corpfin/guidance/tiainterp.htm.


12 The requirements of Rule 13e-4 applicable to issuers are also applicable to affiliates of the issuer. For the purposes of this discussion of Rule 13e-4, references made to the issuer also include affiliates of the issuer.

13 For the purposes of Rule 13e-4, commencement means 12.01 am on the date that the issuer has first published, sent or given the means to tender to security holders. The means to tender includes the transmittal form or a statement regarding how the transmittal form may be obtained.

14 Instruction 1 to schedule TO provides that information previously disclosed in the schedule TO may be omitted in an amendment disclosing a material change.

15 At the time of making the initial schedule TO filing, the issuer will be required to pay a filing fee computed in accordance with Rule 0-11 of the Exchange Act. If a fee has been paid under section 6(b) of the Securities Act with respect to any of the securities issued in connection with the proposed transaction, then the required fee is reduced by that amount. Similarly, the fee required for a Securities Act registration statement would be reduced by the amount of any fee paid in connection with the schedule TO filing.

16 See Instruction 1 to Rule 13e-4(c). The filing person need not respond to the specific line items of schedule TO when filing pre-commencement written communications, and no fee is required with the filing.

17 Instruction 2 to Rule 13e-4(e)(2) provides that a preliminary prospectus cannot omit information under Rule 430 or 430A of the Securities Act. Instruction 3 to Rule 13e-4(e)(2) provides that when a preliminary prospectus is used and the issuer must disseminate material changes, the tender offer must remain open for the period specified in Rule 14d-4(d)(2). If a preliminary prospectus is used, tenders may be requested in accordance with Securities Act Rule 162(a), pursuant to Instruction 4 to Rule 13e-4(e)(2).
An issuer may accept for payment up to an additional 2% of the class without triggering the additional 10 business days. For the purposes of this rule, the percentage of the class is calculated in accordance with section 14(d)(3) of the Exchange Act.

Rule 13e-4(a)(6) specifies that the term security holders means both holders of record and beneficial owners of securities of the class which is the subject of the tender offer. As a result, a tender offer open to only holders of record would not satisfy the all holders requirement.

The SEC has indicated that a tender offer may be made for fewer than all outstanding securities, but all security holders must be eligible to accept the offer if they choose. See Release No. 34-23421 (July 11 1986).

In the SEC staff’s view, a put option whereby the issuer is obligated to repurchase securities at specific dates pursuant to the terms of an indenture would not be considered a redemption for the purposes of this exemption.

Under the SEC's guidance, all security holders whose securities are accepted in a modified Dutch auction issuer tender offer subject to Rule 13e-4 must be paid the highest consideration paid to any other security holder whose securities are accepted. See Release No. 34-23421 (July 11 1986). The Release also notes that pure Dutch auctions are not permitted under Rule 13e-4, stating: “In a pure Dutch auction cash tender offer, the bidder invites security holders to tender securities to it at a price to be specified by the tendering security holder, rather than at a price specified by the bidder. Securities are accepted, beginning with those for which the lowest price has been specified, until the bidder has purchased the desired number of securities.”

See Release No. 34-23421 (July 11 1986) at note 64.


SEC No-Action Letter, Alliance Semiconductor Corp. (September 22 2006).


CHAPTER 7

Tax issues

Tax issues can be an important consideration in any liability management transaction. Even with sound tax advice certain tax consequences are inescapable and must be carefully considered. The following sections discuss several additional nuances that arise when reshuffling a corporation’s liability structure as well as some of the most recent and significant changes to the Internal Revenue Code (the Code) and Treasury regulations thereunder affecting liability management. As reflected below, Congress and Treasury appear to have turned their attention toward the international arena.

Section 108(i) and the deferral of COD income
As discussed under Liability Management Overview, corporations with outstanding debt may be subject to tax on cancellation-of-indebtedness (COD) income when all or a portion of such debt has been economically 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 equity of the issuer. Additionally, repurchases or exchanges by persons related to the issuer can create COD income.

Section 108(a) of the Code provides a number of exceptions to the inclusion of COD income, including exceptions related to insolvency and bankruptcy. In each case, the COD income is permanently excluded from taxation. As a price for the bankruptcy and insolvency exclusions, the tax attributes of the taxpayer (for example, its net operating losses, tax credits or adjusted tax basis in property) are correspondingly reduced.

OID and AHYDO relief
Original issue discount (OID) generally arises when a note is originally issued at a discount to its face amount or, more technically, its “stated redemption price at maturity”. OID equals the amount of the discount. Issuers generally accrue and deduct, and holders generally accrue and include in income, OID on a current, constant yield basis, subject to an exception for instruments issued with a de minimis amount of OID.

An “applicable high yield discount obligation” (AHYDO) is a debt instrument with: (i) a maturity in excess of five years; (ii) a yield that equals or exceeds the sum of the “applicable federal rate” plus five percentage points; and (iii) “significant original issue discount.” The issuer of an AHYDO is denied a deduction for a portion (the “disqualified portion”) of OID. In addition, the non-disqualified portion of OID is deductible only when paid.

Exchanges or modifications of publicly traded debt instruments
As also discussed under Liability Management Overview, an issuer of a debt instrument that exchanges its existing debt for newly issued debt faces the possibility of recognising COD income. Conversely, an exchange generating COD income could generate a corresponding amount of OID. In addition, an investor that had purchased such exchanged debt instrument at a discount could recognise gain if such exchange was not a recapitalisation for tax purposes. Note the same consequences obtain when an existing debt instrument is significantly modified, in which case, for federal income tax purposes, a deemed exchange of a new debt instrument (having the modified terms) for an old debt instrument (having the original terms) occurs.

Generally, the amount of COD income and OID resulting from an exchange equals the excess of the par amount of the old debt instrument over the issue price of the new debt instrument. Similarly, the amount of any gain recognised by an investor equals the excess of the issue price of the new debt instrument over such investor’s cost tax basis in the instrument.

The issue price of a debt instrument issued in an exchange differs markedly depending on whether such instrument, or the instrument for which it has been exchanged, is publicly or privately traded for federal income tax purposes. While public trading results in an issue price equal to the fair market value of the instrument, private trading generally results in an issue price equal to par. Such difference leads to markedly different tax consequences, as reflected in the following example:
A debt instrument with an outstanding principal amount equal to its original issue price of $100 is purchased by an investor for $30 in an over-the-counter transaction for a price negotiated between a securities dealer and the investor. The investor and issuer subsequently agree to lengthen the maturity and reduce the interest rate on the debt instrument; such modification is significant for federal income tax purposes. The debt instrument after the modification is quoted at a purchase price of $35.

If the debt instrument was publicly traded, the issue price of the new debt instrument would be $35. The issuer would recognize COD income of $65 ($100 par less $35 issue price), the debt instrument could have $65 of OID and the purchaser could recognize $5 of gain ($35 issue price less $30 of tax basis). By contrast, if the instrument was not publicly traded and no change was made to the outstanding principal amount, the issue price of the new debt instrument would be $100. The issuer would not recognize COD income on the deemed exchange and no OID would arise but the purchaser could recognize $70 of gain ($100 issue price less $30 basis).

For these purposes, property, such as a debt instrument, is publicly traded – or more precisely, “traded on an established market” in the following situations: (1) the sales price for property is reasonably available; (2) a firm price quote to buy or sell the property is available; or (3) a price quote (i.e., an indicative quote) is provided by a dealer, broker or pricing service. The fair market value of such property is presumed equal to its trading price, sales price or quoted price, whichever is applicable. If more than one price quote exists, taxpayers can reconcile the competing prices in a “reasonable manner.” In the case of an indicative quote, however, if the taxpayer determines the quote materially misrepresents fair market value the taxpayer is entitled to use a reasonable method to determine fair market value.

### Contingent convertible debt instruments

US corporations have raised billions of dollars by issuing so-called contingent convertible debt instruments (CoCos). CoCos are debt instruments convertible into stock of the issuer that provide for the payment of “contingent interest”. For example, a typical CoCo may provide that the amount of interest payable equals the amount of the dividends paid on the stock into which the debt converts and that the CoCo becomes convertible only after the CoCo’s price exceeds a percentage (for example, 120%) of its adjusted issue price. As a result of the contingent interest feature, CoCos are treated as “contingent payment debt instruments” for US federal income tax purposes, and the issuer and holder are subject to the “non-contingent bond method” rules provided for in applicable Treasury regulations. Under this method, the holder is required to include in income, and the issuer deducts, as interest over the term of the CoCo based on the comparable yield of non-contingent debt instruments of the issuer. Differences between taxable income included and cash received are reconciled when a contingent payment is made (which, often, is not until maturity or conversion of the CoCo into stock of the issuer).

On a restructuring or repurchase of a CoCo prior to maturity, the issuer’s COD income is not determined by reference to the CoCo’s face amount but rather by reference to its accreted adjusted issue price, which generally increases as interest is deemed to accrue under the non-contingent bond method. For example, a CoCo issued 10 years ago with a face amount of $1000x and a comparable yield at the time of issuance of 5% currently has an adjusted issue price of approximately $1600x. As a result, a repurchase of the CoCo by the issuer prior to maturity for its face amount would result in COD income to the issuer of $600x. Even absent a repurchase or modification of the CoCo, the issuer faces the same situation at maturity of the instrument. If the CoCo is retired at maturity for its face amount, the issuer would have to include $600x in income. Issuers of CoCos must carefully weigh all available options – alternatives that have substantially the same economic result may not have substantially the same tax result.

Different, and at times more complicated, tax issues arise if the debt instrument is not publicly traded. Such instruments can result in the restructured debt instrument being split into two components for US federal income tax purposes: a non-contingent component and a contingent component. The application of these rules can be extremely complex and must be carefully worked through by issuers and holders that participate in debt restructurings and workouts involving non-public debt (or that result in non-public debt).

### Debt reopenings

Debt issues are often reopened, meaning an issuer issues an additional tranche of notes at some point after the issuance of the original notes. The additional notes bear the same terms and security identification code (for example, the CUSIP number) as the original notes. The issuer’s intent is that the original notes and the additional notes be indistinguishable and, therefore, completely fungible. One benefit of fungibility is that it adds liquidity to the market for the notes. Reopening a debt issue can cause significant
tax consequences, particularly where the additional notes are issued with OID.

By way of background, OID is an attribute of a note itself (in other words, OID travels with the note and does not vary depending on whether an original investor or a secondary market investor holds the note). In contrast, market discount generally arises when an investor purchases a debt instrument in the market at a discount after original issue. Unlike OID, unless the holder elects otherwise market discount is not currently taxable as it accrues but is taxable on retirement or disposition of the note. Original notes often are not issued with OID. Nevertheless, additional notes may be priced at a non-\textit{de minimis} discount because, for example, interest rates have risen after original issue. Notwithstanding the foregoing, a holder generally would prefer the original notes and the additional notes be fungible from a tax standpoint, so that the additional notes are not treated as having been issued with OID, but rather are treated as being acquired with market discount. The reopening rules discussed below police the boundaries within which additional notes may be treated as fungible with original notes in this manner. If original and additional notes do not meet the requirements described below, the tax law treats the additional notes as a fresh issuance issued with OID and, accordingly, the original and additional notes would not be fungible from a tax standpoint.

To be fungible from a tax standpoint, the original and additional notes must have terms identical in all respects and must satisfy one of three tests, the first of which focuses entirely on time of issuance and the second and third of which focus on whether the reopening is qualified.

Under the first test, the original notes and the additional notes must be issued within thirteen days of each other.

Under the second test, a reopening of debt instruments will be a qualified reopening, and hence will result in fungible notes, if:

- the original notes are "publicly traded" within the meaning of applicable Treasury regulations;
- the issue date of the additional notes is not more than six months after the issue date of the original notes; and
- on the pricing date of the reopening (or, if earlier, the announcement date), the yield of the original notes (based on their fair market value) is not more than 110% of the yield of the original notes on their issue date (or, if the original securities were issued with no more than a \textit{de minimis} amount of OID, their coupon rate).

Under the third test, a reopening of debt instruments (regardless of whether the reopening occurs within six months of original issuance) is treated as a qualified reopening if:

- the original notes are publicly traded; and
- the additional notes are issued with no more than a \textit{de minimis} amount of OID.

In 2012, the Treasury regulations were issued that expand the definition of a qualified reopening to two additional circumstances. A reopening of non-publicly traded debt will be a qualified reopening if:

- the additional notes are issued to persons unrelated to the issuer; and
- one of the following requirements is met:
  - the issue date of the additional notes is not more than six months after the issue date of the original notes and, on the pricing date of the reopening (or, if earlier, the announcement date), the yield of the additional notes (based on their cash purchase price) is not more than 110% of the yield of the original notes on their issue date (or, if the original securities were issued with no more than a \textit{de minimis} amount of OID, their coupon rate); or
  - the additional notes are issued with no more than a \textit{de minimis} amount of OID.

The new regulations also allow for qualified reopenings more than six months after the original notes were issued where:

- the additional notes are either publicly traded or are issued to persons unrelated to the issuer; and
- on the pricing date of the reopening (or, if earlier, the announcement date), the yield of the additional notes (based on their fair market value or cash purchase price, whichever is applicable) is more than 100% of the yield of the original notes on their issue date (or, if the original securities were issued with no more than a \textit{de minimis} amount of OID, their coupon rate).

As a practical matter, if neither the original notes nor the additional notes would be viewed as issued with OID (each tested on a separate basis), the original notes and the additional notes may, nonetheless, be fungible for tax
purposes regardless of whether the reopening is a qualified opening.

If the original and additional notes are not fungible under the foregoing rules but the original and additional notes are, nonetheless, issued as indistinguishable (issued with the same terms and CUSIP number), it would be impossible for secondary market purchasers or, for that matter the Internal Revenue Service, to trace such notes through the chain of intermediate ownership and determine whether a particular note was issued as part of the original issuance (without OID) or the additional issuance (with OID). As a result, there is a risk additional, non-fungible notes may taint original notes, with the Internal Revenue Service treating both the original and additional notes as having OID.

### Source rules for guarantee income

Subject to numerous exceptions, the United States generally imposes a 30% withholding tax on US-source fixed or determinable, annual or periodical income (FDAP) of a nonresident alien individual or foreign corporation that is not effectively connected with the conduct of a US trade or business. FDAP includes interest and guarantee fees. While it has detailed rules to determine the source of various types of FDAP such as interest, the Code is silent with respect to other types of FDAP, such as guarantee income.

In response to a Tax Court decision to the contrary, the Small Business Jobs Act of 2010 (the SBJ Act) enacted a new Section 861(a)(9) of the Code, under which US-source income includes: (i) amounts received (directly or indirectly) from a non-corporate resident or a domestic corporation for the provision of a guarantee of indebtedness of such person; and (ii) amounts received from a foreign person (directly or indirectly) for the provision of a guarantee of indebtedness of that foreign person if the payments received are effectively connected with the US trade or business of such foreign person.

In addition, the SBJ Act provides that this new rule applies to payments made indirectly for the provision of a guarantee. The legislative history provides the following example:

A foreign parent of a US subsidiary guarantees the debt of such US subsidiary owed to a foreign bank. However, instead of receiving a guarantee fee from its US subsidiary, the foreign parent receives a fee from the foreign bank, which recoups this cost by charging additional interest to the US subsidiary.

In this case, new Section 861(a)(9) would treat the fees received by the foreign parent from the foreign bank as US-source guarantee fees.

### Foreign Account Tax Compliance Act

On March 18, 2010, President Obama signed into law the Hiring Incentives to Restore Employment Act, which incorporated the Foreign Account Tax Compliance Act (Fatca). Fatca included provisions which: (i) introduce a new 30% withholding tax on certain payments, including interest, made to foreign entities that fail to comply with specified reporting or certification requirements; and (ii) effectively end the practice whereby US issuers sold bearer bonds to foreign investors by repealing the US bearer bond exception. The new withholding tax began applying to payments made after June 30, 2014. Importantly, debt obligations outstanding on July 1, 2014 are grandfathered from the new withholding tax and debt obligations outstanding on March 18, 2012 are grandfathered from the repeal of the US bearer bond exception.

### New withholding tax

Fatca introduced a new 30% withholding tax (subject to refund or credit under certain circumstances) on any “withholdable payment” made to a foreign entity unless such entity complies with certain reporting requirements or otherwise qualifies for an exemption. A withholdable payment includes interest. Beginning January 1, 2017, it also includes gross proceeds from the sale of property that is of a type that can produce US-source dividends or interest, such as debt issued by domestic corporations. In response to Fatca, several dozen countries have entered into intergovernmental agreements with the United States in order to modify the reporting requirements with respect to that country’s financial institutions.

### Repeal of bearer bond exception

In 1982, Congress passed the Tax Equity and Fiscal Responsibility Act (Tefra), which restricted the issuance of debt instruments in bearer form. Under Tefra, issuers of debt instruments in bearer form generally are denied deductions for interest paid with respect to such debt instruments and are subject to an excise tax equal to 1% of the principal amount of such instruments times the number of years to maturity. Various additional sanctions also apply to holders. However, the aforementioned sanctions have not applied with respect to bearer debt instruments issued under circumstances in which they are unlikely to be sold to US persons. These circumstances include an issuance of foreign-targeted bearer debt instruments that complies with Treasury regulations referred to as Tefra C and Tefra D. In addition, Congress provided that debt instruments in bearer form do not qualify for the “portfolio interest” exemption from the 30% withholding tax generally applicable to the payment of interest to foreign persons unless such instruments are...
issued in compliance with the foreign-targeted requirements imposed by Tefra.

Many US issuers have European medium-term note or other foreign-targeted programs under which they issue bearer notes to non-US investors. These issuances comply with the Tefra regulations and, as such, the instruments are not subject to the sanctions described above or to US withholding tax. In addition, many non-US issuers include Tefra restrictions in their debt offerings outside the US to ensure they are not subject to the Tefra excise tax.

Fatca effectively ended the practice of US issuers selling bearer bonds to foreign investors under Tefra C and Tefra D. With respect to US issuers of foreign-targeted bearer bonds, Fatca repealed the exception to a denial of interest deduction for interest on bearer bonds. In addition, interest paid on such bonds no longer qualifies for treatment as portfolio interest. As a result, US issuers revised their existing programs to prohibit bearer debt. Fatca did, however, preserve the exception to the excise tax for bearer bonds issued under Tefra-compliant procedures. As a result, foreign issuers of a foreign-to-foreign bearer debt offering that is Tefra-compliant are not subject to the excise tax.

For more detailed information regarding Fatca, please see our website at www.knowfatca.com.

**Interest expense allocations**

On August 10 2010, President Obama signed into law the Education Jobs and Medicaid Assistance Act of 2010 (the Education Jobs Act), which, among other things, affects the allocation of interest expense for foreign tax credits and repeals the rules regarding 80/20 companies.

In determining a taxpayer’s foreign tax credit limitation, interest expense is allocated to each affiliate in a group, including domestic corporations and, in certain limited circumstances, foreign corporations. For purposes of the interest expense allocation rules, the Education Jobs Act treats a foreign corporation as an affiliate of a group if more than 50% of its income is effectively connected with a US trade or business and if it is at least 80% owned (by vote or value) by the affiliated group. As a result, a larger portion of interest expense may be allocated to foreign subsidiaries, thereby reducing foreign source income and limiting the use of foreign tax credits.

Under prior law, if a US corporation, during a three-year testing period, derived at least 80% of its gross income from foreign sources and such income was attributable to the active conduct of a trade or business in a foreign country (generally referred to as an 80/20 company), then interest paid by such corporation was treated as foreign source and therefore was not subject to US withholding tax. Subject to certain grandfathering clauses, the Education Jobs Act repeals the 80/20 rules effective for taxable years beginning after December 31 2010. Under the grandfather clauses, if a US corporation: (i) meets the above-described 80/20 test for its taxable year beginning before January 1 2011; (ii) meets a new modified 80/20 test with respect to each taxable year beginning after December 31 2010; and (iii) has not added a substantial line of business after August 10 2010, then any payment of interest will be exempt from US withholding tax to the extent of its active foreign business income. In addition, under the grandfather clauses the repeal of the 80/20 company provisions does not apply to the payment of interest to unrelated persons on obligations issued before August 10 2010.
1 The “applicable federal rates” are interest rates published monthly by the US Treasury for purposes of applying various provisions of the Code.

2 Under Section 165(i)(2) of the Code, OID is significant if, immediately before the close of any accrual period ending more than five years after issue, the aggregate amount that has been included in gross income with respect to an instrument exceeds the sum of actual interest payments plus an amount equal to the product of the instrument’s issue price and yield to maturity.

3 Under Section 165(e)(5), the disqualified portion of OID is the lesser of (i) all OID or (ii) the product of (a) the sum of OID and stated interest on the instrument and (b) the ratio of (X) an amount by which the yield to maturity exceeds 6% plus the AFR to (Y) the yield to maturity.

4 Container Corp. v. Comm., 134 T.C. No. 5 (February 17 2010).
CHAPTER 8

Distressed Debt Exchange
Global Cross-Sector Criteria

Scope and Limitations

This report describes Fitch Ratings’ criteria for the rating of Distressed Debt Exchanges (DDEs). These criteria apply globally to the following sectors: corporates, financial institutions including covered bonds, insurers, sovereigns and subnationals, and global infrastructure. These criteria do not apply to Structured Finance ratings — for those, please refer to Fitch’s report, Distressed Debt Exchange Criteria for Structured Finance (June 2014).

These criteria apply to instruments and other financial obligations owned by third-party investors who would usually be expected to exercise all remedies available to them. Instruments issued to affiliated investors (eg, parent companies to optimize tax efficiency, central banks or government bodies) may be treated differently.

Summary

Key DDE Rating Drivers: When considering whether a debt restructuring should be classified as a DDE, Fitch expects both of the following to apply: the restructuring imposes a material reduction in terms compared with the original contractual terms; the restructuring or exchange is conducted in order to avoid bankruptcy, similar insolvency or intervention proceedings or a traditional payment default. Additional nuances for banks and sovereigns are covered elsewhere in this report.

Options When Under Distress: Issuers with untenable capital structures, either insolvent or illiquid (for example, due to excessive debt, high coupon rates, or substantial near-term maturities), generally have three options for restructuring their obligations: bankruptcy or similar insolvency or intervention proceedings; refinancing — generally available where an issuer’s problem arises from liquidity rather than solvency; or a DDE.

How Fitch Records DDEs: When an exchange or tender offer that Fitch considers to be distressed is announced, an issuer’s Issuer Default Rating (IDR) typically will be downgraded to ‘C’. Completion of the DDE typically results in an IDR being downgraded to ‘Restricted Default (RD); see Appendix for definitions). Shortly after the DDE is completed, an IDR will be re-rated and raised to a performing level, usually still low speculative grade.

Considerations for Sovereigns and Subnationals: Bankruptcy is not an option for sovereigns, US state governments or subnational and municipal issuers in the majority of jurisdictions. However, in the US bankruptcy is available for municipalities and some other types of public-sector entities such as hospital, sewer, water, or power districts.

It is feasible for a sovereign to pursue a DDE to improve its policy options, rather than as a last resort to avoid a payment default. In addition to the cross-sector criteria on recognizing DDEs as Defaults, a sovereign DDE could exhibit other characteristics, outlined in Additional Considerations for Sovereigns.

Considerations for Banks: Banks often have tranché liability structures that include junior securities, which are designed, in various ways, to be loss-absorbing. When a bank undertakes a DDE of junior (eg, regulatory capital) securities, Fitch is unlikely to lower its IDR to ‘RD’. The securities subject to DDE will be downgraded to a level consistent with their non-performance, and the bank’s Viability Rating (VR) will usually be downgraded to ‘F’ if not already there. A DDE of a senior obligation will result in a bank’s IDR being downgraded to ‘RD’.

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DDE Criteria for Bonds

An exchange offer will be considered a DDE and recorded as an ‘RD’ if there is a material reduction in terms compared with the original contractual terms, and the exchange is necessary to avoid bankruptcy, similar insolvency or intervention proceedings, or a traditional payment default.

A material reduction in terms could be any one or a combination of the following:

- Reduction in principal.
- Reduction in interest or fees.
- Extension of maturity date.
- Change from a cash pay basis to pay-in-kind (PIK), discount basis or other form of non-cash payment.
- Swapping of debt for equity, hybrids or other instruments.
- Cash tender for less than par if acceptance is conditional on a minimum aggregate amount being tendered or if combined with a consent solicitation to amend restrictive covenants. If either of these conditions is not evident, then cash tender offers for less than par will not be DDEs, unless other circumstances indicate that failure of a large percentage of creditors to participate in the tender would be likely contribute to the entity defaulting.
- Exchange offers or cash tenders that are accepted only if the tendering bondholder also consents to indenture amendments that materially impair the position of holders that do not tender.

Fitch will review the circumstances of any exchange offer and consider the impact of each of these factors. Theoretically, an exchange could be executed to be at least neutral to existing creditors, but the likelihood is remote for a distressed issuer.

DDE Criteria for Bank Loans

A material reduction in terms, by itself, is not sufficient for an amendment to a revolving credit or term loan to be classified as a DDE. The flexibility of loans compared to bonds, and the frequency with which loans are amended across the spectrum of credit quality, make it difficult to have a categorical determination of a DDE for a loan.

For example, extending the maturity and reducing the interest on a revolving loan could result either from an improvement or deterioration in credit quality, and non-payment defaults caused by covenant violations are commonly waived or amended. Banks and other investors in term loans are frequently willing to extend maturities for reasons other than avoiding a liquidity crisis.

Therefore, while Fitch’s DDE criteria may be applied to bank loan restructurings in a similar fashion to bond DDEs, it will also be necessary to consider the issuer’s solvency, liquidity, and access to additional funding.

Indicators that a loan exchange, typically an “amend and extend” transaction, is a DDE include any one or a combination of the following:

- The issuer’s declared intention to file for bankruptcy if the loan amendment is not accepted.
- A reduction in terms coupled with a concurrent bond exchange considered to be a DDE.
- The introduction of PIK interest (but not exercise of a previously agreed PIK option).
- An exchange of debt for equity.
- Above-market compensation (eg, equity in addition to rather than in exchange for debt or interest materially above market).
• A significant reduction in terms coupled with an obvious, significant deterioration in credit quality.
• Use of a formal court process to change original contractual terms to impose changes upon creditors outside a formal bankruptcy or insolvency framework (such as Chapter 11 in the US).

Ratings Implications

Issuer Default Ratings

Pre-Execution

On the announcement of a prospective debt exchange offer that Fitch determines to be a DDE, the IDR will likely be lowered to ‘C’, indicating imminent default. In situations where the completion of the DDE is subject to material uncertainty — for example, because of a minimum acceptance level that the agency believes may not be reached — a RWN classification may be used as an alternative to lowering the IDR to ‘C’.

On Execution

On completion of the exchange, the IDR will be lowered to ‘RD’ to record the default event unless an issuer’s IDR is already at ‘RD’ because default has already occurred in another form (eg, uncured non-payment of coupon).

For non-financial corporates a DDE offer may target one or more debt issues within the issuer’s capital structure and exclude other debt issues. In such cases, rather than downgrade the IDR to, or closer, to ‘C’ at the time of the DDE offer announcement and immediately re-rate all instrument ratings using recoveries based on that, Fitch may put the IDR and those instrument ratings included in the offer on RWN on the offer announcement. It will then change ratings when the DDE transaction closes, including registering the IDR going to ‘RD’. This means that unaffected instrument ratings would not change unless their recovery prospects changed as a result of the DDE transaction. Fitch would expect this situation to apply to non-financial corporate entities with a ‘B’- and lower IDRs.

Post-Execution

Once sufficient information is available, the ‘RD’ rating will be re-rated to reflect the appropriate IDR for the issuer’s post-exchange capital structure, risk profile and prospects in accordance with relevant Fitch criteria.

At the same time as the new IDR is assigned, all related issue ratings may be adjusted, including those that were not part of the exchange, to ensure that all ratings are consistent with applicable notching guidelines in the relevant criteria. As these criteria will apply to a broad range of situations across a variety of sectors, it is difficult to define precisely the length of time that the IDR will remain at ‘RD’ before the new post-exchange IDR is assigned. However, it may occur contemporaneously (ie, the IDR is downgraded to ‘RD’ and then upgraded to its new post-exchange level on the same day and in a single Rating Action Commentary).

If the DDE does not close, Fitch will review the issuer’s liquidity and solvency prospects and assign the appropriate IDR.
Tendered Bond Issues

The ratings of eligible securities that are subject to a prospective DDE will likely be lowered to very low speculative grade — typically in the 'C'–'CCC' range — on announcement of the DDE. On completion of the exchange, the ratings of the securities subjected to the DDE will be downgraded to a level consistent with non-performing instruments, if not at such a level already (see Fitch’s Rating Definitions at www.fitchratings.com). In most instances, this is likely to be 'CC' or 'C'. The issue ratings will then be withdrawn after a short time, reflecting that those securities have been extinguished in the exchange.

Untendered Bond Issues

The ratings of eligible securities that are not tendered and continue to be serviced will remain at very low speculative grade — typically in the 'C'–'CCC' range — until the exchange is completed. They will then be rated according to their priority in the new, post-exchange capital structure — i.e., reflecting the specific issue structure and recovery prospects, as well as the newly restructured company’s credit and business profile. In the event that insufficient information is available to enable Fitch to maintain ratings on any untendered bond issues, the agency will withdraw those obligation ratings.

New Bond Issues

Any new bond issue or loan package resulting from a DDE will be rated on the issuing entity’s credit profile post-exchange, any structural considerations related to the specific issue, and recovery prospects should an additional or subsequent default occur. It is not relevant to the rating that the issue was a product of a DDE.

Additional Considerations for Sovereigns

A sovereign DDE occurs in an environment in which, in the absence of the exchange offer, a missed interest and/or principal payment would be highly likely. However, in the sovereign context, where a bankruptcy-type reorganization is not possible, it is also feasible for a sovereign to pursue a DDE to improve its policy options, rather than only as a last resort to avoid a payment default.

In addition to the criteria covering corporate DDEs, a sovereign DDE could exhibit all or some of the following characteristics:

- The currency denomination or indexation of the securities is altered in a way that could be disadvantageous to bondholders.
- Existing obligations are de-listed from securities exchanges.
- Retrospective changes to the legal framework governing the affected securities or to the terms and conditions of the securities that penalize holders of those securities.
- The law governing the new bonds is changed in a way that could be disadvantageous to bondholders (e.g., change from the law applicable in a major international capital market, such as New York or London, to local law).

In terms of the rating mechanics for DDEs of sovereign issuers, if Fitch believes an announced exchange offer constitutes a DDE, the IDR will be lowered to 'C', indicating that default is highly likely in the near term. The ratings of the securities subject to the exchange will also be lowered to 'C'.

On closing of the exchange offer and following confirmation that the exchange will be completed (for example, because the minimum threshold for participation has been met), Fitch will place the sovereign’s IDR into default, specifically ‘RD’. The ratings of the tendered
securities will be lowered to ‘D’ and will remain at that level for as long as the sovereign is rated ‘RD’. The ratings of eligible securities that are not tendered and continue to be serviced will remain at ‘C’ until the exchange is completed and then rated according to their priority in the new, post-exchange capital structure.

Following completion of the DDE, the sovereign IDR will likely be lifted out of ‘RD’ to a rating appropriate for its prospects on a forward-looking basis shortly after the effective date of the exchange (likely constrained to the low speculative grade range). However, if the share of eligible securities not tendered in the exchange is large and the securities are non-performing, the ‘RD’ rating will likely be maintained until the default is cured, such as through a further exchange, or until Fitch deems that the sovereign has normalized relations with the international financial community despite outstanding non-performing securities.

Additional Considerations for Financial Institutions and Banks

As noted in the Global Financial Institutions Rating Criteria, ‘an FI’s IDRs usually express Fitch’s opinion on the risk of default on senior obligations to third-party, non-government creditors as in Fitch’s view these are typically the obligations whose non-performance would best reflect the uncured failure of the entity’. Consequently, an FI’s IDRs do not usually reflect default risk on subordinated or junior debt, including by way of a DDE. Only when subordinated obligations comprise a substantial part of an FI’s liabilities and effectively represent part of the entity’s core funding (as is the case for some non-bank financial institutions) will an FI’s IDR rate to these as reference obligations.

**Banks and Bank Holding Companies:** While not always the case, bank DDEs are likely to occur when investors are threatened with regulatory intervention (ie, bankruptcy or statutory resolution) that will lead to a more adverse outcome for an instrument (eg, payment default or bail in) than is contractually possible.

Initially and unless a bank’s problems are very substantial, Fitch expects a DDE would likely focus on junior instruments where actions such as write-offs, conversion to equity, or deferral/omission of coupons are either permitted by terms of the hybrid issues or may be triggered statutorily outside a formal bankruptcy process.

Where distressed exchange/tender offers are undertaken on such junior instruments, Fitch would usually not expect to lower the IDR of the bank to ‘RD’. However, given that the bank was stressed to the point of being at the threat of regulatory intervention, Fitch would normally expect to lower the bank’s VR to ‘F’ and the instrument rating, briefly, to a non-performing level, if the ratings are not already at such levels.

Whether bank or regulator-initiated, key to avoidance of a DDE from the perspective of the IDR is that the actions are designed to support the senior obligations and that the senior obligations are not adversely restructured. Senior obligations – while themselves becoming increasingly tranched for example due to depositor preference regimes - typically make up the vast majority of claims against a bank, which is why Fitch believes their non-payment best reflects the uncured failure of a bank. To avoid doubt, should a bank complete a DDE for senior obligations, the bank’s IDR will be downgraded to ‘RD’ or even ‘D’.

In situations where there has already been intervention in a bank and it is in a state of full operational limbo pending a regulator’s decision on its fate or of orderly resolution (ie, wound down but obligations are being serviced according to terms), Fitch will assess tender or exchange offers for obligations on a case-by-case basis. Any tender or exchange for junior obligations is unlikely to be recorded as a default at an IDR level. Key to determining whether a
tender or exchange for unsubordinated obligations will constitute a default at an IDR level is likely to be whether Fitch believes failure to tender would lead to a more adverse scenario than is contractually possible (examples could include payment default or enforced squeeze-out).

**Covered Bonds:** Covered bonds are often designed to survive the insolvency or resolution of their issuer banking group. In many jurisdictions, covered bonds are exempt from bail-in. Whereas the bail-out of troubled banks has so far mostly avoided the need to enforce the security against the cover pool, the implementation of banks recovery and resolution regimes means that protections against payment interruption risk for covered bonds are more likely to be put to test in the future.

In the event of a transfer from the issuer to the cover pool as a source of payment, a typical protection against payment interruption risk consists in extending the maturity of the bonds, for example by one year (so-called soft-bullets), or up to a later date depending on the cash flows profile from the cover assets (so-called pass-through). Fitch will not treat as DDE bonds that are extended, provided the extension and its conditions are part of the original documentation at bond issuance. Fitch may treat as a DDE cases which lack clarity on the final maturity date or discretionary use of the extension clause by issuers. To date no covered bond rated by Fitch has been considered as a DDE.
Appendix: Rating Definitions

‘C’: Exceptionally High Levels of Credit Risk

Default is imminent or inevitable, or the issuer is in standstill. Conditions indicative of a ‘C’ category rating include:

- The issuer has entered into a grace or cure period following non-payment of a material financial obligation.
- The issuer has entered into a temporary negotiated waiver or standstill agreement following a payment default on a material financial obligation.
- Fitch otherwise believes a condition of ‘RD’ or ‘D’ to be imminent or inevitable, including through the formal announcement of a DDE.

‘RD’: Restricted Default

‘RD’ ratings indicate an issuer that, in Fitch’s opinion, has experienced an uncured payment default on a bond, loan or other material financial obligation but which has not entered into bankruptcy filings, administration, receivership, liquidation or other formal winding-up procedure, and which has not otherwise ceased operating. RDs would include:

- the selective payment default on a specific class or currency of debt;
- the uncured expiry of any applicable grace period, cure period or default forbearance period following a payment default on a bank loan, capital markets security or other material financial obligation;
- the extension of multiple waivers or forbearance periods upon a payment default on one or more material financial obligations, either in series or in parallel; or
- execution of a DDE on one or more material financial obligations.

‘D’: Default

A ‘D’ rating indicates an issuer that in Fitch’s opinion, has entered into bankruptcy filings, administration, receivership, liquidation or other formal winding-up procedure, or which has otherwise ceased business.

Default ratings are not assigned prospectively to entities or their obligations; within this context, nonpayment on an instrument that contains a deferral feature or grace period will generally not be considered a default until after the expiration of the deferral or grace period, unless a default is otherwise driven by bankruptcy or other similar circumstance, or by a DDE.

“Imminent” default typically refers to the occasion where a payment default has been intimated by the issuer and is all but inevitable. This may, for example, be where an issuer has missed a scheduled payment but (as is typical) has a grace period during which it may cure the payment default. Another alternative would be where an issuer has formally announced a DDE, but the date of the exchange still lies several days or weeks in the immediate future.

In all cases, the assignment of a default rating reflects the agency’s opinion as to the most appropriate rating category consistent with the rest of its universe of ratings, and may differ from the definition of default under the terms of an issuer’s financial obligations or local commercial practice.
Commentary

General Criteria:
Rating Implications Of Exchange Offers And Similar Restructurings, Update

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Frequently Asked Questions
General Criteria:

Rating Implications Of Exchange Offers And Similar Restructurings, Update

(Editor's Note: We originally published this criteria article on May 12, 2009. We are republishing this article following our periodic review completed on May 1, 2014. This article supersedes the article titled, "Corporate Default Risk With A Twist," published July 5, 2005. In addition, this article has been partially superseded by "Use Of 'C' And 'D' Issue Credit Ratings For Hybrid Capital And Payment-In-Kind Instruments," published Oct. 24, 2013.)

Entities in distress often restructure their obligations, offering less than the original promise. There recently has been a great deal of such activity, taking the form of exchange offers and buybacks. The alternative of a potential conventional default, in which the investor or counterparty stands to fare even worse, motivates (at least partially) their acceptance of such an offer. Standard & Poor's Ratings Services treats such offers and buybacks as equivalent to a default on the part of the issuer.

To consider an exchange offer as tantamount to default, we look for two conditions to be met:

• The offer, in our view, implies the investor will receive less value than the promise of the original securities; and
• The offer, in our view, is distressed, rather than purely opportunistic.

Upon completion of an exchange we view to be distressed, we lower our ratings on the affected issues to 'D', and the issuer credit rating is reduced to 'SD' (selective default), assuming the issuer continues to honor its other obligations. This is the case even though the investors, technically, may accept the offer voluntarily and no legal default occurs. Subsequently, we raise the rating to again focus on conventional default risk. This applies even in the case of an extended de facto restructuring—such as a proposed series of auctions to buy back distressed debt.

Our approach to such transactions pertains equally to the restructuring of any financial obligation of the entity—debt security, loan, or derivatives contract.

This article updates and supersedes Distressed Exchange Offers: Tantamount To Default, published Nov. 2, 2001, and Rating Implications Of Exchange Offers And Similar Restructurings, published Jan. 28, 2009, on RatingsDirect. In particular, questions 9-12 have been added, and we have tried to better clarify some of the original answers.

Compared with the Nov. 2, 2001 article, we have widened the scope to include:

• Methodology for considering whether the renegotiation of a derivative contract is equivalent to a distressed exchange and, therefore, tantamount to default for the issuer rating and, if the derivative is a rated obligation, a default for the issue-level rating;
• Specific discussion on how we apply the methodology to equity hybrid instruments, such as preferred stock;
• Specific discussion on how we apply the methodology to structured finance transactions; and
• Additional discussion on when we consider an exchange or tender offer as “distressed,” including reference to the current rating of the issuer and/or instrument.

Compared with the Jan. 28, 2009 article, we have added a number of clarifications, and also clarified the approach we
take to determine recovery ratings on debt issues subject to distressed exchange offers, in that recovery ratings (and related issue rating notation implications) will not focus on the selective default transaction; rather, they will continue to focus on post-conventional default recovery (see question No. 5, below).

The criteria discussed in this article reflect our principle-based methodology, as discussed in Principles Of Corporate And Government Ratings, published June 26, 2007, and Principles-Based Rating Methodology For Global Structured Finance Securities, published May 29, 2007, on RatingsDirect. This article is part of a broad series of measures announced last year to enhance our governance, analytics, dissemination of information, and investor education initiatives. These initiatives are aimed at augmenting our independence, strengthening the rating process, and increasing our transparency to better serve the global markets. (See also Rating Policies And Procedures: Distress And Default," published March 5, 2001, on RatingsDirect.) This article also partially supersedes the article, Credit FAQ: How the Expansion Of The ‘C’ Rating Definition Affects Its Use For Hybrid Capital and Payment-In-Kind Instruments, published Aug. 1, 2008, on RatingsDirect.

Frequently Asked Questions

1. How do you determine whether an offer is distressed or opportunistic?
We distinguish between distressed offers and those that are merely opportunistic. In a distressed exchange, holders accept less than the original promise because of the risk that the issuer will fulfill its original obligations. By way of contrast, an entity that is a strong credit may offer to exchange bonds for below par where changes in market interest rates, other technicalities, or market developments have caused its bonds to trade at a discount. Such an offer is opportunistic, and would have no rating implications (other than the resulting beneficial impact on future financial profile.)

For an exchange offer to be viewed as distressed, we must decide that, apart from the offer, there is a realistic possibility of a conventional default (i.e., the company could file for bankruptcy, become insolvent, or fall into payment default) on the instrument subject to the exchange, over the near to medium term. Alternatively, exchange offers for which we believe the issuer does not face insolvency or bankruptcy in the near to medium term if the offer is not accepted are viewed as opportunistic exchanges, not distressed exchanges.

The extant issuer credit ratings, as well as rating outlooks or CreditWatch listings, can often serve as proxies for that assessment.

For example, we consider the following guidelines, in addition to other information:

• If the issuer credit rating is ‘B-‘ or lower, the exchange would ordinarily be viewed as distressed and, hence, as a de facto restructuring.
• If the issuer credit rating is ‘BB-‘ or higher, the exchange would ordinarily not be characterized as a de facto restructuring.
• If the issuer credit rating is ‘B+‘ or ‘B’, market prices or other cues would be used to make the call.

Trading prices of the securities under offer and/or the offering prices can also provide some insight about the characterization of the exchange offer and other buyback activity. Investors, or counterparties—whatever their trading
strategies—would be assessing the likelihood of receiving the originally promised amount and comparing the offer to what they expect to receive if a conventional default occurs.

An exchange offer conducted several quarters in advance of maturities, where investors are asked to extend the tenor, with compensation in the form of amendment fees or increased interest rates, would be considered proactive treasury management, rather than a de facto restructuring.

2. Aren’t such offers and similar restructuring positive for the company’s credit quality?

Indeed, upon completion of a distressed offer, the entity ordinarily will benefit financially, helping it to avoid a conventional insolvency and reduce risk going forward. This may ultimately lead to higher ratings than before the offer was announced.

However, this positive change would be the result of restructuring the obligation (i.e., not meeting its financial obligations in accordance with its terms). In our view, it is analogous to a bankruptcy—a process that also benefits an entity by relieving it of the financial burdens that it undertook previously. Accordingly, our ratings take into account this failure to pay in accordance with the terms of the obligation, and any subsequent benefit would be reflected only afterwards.

3. Exchange offers are sometimes referred to as "coercive." Is this the same as a "distressed offer"?

No. An offer may be deemed coercive, if, for example, the entity employs tactics that pit holders of one series against holders of another series, or imperils holdouts with the threat of stripping covenants once 51% of the bonds are bought in. But from a credit perspective, the coercive aspect of an offer is largely irrelevant. While it may reflect on management style and financial policy, incorporating coercive tactics into an offer would not cause us to view that offer as a de facto restructuring, just as the absence of such tactics would not prevent an offer from being characterized as a distressed offer.

Whether coercive tactics are involved or not, exchange offers are entirely voluntary: Investors can elect not to participate. However, the voluntary acceptance of an offer at a distressed value implies a perception of a significant risk the original obligation may not be fulfilled. The entity's offer acknowledges this reality.

Holders may be very pleased with an offer that is above market prices, especially if they account for the investment on a mark-to-market basis. Moreover, holders that bought their securities at distressed prices may be elated to turn a quick profit. In fact, holders often are the ones to initiate such transactions. But such considerations do not detract from the credit perspective: The obligation is not being fulfilled as originally promised.

4. What constitutes "less than the original promise"?

Investors may receive less value than the promise of the original securities, if one or more of the following happens without adequate offsetting compensation:

- The combination of any cash amount and principal amount of new securities offered is less than the original par amount;
- The interest rate is lower than the original yield;
- The new securities' maturities extend beyond the original;
- The timing of payments is slowed (e.g., zero-coupon from quarterly paying, or bullet from amortizing); or
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• The ranking is altered to more junior.

Even a small discrepancy between the offer and the original promise may be deemed a de facto restructuring. However, if an offer is so close to the original promise that it is hard to discern any shortfall, we would not characterize that as a default.

It does not matter if the entity is offering cash, securities, or common equity, as long as the market value of the offer can reasonably be shown to equate to the accreted value of the original securities (par and any accrued interest).

5. What specific rating actions do you take in the case of a distressed transaction?

The consummation of a distressed exchange offer or analogous transaction is viewed as a de facto restructuring with respect to the security involved, resulting in a 'D' rating on that security, even if only a portion of it is subject to the exchange. The issuer credit rating is downgraded to 'SD' (selective default) to reflect the de facto restructuring on some of its obligations. We lower the issuer rating to 'SD' rather than 'D' if the entity continues to honor all its other obligations, and there is no conventional default or broad de facto restructuring, as there would be in the case of a bankruptcy.

For sovereigns, once the distressed exchange offer has been confirmed (albeit with a future effective date), we also lower the issuer rating to 'SD' and the affected issue rating to 'D'.

Once a distressed offer is announced or otherwise anticipated, we lower the issuer and issue ratings to reflect the risk of the expected de facto restructuring. The issuer credit rating is generally lowered to 'CC' and ordinarily carries a negative rating outlook. The issue that is subject to the exchange offer is cut to 'CC'. Recovery ratings—and related notching implications—do not focus on the selective default transaction; rather, they continue to focus on post-conventional default recovery.

If the offer is rejected and there is no expectation of another offer being made, the issuer and issue ratings will ordinarily be restored to their previous levels (unless credit quality has evolved in the meantime for other reasons, including the increased risk of additional distressed exchange offers).

After an exchange offer is completed, the entity is no longer in default—similar to an entity that has exited from bankruptcy. The 'SD' issuer credit rating is no longer applicable—and we change it as expeditiously as possible (that is, once we complete a forward-looking review that takes into account whatever benefits were realized from the restructuring, as well as any other interim developments). If the exchange offer applies to only part of an issue—either because the offer was limited or because some holders declined it—we could raise the rating on the portion of the original securities that remain outstanding, if the issuer continues full debt service as originally contracted. The rating could also remain at 'D' if payments are not made on time and in full on that portion.

6. How do you treat loan modifications?

Similar to exchange offers for bonds, if a bank loan is rescheduled such that the lender receives less value than the original value of the loan—for example, if tenor is extended without appropriate compensation (e.g., an amendment fee or increased interest rate), or interest or principal is reduced, we may consider it a de facto restructuring. However, the extension of bank loan maturities for a bilateral bank loan (between a bank and its customer, as opposed to a syndicated loan) considered in the normal course of business (rather than an extension for a distressed issuer) would
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not be considered a de facto restructuring.

Sometimes it is difficult to discern the nature of the changes. Apart from the credit risk of the borrower (i.e., whether it viewed as distressed by virtue of low ratings), the context and timing of an extension may offer insights. Accordingly, whether we consider them de facto restructurings depends on the circumstances.

7. How do you treat secondary market repurchases below par?
We make an exception for open-market purchases; however, this exception applies only in a limited fashion. When the market is liquid, so that an issuer's market repurchases can be anonymous, we view that as if any other investor were buying the securities. By contrast, when a company faces its investors through direct or indirect interaction— including advertising itself as a buyer—we treat such repurchases as a debt restructuring. Typically, repurchases of significant percentages of an issue indicate that the issuer is playing at least a behind-the-scenes role.

8. What if a shareholder or one of its affiliates, launches the offer, rather than the company itself?
A related party offering at clearly less than par would be seen in the same light as if the entity itself made the same offer. The fact that the loan remains outstanding—held by the affiliate—is irrelevant, because the investors participating in the transaction received less than the original promise.

(This situation is obviously distinct from restructuring a loan originally extended by the shareholders, which would be viewed as the equivalent of infusion of equity.)

9. How does a selective default affect ratings on the entity's affiliates— including parent companies and subsidiaries?
Ordinarily, ratings indicating default apply strictly to the legal entity involved. That applies to de facto restructurings as well. However, we extend that to affiliates that guarantee the issues which are subject to the restructuring.

If the obligation was guaranteed by a third party, there would be no implications for that other entity, inasmuch as the guarantee is not invoked.

10. Does the amount of debt restructured matter?
Yes and no. The amount of "par" that gets restructured does not directly matter, because even very small amounts may be deemed a default, just as if a company misses a minimal amount of payment due.

However, if the transaction involves only a trivial amount, we would not characterize that as restructuring. Consider that in such instances any impact on the company's risk profile is de minimus (even though we do not otherwise attempt to gauge the extent to which a de facto restructuring will succeed in relieving the risk of a conventional default.)

11. What about restructurings that are not effected in a single transactions, but rather involve multiple separate transactions over several weeks or months? How do you deal with such situations?
We have recently seen a number of cases, especially on bank loans, where the issuer intends to conduct periodic auctions to repurchase some of its debt over several weeks or several quarters. We downgrade to 'D'/"SD" on completion of the first repurchase. Subsequently— as early as the next business day— we would raise the corporate rating so that it reflects the risk of a conventional default—i.e., not focusing on the ongoing restructuring associated with the buyback. (In some cases, this rating will be higher than the original rating, given the debt reduction resulting
from the buybacks. However, any issues subject to the buyback remain at 'D' until the termination of the restructuring that pertains to them.

12. How do you treat standstill agreements?
Unless the standstill provides for appropriate compensation with respect to the obligations that will be deferred, we will typically lower the issuer's credit rating to 'D' (or 'SD' if some obligations would not be subject to the standstill). Similarly, we would lower the issue ratings to 'D' for those obligations subject to the stand-still agreement.

In particular, we do not wait until a payment is first missed on an obligation but would typically lower the issuer's credit rating to 'D'/SD (and affected issue ratings to 'D') upon agreement with lenders on the standstill or any like formalization of the default. The ratings in such cases will remain 'D' or 'SD' until the obligations are subsequently restructured.

13. What about the entity's other rated obligations?
A distressed exchange offer for specific securities may have no direct bearing on the entity's other securities and/or loans, so the ratings on these may not be immediately affected. (Whereas issue ratings typically are anchored by the issuer rating—i.e., they reflect a combination of the issuer's credit rating and the issue-specific recovery prospects—we make an exception in the case of selective default situations, such as de facto restructurings.)

However, as mentioned earlier, in the aftermath of an exchange offer, the entity may be in a better financial position than before—and that could potentially benefit all its rated obligations. Accordingly, these issue ratings could be placed on CreditWatch with positive (or developing) implications when an exchange offer is announced. The listing would be based on the likelihood that post-completion default risk or recovery prospects, or both, would have improved enough to warrant an upgrade on the issue. Such a CreditWatch listing would be resolved once we know the offer will be consummated as proposed and can assess its implications for ongoing credit quality. An opportunistic offer rarely affects our ratings on the issuer's other obligations.

14. How do you apply this methodology to ratings of equity hybrid instruments?
Hybrids typically incorporate features other than fixed obligations—such as deferral and/or conversion provisions. An exchange offer on an equity hybrid instrument may reflect the possibility that, absent the exchange offer taking place, the issuer would exercise the coupon deferral option—in accordance with the terms of the instrument.) In such instances, the hybrid's rating would go to 'C', rather than the 'D' rating used for nonhybrids. Since deferral on a hybrid in accordance with its terms (outside of the offer scenario) would result in a rating of 'C', a distressed exchange offer should not result in a lower rating. Similarly, the issuer rating would not be affected—just as deferral on hybrid instruments in accordance with terms does not automatically lead to a change in the issuer rating.

15. What about exchange offers for unrated obligations?
Where we determine that a rated issuer's offer in reference to unrated financial contracts constitutes a distressed exchange, the issuer credit rating will be lowered to 'SD'. Such offers in reference to unrated financial obligations may include: bank loan modifications (see question No. 6), offers in reference to the commutation of credit default swaps, or offers in reference to the restructuring of other derivatives. We review these offers using the same factors we review for rated obligations, in order to determine whether we consider such exchanges distressed, resulting in an issuer rating of 'SD'. Exchange offers for unrated obligations that are not considered financial obligations or do not provide
credit enhancement for financial obligations, such as commutation offers on traditional insurance policy claims or a settlement offer for a commercial dispute, would not be considered a distressed exchange offer for the purpose of these criteria. We also do not consider modifications to pension plans, other retirement benefit plans, other labor obligations, or operating leases a default event for the purpose of these criteria.

16. How do you apply this methodology to structured finance ratings?

Many issuers of structured finance obligations are incorporated with a very limited purpose; thus, we refer to them as special purpose vehicles (SPVs) or special purpose corporations (SPCs). We generally do not assign issuer credit ratings to these entities, so the 'SD' treatment would not be relevant.

The most frequent request reviewed by our Structured Finance group does not typically concern a distressed exchange of notes, but rather an amendment of existing debt document terms and conditions. The most frequent type of amendment, in this context, concerns credit derivative swap amendments, such that the floating-rate payer (the protection buyer--most typically a swap broker-dealer counterparty) agrees to a higher or more remote threshold amount or attachment point in exchange for paying a far lower insurance premium or fixed-rate swap payment leg.

The impact of such an amendment is often to lower the coupon on a note issued by the trust or special purpose vehicle that has entered into the credit default swap as a seller of protection. In contrast with a distressed exchange offer, these amendments for swaps and notes typically reference vehicles that currently have 'AAA' or other investment-grade ratings. Thus, such amendment requests are not typically being made to avoid a payment default or insolvency of the SPV.

Nevertheless, the same principles will apply as described in the previous paragraphs, with the proviso that we will publish supporting information that details the amendment request and rationale for the rating decision. When we believe an amendment was not requested in order to avoid an issue payment default or an SPV insolvency or bankruptcy if the offer was not accepted, we will view the amendment as opportunistic and not distressed, and we would not lower the rating to 'D'.

Recently, we have also seen proposals for exchange offers involving traditional securitization structures, such as student loan asset-backed securities. To date, such offers have been opportunistic and, therefore, would not affect outstanding ratings. However, if we believe the issuer would face insolvency, bankruptcy, or imminent payment default if the exchange or amendment were not executed, then we would view it as commensurate with a distressed exchange and lower the issue rating to 'D' before raising it to a level that reflects the then-current credit quality.