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Debt Exchange Offers in the Current Market

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The recent financial crisis and dislocation in the financial markets has had significant consequences for bankruptcy and restructuring professionals. One such consequence is a dramatic increase in the use of debt exchange offers as a liability management tool.

There has recently been an unprecedented level of debt exchange offer activity in the United States: nearly $30 billion was exchanged in 2008, compared with $15 billion in the previous 24 years combined, according to professor Edward Altman of NYU's Stern School of Business. *See* Dena Aubin, More Debt Exchanges Loom As Buyout Loans Come Due, REUTERS, Apr. 17, 2009. Such activity accelerated in December 2008, when eight of the 12 exchanges in 2008 occurred. *See* Vyvyan Tenorio, Debt Exchange Offers Expected to Rise, THEDEAL.COM, Jan. 30, 2009. During the first four months of 2009, at least 28 companies engaged in debt exchange offers and/or made arrangements with lenders to extend payments, repurchase debt at a discount or reissue debt on more favorable terms, in most cases at less than 50 cents on the dollar and a few close to 10 cents. *See* Matthew Sheahan, Bondholders Push Back on Exchanges, LEVERAGED FIN., May 6, 2009. This surge in activity is expected to continue into 2010, as various underlying market conditions persist — *i.e.*, an abundance of over-levered companies, tight credit markets, increasing default rates, bleak near-term earnings and revenue prospects, and depressed trading prices for speculative-grade corporate debt.

This article provides a brief overview of debt exchange offers, together with some observations on how current market conditions are driving the recent surge in such offers and influencing their terms and prospects for success.

Debt Exchange Offers: Overview

Debt exchange offers generally seek to reduce outstanding debt and/or extend debt maturity, and are a potentially powerful liability management tool. They are an attractive alternative for companies struggling to address liquidity problems, because they do not require cash, except to pay transaction costs and professional fees.

Offerors have significant flexibility in establishing the offer terms and conditions, subject to the restrictions contained in their outstanding debt documents. Such restrictions may, for example, limit the offeror's ability to issue debt, incur liens, or fund cash payment obligations on new debt. The offer may seek all of the outstanding debt of a particular issue or a specified percentage thereof, or may seek securities from multiple issues of debt.

Securities Law Considerations

The manner in which a debt exchange offer is conducted will be subject to regulation under the SEC's tender offer rules, but unless the offer seeks convertible debt, it will not be subject to the more stringent rules — including mandatory withdrawal rights and the "all holders/best price" rule — that apply to offers for equity securities. Debt exchange offers are also subject to the general antifraud provisions of the federal securities laws, and applicable state and foreign securities laws.

The new securities offered in the exchange must be registered with the SEC unless an exemption applies. Accordingly, offers are often limited to certain holders to qualify for an exemption — for example, an offer may be limited to offshore holders to qualify under Regulation S of the Securities Act and/or limited to holders who are "qualified institutional buyers" or "accredited investors" to qualify as a private placement. Offers may also be structured to qualify under § 3(a)(9) of the Securities Act, but such exemption is subject to restrictions that limit its appeal, including restrictions on who may issue the offered securities and a prohibition on payments to persons who solicit exchanges.

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Addressing the Holdout Problem

For various reasons, some holders may not be inclined to participate in a particular debt exchange offer, and unlike bankruptcy — where a result can be forced on all holders subject to obtaining the requisite plan votes — holders cannot be forced to participate. Debt exchange offers can, however, be structured to include various "carrots" and "sticks" to incentivize holders to participate. For example, it may be possible to offer debt that is structurally senior to the debt sought in the offer, or an "early tender premium" to holders who tender by a specified early deadline.

Debt exchange offers may be conditioned on the tender of a high percentage (*e.g.*, 90% or more) of the debt sought in the offer. Such a "minimum condition" can provide comfort to holders who may otherwise be wary of exchanging debt securities at a discount if other holders who do not participate will reap the benefits of the exchange (*i.e.*, the borrower's improved balance sheet and ability to pay debts) without the cost. A minimum condition provides assurance that there will be, at most, a limited number of such "free riders." It may also incentivize holders wary of being left with debt securities that are part of a significantly reduced total issue amount, because of the potential negative impact on the liquidity and trading prices of such securities.

Debt exchange offers are often combined with consent solicitations that propose, through an indenture amendment, to strip covenants and other protections from the debt sought in the offer, and may also seek to release collateral to the extent permitted by the underlying indenture. Consent solicitations are designed to incentivize participation by making the subject debt relatively less attractive. Indentures typically require consents from a majority of the outstanding principal amount, but sometimes require two-thirds or more, and certain "money terms" — including the principal amount, interest rate and payment and maturity dates — cannot be amended without the consent of each affected holder. A "consent fee" may be offered to holders who consent by a specified deadline, but this may limit the availability of a private placement registration exemption because indentures typically require that any consent fee be offered to all holders.

Debt exchange offers may also be combined with a solicitation of votes for a prepackaged plan of reorganization. The plan would be filed if the minimum condition is not satisfied but the requisite votes to accept the plan are obtained. This may incentivize holders who view the exchange offer as preferable to the bankruptcy alternative set forth in the prepackaged plan.

Impact of Current Market Conditions on Debt Exchange Offers

Nearly all of the companies that have recently made debt exchange offers can be grouped into one of two general categories: 1) distressed companies that need to reduce debt and free up cash to avoid an imminent default and/or insolvency; and 2) overleveraged companies that are not currently distressed but have a significant amount of debt coming due within the next few years and want to reduce refinancing risk. Current market conditions have played a significant role in the recent surge of debt exchange offers in both categories.

Offers Designed to Avoid Bankruptcy

The recent experience of many companies in bankruptcy has been influenced significantly by two recent developments — a general shortage of buyers willing to pay more than "fire-sale" prices for distressed company assets, and limited availability of DIP and exit financing. This has fueled concerns that a bankruptcy filing might lead to liquidation of the company at fire-sale prices, or a protracted bankruptcy case if the company is unable obtain sufficient cash, through asset sales and/or exit financing, to exit bankruptcy. Accordingly, distressed companies and their stakeholders appear to be placing an increased emphasis on out-of-court solutions such as debt exchange offers, with bankruptcy as a last resort.

Moreover, equity sponsors can be expected to aggressively press out-of-court solutions for their portfolio companies because they stand to lose their entire equity investment in bankruptcy. For example, Apollo recently made a debt tender for approximately one third of a bond issue by Harrah's Entertainment, one of its portfolio companies. This led to speculation that Apollo's offer was designed to acquire a blocking position in a possible Harrah's bankruptcy, and thereby obtain significant leverage to negotiate an out-of-court solution with creditors and/or control any bankruptcy process. *See* Karen Brettell, Apollo May Seek Control with Harrah's Debt Offer-KDP, REUTERS, Mar. 5, 2009.

Offers Designed to Limit Refinancing Risk

During the leveraged buyout wave that ended in 2007, equity sponsors acquired numerous portfolio companies in acquisitions financed at historically high earnings multiples. These portfolio companies now face the prospect of having to repay or refinance large amounts of debt in the near- or mid-term future, when earnings may still be relatively low and the credit markets relatively tight.

More than a trillion dollars of such LBO debt is scheduled to mature between 2011 and 2014, and some borrowers are concerned that a surge in demand for capital to repay such loans will leave many borrowers "out in the cold" when their debt matures. *See* Dena Aubin, More Debt Exchanges Loom As Buyout Loans Come Due, REUTERS, Apr. 17, 2009. Some equity sponsors have begun taking steps to address this risk with respect to their portfolio companies, by engaging in debt buybacks or debt exchange offers that seek to reduce the total amount of debt and/or extend debt maturity.

Holders of speculative-grade corporate debt have become increasingly concerned about certainty of repayment in the current market, and may be willing to trade principal for improved security and/or payment priority. This may present an attractive opportunity for certain borrowers to address refinancing risk through a debt exchange offer, because they may be able to entice holders to exchange outstanding debt for equity and/or new debt at a significant discount by offering debt that would move holders "up the ladder" with respect to collateral or payment priority. Whether such an offer is possible will be determined by the documents for the borrower's outstanding debt — a significant amount of the debt used to finance the recent LBO wave was incurred pursuant to documents with relatively few restrictions, and borrowers with such "covenant lite" debt may have the requisite flexibility to make such an offer. For example, an indenture may allow the borrower to offer debt securities that are structurally senior to the securities sought in the offer, or a secured debt facility may include an "accordion" feature with flexibility to issue additional secured debt in exchange for unsecured debt.

This is a particularly attractive prospect for equity sponsors, because any reduction in a portfolio company's total debt will accrue directly to the value of the sponsor's equity investment. Furthermore, debt exchange offers are cashless transactions that allow sponsors to "refinance" portfolio company debt while preserving cash for reinvestment and/or dividends.

Underlying Holder Motivations

The prospects of success for a particular debt exchange offer will be influenced by a variety of factors, including the offer terms and the nature of the holders of the subject securities. Debt exchange offers are susceptible to holdout problems, as noted above, and it has become increasingly difficult to assess how holders will likely respond to a particular offer.

Credit default swaps are expected to have a significant influence on how holders will respond to any particular debt exchange offer. This is because of the huge size of the CDS market and the potential for conflicting economic incentives for holders who also hold a CDS position with respect to the issuer of the subject security, particularly in offers designed to keep such issuer out of bankruptcy. The economic implications for the CDS may cause such an investor to refrain from participating in any particular offer, even if it would otherwise be inclined to do so.

Market conditions have also led to increasing uncertainty as to the general effectiveness of consent solicitations as an incentive for holders to participate in debt exchange offers. Some holders may not be concerned about holding onto a relatively illiquid debt security that has been stripped of most of its protections, particularly if the offered security has a longer maturity than the subject security. This is because the exchange could actually improve the likelihood that the subject security will be repaid, because it will be first in time and the total funds required to repay or refinance the subject securities that remain outstanding will be reduced significantly.

Conclusion

Current market conditions have engendered an environment in which over-leveraged borrowers are increasingly likely to consider debt exchange offers, and can be expected to influence how any particular offer will be received by holders of the subject securities. Success or failure will be tied to how closely aligned the offer terms are with the goals and preferences of such holders. By keeping current market conditions and holder preferences in mind in structuring any debt exchange offer, an offeror will increase the likelihood that its offer will find the "sweet spot" for holders and achieve the desired result.