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Today's Marketplace Highlights Increasing Use of and Great Opportunities for Exchange Offers

The recent turmoil in the financial markets and slowing economic growth has led to companies taking a variety of steps to de-lever their balance sheets and/or tap new or cheaper funding sources. Evidence of this includes recent exchange offers and debt tender offers, including those launched by GMAC, CIT Group, Harrah's Entertainment and Realogy. Residential Capital and Tyco International both completed exchange offers earlier this year. Companies are using exchange offers to increase regulatory capital (in the case of CIT Group and GMAC) as well as to de-leverage and extend the weighted-average maturity of their outstanding debt (ResCap, Harrah's, Realogy, Tyco). Others will no doubt follow, and those who do should be aware of the legal context in which exchange offers take place. Summarized below are various considerations which should be taken into account in structuring exchange offers and debt tender offers.

Tender Offer Rules. Both debt-for-debt and debt-for-equity exchange offers are subject to the anti-fraud provisions of Regulation 14E. An exchange offer or tender offer for a debt security is exempt from Regulation 14D, whereas a tender for a registered equity security generally is not. Regulation 14D imposes disclosure requirements as well as limitations with respect to the timing and duration of the offer, offeree withdrawal rights, proration of purchases, equal treatment of offerees and other anti-discrimination requirements. Regulation 14E subjects the issuer to certain anti-fraud restrictions and requires the issuer to keep the offer open for a minimum 20-day period, but does contain the other detailed rules of Regulation 14D. As a result, a debt-for-debt exchange generally gives the issuer more flexibility with respect to key terms of the offer including pricing, timing and offeree withdrawal rights and also gives the issuer the ability to make the offer to a limited group of security holders, which can be extremely helpful where time is of the essence.

Pricing Considerations. The best approach to pricing an exchange offer will depend on the circumstances, and there are a great variety of methods available to the issuer. Among the choices are whether to fix a price in advance (either as a number or a formula) or to use a Dutch auction mechanism. In debt-for-debt offers, price fine-tuning can be taken further by, for example, establishing priority tiers among different classes of notes as to whether or how much they will be cut back in favor of other classes in the event of oversubscription. In addition, participants may be offered a mix of consideration, including cash, common or preferred equity, and secured, senior or subordinated notes. This consideration may also be offered on an election basis with participants being allowed to elect a single form of consideration or a "mixed" election of different forms of consideration, subject to proration in each case.

Inducement Payments for Early Delivery and Solicitations. One approach that has been employed by a number of issuers in exchange offers not subject to Regulation 14D is to offer an inducement payment for holders that tender their notes in advance of a specified deadline (typically within the first 10 days after commencement). These holders receive increased consideration (which can be cash or other consideration, such as an additional amount of notes) in respect of their early tender, and typically can be prohibited from withdrawing their securities after the early delivery period has expired. In addition, to aid in soliciting tenders issuers pay soliciting dealers fees based on the face value of bonds that are exchanged which can help to ensure success.

Consent Solicitations. An issuer may also consider conducting an "exit consent" solicitation to remove covenants in conjunction with an exchange offer. If the issuer is able to conduct a successful exit consent solicitation, holders who do not tender into the offer will continue to hold their old securities but may become effectively subordinated or entitled to fewer protections. Under the Trust Indenture Act of 1939, as amended, provisions relating to interest rate, principal amount and maturity can be amended only by unanimous consent; however, all other provisions can be amended in accordance with the voting requirements specified in the governing indenture. IAC/Interactive Corp., Tyco International, D.R. Horton, Thornburg Mortgage and NRG Energy are examples of companies who have coupled consent solicitations with exchange or tender offers within the last year.

Tax Considerations. The tax consequences of an exchange offer to both the issuer and the security holders merit careful consideration. An exchange of notes or stock for existing notes may result in taxable cancellation of indebtedness income to the issuer and gain or loss to the holder. Debt-for-debt and debt-for-equity exchanges can, however, be structured to be tax-free for participating holders if the existing notes and, in the case of a debt-for-debt exchange, the new notes, are "securities" for federal income tax purposes. An exchange offer can also have consequences for non-participating holders in the event that the terms of the existing debt are significantly modified. Any exchange offer should be structured in light of the particular tax circumstances of the issuer and the business objectives of the exchange offer.

Special Concerns for Financial Companies. If the exchange offer is designed to create regulatory capital to meet the requirements to be a bank holding company under the Bank Holding Company Act of 1956, a company and its advisors should carefully review the new debt and/or equity securities being offered to make sure said securities will in fact achieve the desired result, including qualifying as Tier I or Tier II capital (as applicable) under the Act and not exceeding regulatory limits on the types of securities composing an institution's overall regulatory capital.

Offeree Considerations. Issuers may limit the exchange offer to "qualified institutional buyers" (QIBs) and "non-U.S. Persons" in order to qualify for the private placement exemption from registration under the securities laws. The main advantage of a private placement is speed – an important consideration given the state of today's capital markets. The offer should be carefully structured so that only QIBs and "non-U.S. Persons" are solicited, and the issuer should be sure to receive "eligibility letters" from each person choosing to participate in the offer to assure compliance with the Securities Act.

Registration Rights. Notes purchased under Rule 144A are "restricted securities" for purposes of the Securities Act, however, and can only be traded among institutional investors in the Rule 144A market (and must be carried as "restricted" and remain subject to resale limitations). Thus, in order to create liquidity for the purchasers of the new notes, notes sold in 144A offerings are typically entitled to post-closing registration rights, which may include a commitment from the issuer to exchange the new notes purchased in the exchange for substantially identical notes registered under the Securities Act within a specified time frame (often 180 days post-closing) or to file a shelf registration statement covering the new notes issued in the exchange.

Exemption under Section 3(a)(9). In some limited situations, issuers can also consider the exemption from registration under Section 3(a)(9) of the Securities Act for "any security exchanged by the issuer with its existing security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange." However, this exemption strictly limits the communications that officers, directors and employees of the issuer and its outside advisors can have with security holders. In general, only the issuer can discuss the substance and merits of the offer with security holders and solicit participation in the offer. Advisors can assist only in purely mechanical aspects of the transaction. Issuers should therefore consult with their advisors to make sure they understand what constitutes permissible activities. Use of the Section 3(a)(9) exemption may be less practical for issuers who need the services of financial advisors and others, or who wish to use a compensation structure for their advisors that is based on the success of the offering.

Compliance in Foreign Jurisdictions. Today, many bonds are likely to be held in many different countries. Well before the commencement of the exchange offer, the company and its advisors should confirm the jurisdictions of security holders and consider whether soliciting tenders in foreign jurisdictions (or having the flexibility to do so) is necessary to ensure a successful transaction. If the offer is, or may be, conducted in jurisdictions other than the U.S., the offer must comply with applicable foreign laws.

Foreign Exchange Listings. If a company has issued Euro-denominated bonds, they are likely to be listed on the Luxembourg Stock Exchange. Under Luxembourg laws, the Exchange may force issuers to make corrective disclosure where it finds the disclosure in the offering materials is inadequate, although the relevant Luxembourg authority have been willing to review materials submitted to them in advance of launching a tender offer. Euro-denominated bonds are typically held in book-entry form through the Euroclear and Clearstream clearing systems, and offering materials need to accurately describe the procedures for tendering and settling bonds through these clearing systems.

Effect on Existing Obligations. The company's existing debt agreements and other material contracts should be carefully reviewed to determine whether the issuance of new and/or additional debt or equity pursuant to the exchange offer is a breach of any such agreement, or would cause the acceleration of the maturity of any obligations under any such agreement (as well as any cross-default provisions in other instruments). In addition, issuers should be aware of the availability of any "accordion" features under existing debt agreements. Accordion features were originally intended to allow fast-growing companies to add a specified amount of senior debt, secured by the same collateral as the senior lenders, without having to seek the senior lenders' approval. Today, some companies, including Realogy and Harrah's, are using these accordion features to allow junior lenders to exchange their unsecured bonds for secured "accordion" debt. The junior lenders, in return for benefiting from senior secured status, may accept a lower interest rate and take a substantial haircut on their original investment. The main advantage of using an accordion feature is the ability to move forward more quickly since no additional consent of the senior lenders to the issuance of new debt need be obtained. In addition, offering shorter maturity dates, subsidiary guarantees, or greater liquidity may further enhance the new notes relative to existing obligations.

Appropriate Disclosure in Offering Documents. Recently, exchange offers have been used as one element of an issuer's multi-pronged recapitalization and restructuring plan. Careful consideration must be paid to the accuracy of the disclosure in these situations to both accurately capture the other elements of the recapitalization, material recent developments and risks to successfully carrying out the various aspects of the restructuring plan.

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