CAMBRIDGE

Cambridge University Press
978-1-107-02034-4 - Law and Practice of Liability Management: Debt Tender Offers, Exchange Offers, Bond Buybacks and Consent Solicitations in International Capital Markets
Apostolos Ath. Gkoutzinis
Excerpt
More information

1

Liability management for issuers of debt securities:

Summary of options and legal framework

1 Introduction

As the issuer of debt securities in the capital markets and its advisors are preparing for the customary celebratory closing dinner following the issuance of the securities to investors and the successful completion of an intense and (probably) expensive capital markets project, a liability management transaction for those same securities is probably the last thing on their minds. It is entirely unromantic for any newly wedded couple to be discussing the advantages and disadvantages of a divorce or going through the provisions of a nuptial agreement as they are boarding a flight, holding hands, to their honeymoon destination. And yet, honeymoons never last forever and marriages often come to a sudden end as well. For the issuer of debt securities that had once been issued and celebrated with a lot of fanfare, the equivalent of a messy divorce from its hapless investors takes the form of a liability management transaction against the background of the issuer's or its controlling shareholders' new financing or strategic plans and, in the worst case, against the background of considerable financial stress and the risk or the reality of bankruptcy.

No issuer of debt securities is protected forever from competitive market forces and external economic shocks. The issuer's (hitherto seemingly robust) financial and business plan may become entirely fanciful or require substantial revision as a result of tougher economic and financial conditions, structural changes, limited financing options, poor profitability, rising costs, and/or volatile macroeconomic environments in the issuer's main markets.

Often, issuers with fundamentally sound businesses and operations may suffer from lack of liquidity, working capital, and/or long-term funding. They may also find that financial and non-financial covenants in their existing financing agreements are at risk of being violated as a result of weaker than expected economic performance, which may

© in this web service Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
978-1-107-02034-4 - Law and Practice of Liability Management: Debt Tender Offers, Exchange Offers, Bond Buybacks and Consent Solicitations in International Capital Markets
Apostolos Ath. Gkoutzinis
Excerpt
More information

trigger, in turn, default clauses in the same financing agreements and cross-default or cross-acceleration clauses in other financing documents then in effect. As issuers of debt securities come under operational and financial stress, their creditors (including debt investors), suppliers, and customers become extremely uncomfortable and begin to demand additional legal protections. These protections include more-favorable payment or prepayment terms, higher-quality collateral and tighter contractual protections, and often accelerate rather than avert the issuer's ultimate demise in the absence of a radical restructuring plan.

Any company in that or a similar situation should carefully identify, together with its financial and legal advisors, all the options that may help the company to manage its liabilities and cash payments, turn the business around, and avoid bankruptcy and other terminal events. In addition to operational improvements, sales of assets, and injections of fresh equity (which are outside the scope of this work), one or more liability management transactions in relation to the issuer's outstanding debt securities will always be on the menu of alternative options.

Corporate and sovereign issuers of debt securities seeking to manage their financial liabilities represented by such debt securities have a range of options at their disposal:

- to repay the principal amount due under the debt securities on the contractually agreed maturity date or to redeem the debt securities early, in whole or in part, in accordance with the terms and conditions of the relevant securities (*optional redemption*);
- to purchase the relevant debt securities, either directly or through an affiliate of the issuer, in a privately negotiated transaction from the holder(s) of those securities or in the open market through the services of a broker or dealer (*repurchase*);
- to offer publicly to purchase the principal amount outstanding of the relevant debt securities, in whole or in part, from the holders of the relevant securities, at a price to be determined by the terms of the offer and through a structured tendering process (*cash tender offer*); or
- to exchange the relevant series of debt securities, in whole or in part, for newly issued securities (debt or equity) or other liabilities having different terms and conditions relating to the principal amount, interest rates, payment dates, covenants, events of default, or other structural or contractual features as more specifically set forth in the terms and conditions of the exchange offer (*debt for debt* or *debt for equity exchange offer*).

© in this web service Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
978-1-107-02034-4 - Law and Practice of Liability Management: Debt Tender Offers, Exchange Offers, Bond Buybacks and Consent Solicitations in International Capital Markets
Apostolos Ath. Gkoutzinis
Excerpt
More information

Which option or combination of options the issuer and its advisors will decide to pursue will depend on a number of different factors, including the following important legal, commercial, and structural factors:

- the commercial and financial objectives of the liability management transaction;
- prevailing market conditions;
- the commercial feasibility of the transaction in light of the interests and objectives of the holders of the relevant securities;
- the identity and number of the holders of the debt securities;
- whether or not the holders of the securities are widely dispersed and located in different jurisdictions;
- the time and effort required to finalize the necessary documentation;
- the manner in which the debt securities are held (registered or bearer securities), and the clearing and settlement system in which transactions in the relevant securities clear and settle;
- legal and regulatory considerations;
- tax considerations;
- accounting considerations;
- contractual limitations and restrictions in the underlying legal documentation relating to the relevant securities and other existing contractual agreements;
- the commercial and legal framework of the market or markets on which the relevant securities are listed and traded (if at all);
- the estimated cost of the relevant liability management transaction; and
- whether or not the issuer has cash resources available to it and is willing or not to use such cash resources in connection with the relevant transaction.

Some of the options may even be appropriate for healthier companies that are not distressed as new funding sources, hitherto unavailable or unattractive to them, suddenly become available and attractive.

Annex I contains a summary guide to the various transaction alternatives available to issuers of debt securities in structuring liability management transactions.

1.1 Commercial objectives

In pursuing a liability management transaction for debt securities, the issuer and its advisors will want to achieve one or more of the following commercial objectives:

© in this web service Cambridge University Press www.cambridge.org

Cambridge

Cambridge University Press
978-1-107-02034-4 - Law and Practice of Liability Management: Debt Tender Offers, Exchange Offers, Bond Buybacks and Consent Solicitations in International Capital Markets
Apostolos Ath. Gkoutzinis
Excerpt
More information

- the extinguishment, in whole or in part, of the relevant debt obligation represented by the relevant debt securities;
- a reduction of interest expense attributable to the debt securities;
- the extension of the stated date of maturity of the relevant debt obligation;
- amendment or modification of other economic or payment terms and conditions of the relevant debt securities (including, without limitation, amendments or modifications changing the mechanics of payment of interest and/or principal, changes affecting redemption or change of control provisions, or changes affecting the location or manner of payment);
- the amendment, modification, or elimination of restrictive covenants in relevant debt securities and other changes in the legal structure advantageous to the issuer such as releases of guarantees or security, assignment of the relevant legal obligation to a different legal entity, and the elimination of restrictions on asset disposals, mergers, and other business combination transactions;
- improvement in certain financial ratios of the issuer that are directly or indirectly affected by the cost of financial debt on the issuer's balance sheet;
- recognition of accounting gains (per share or in total) through the extinguishment of debt obligations at less than face value;
- regulatory or credit rating advantages; and
- extended corporate and financial restructuring, the management of cash and cash equivalents, and/or, in relation to issuers under severe stress, the avoidance of bankruptcy, liquidation, and similar terminal events.

Corporate and sovereign issuers of debt securities embarking on a liability management transaction usually pursue a combination of commercial objectives, while at the same time seeking the best possible documentary, legal, regulatory, accounting, and tax treatment of the commercial result that they desire to accomplish. A careful analysis of the reasons for a particular restructuring, the commercial objectives, and the other transactions that are involved in the restructuring must be undertaken to determine which particular liability management technique is the most suitable in a given situation. For example, an issuer that is able to meet its payment obligations under existing debt securities but needs permanent or temporary relief from the effects of existing maintenance or incurrence covenants will simply need to solicit the consents of the holders of the relevant securities to waivers of or amendments to the relevant restrictive covenants without seeking to change the economic terms of the relevant securities.

© in this web service Cambridge University Press www.cambridge.org

Cambridge

Cambridge University Press
978-1-107-02034-4 - Law and Practice of Liability Management: Debt Tender Offers, Exchange Offers, Bond Buybacks and Consent Solicitations in International Capital Markets
Apostolos Ath. Gkoutzinis
Excerpt
More information

1.2 Differences between debt securities and equity securities

Securities issued by corporate or sovereign issuers and traded in capital markets are either *equity* (or *equity-linked*) securities or *debt* securities.

Equity securities such as stocks, shares, partnership or participation interests, investment contracts, and other similar securities are securities representing an initial equity contribution into the issuer of the relevant security and a set of voting and economic rights stemming from that contribution, as more specifically prescribed in the relevant corporate law of the jurisdiction of incorporation or organization of the issuer of the security and its charter or articles of association or similar constitutional document of the issuer.[1]

The *economic rights* represent the residual economic interest in the issuer of such security, i.e., the claim to the assets left after all other claimants (including financial and trade creditors, employees, and the government) have been satisfied in full. The *voting rights* allow the holders of the equity securities to exercise control over the issuer of those securities through the election of the board of directors of the issuer (or similar governing body) and their power to block or determine the outcome of certain significant economic or organizational events in the life of the issuer.

Debt securities such as bonds, notes, debentures, commercial paper, and other types of debt securities represent the simplest form of legal obligation, i.e., an obligation to pay an amount of money sometime in the future. They are financial liabilities on the issuer's balance sheet without any voting rights or any economic rights in the profits and losses of the issuer (other than the contractual right to receive payment of a fixed or determinable sum of money as more specifically determined by and/or in accordance with the terms and conditions of the relevant security). Long-term debt securities represent the commitment of capital to an issuer for a relatively long period of time (five years or more), whereas short-term debt securities represent the commitment of capital for a short period of time (between ninety days and five years).

The difference between liability management transactions for debt securities (e.g., tender offers, privately negotiated or public repurchases, exchange offers, redemptions, or consent solicitations) and similar transactions in the issuer's equity securities is significant.

[1] For an excellent discussion of the attributes of equity securities and its differences from debt securities, see William A. Klein and John C. Coffee, Jr, *Business Organization and Finance, Legal and Economic Principles*, 9th edn (Foundation Press: New York, 2005), ch. 4.

© in this web service Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
978-1-107-02034-4 - Law and Practice of Liability Management: Debt Tender Offers, Exchange Offers, Bond Buybacks and Consent Solicitations in International Capital Markets
Apostolos Ath. Gkoutzinis
Excerpt
More information

Tender offers or purchases of equity securities (in the open market or in privately negotiated transactions) aim to transfer corporate control from the existing holders of the equity securities to the buyer or, in the case of purchases of shares in the issuer by the issuer itself, to return equity capital back to the issuer's shareholders. Tender offers or purchases of debt securities aim to manage the financial liabilities of the issuer to achieve one of the restructuring objectives set forth above but do not affect, or aim to affect, the exercise of voting and investment control in the issuer by the holders of the equity securities of the issuer. This fundamental difference between certain types of liability management transactions in debt securities, compared to similar transactions in equity securities, has profound effects on the legal and regulatory framework governing liability management transactions relating to debt securities.

1.3 Types of transactions in debt securities

1.3.1 Sales and purchases of debt securities in secondary markets

Following the initial offer, issuance, and sale of debt securities to investors (a *primary sale*), which results in cash proceeds to the issuer of the relevant securities in consideration for the issuance of the securities to the relevant investors, debt securities are sold and purchased among investors in the secondary markets (a *secondary sale*) like any other asset is bought and sold in any other market. Sales of debt securities by the holders of the securities to other investors or back to the issuer do not generate any proceeds for the issuer.

Sales, purchases, and other transactions in equity and debt securities are conducted on securities exchanges and other organizations that maintain or provide a marketplace or facilities for bringing together purchasers and sellers of securities. They are also conducted in the over-the-counter markets in large volumes by the public generally (including retail investors and sophisticated institutional and professional investors). The prices established and offered in such secondary transactions are generally disseminated and quoted publicly, and constitute the basis for determining and establishing the prices at which securities are bought and sold between investors and other market participants.[2] As the history of finance amply demonstrates, the prices of securities, and the volumes of securities

[2] See generally Section 2 of the Securities Exchange Act of 1934, as amended (the "Securities Exchange Act").

© in this web service Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
978-1-107-02034-4 - Law and Practice of Liability Management: Debt Tender Offers, Exchange Offers, Bond Buybacks and Consent Solicitations in International Capital Markets
Apostolos Ath. Gkoutzinis
Excerpt
More information

offered for sale or sold, are susceptible to manipulation and control, and the dissemination of prices and other relevant information often triggers excessive speculation, resulting in market distortions, unreasonable fluctuations in the prices of securities, and outright fraud.[3]

Most secondary transactions in securities are sales or purchases of securities between a willing buyer and a willing seller in the secondary market. Securities transactions in the secondary market include any offer or sale of any security by any holder thereof (other than the issuer) to any other person (including the issuer of such security or an affiliate of the issuer). The number and value of transactions in securities in the secondary market easily dwarfs the number and value of securities issued by issuers and offered to buyers in primary capital-raising transactions. The concept of a secondary transaction therefore encompasses a wide range of transactions, from isolated trades by a particular investor on a securities exchange to an underwritten offering by affiliates of the issuer of the security.

Secondary transactions also include trades in the relevant securities in the secondary market by the issuer of those securities or an affiliate of the issuer. They also include tender offers for issued securities by the issuer of the securities (or an affiliate of the issuer) or an unaffiliated third party, or repurchases of the issued securities in the open market by the issuer of those securities or an affiliate of the issuer.

1.3.2 Purchases of debt securities for cash

A purchase of debt securities for cash is a very simple capital markets transaction: a person purchases a debt security for cash from an existing holder of the subject security. The purchaser of the subject securities could be the issuer of the securities (or an affiliate of the issuer) or a non-affiliated third party that purchases the subject securities for investment purposes.

An issuer of debt securities (or an affiliate of the issuer) may repurchase the outstanding debt securities for cash either (i) through the redemption of the subject securities in accordance with their terms, or (ii) in a privately negotiated transaction with a willing seller in the secondary capital market, in a public tender offer, or in one or more transactions in the open market.

[3] This is, for example, the rationale for the introduction of federal regulation of securities markets in the United States as set forth in Section 2 of the Securities Exchange Act.

© in this web service Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
978-1-107-02034-4 - Law and Practice of Liability Management: Debt Tender Offers, Exchange Offers, Bond Buybacks and Consent Solicitations in International Capital Markets
Apostolos Ath. Gkoutzinis
Excerpt
More information

Issuers of debt securities repurchase or redeem their debt securities to change the composition of their debt liabilities on the balance sheet. An issuer whose outstanding debt securities are trading in the securities markets at prices below the principal amount of the relevant securities due on the date of maturity may desire to purchase those securities at such discounted prices to reduce the overall debt burden of the issuer. Redemptions and repurchases of debt securities are also effective methods of reducing the overall cost of the debt capital of the relevant issuer. For example, if interest rates on debt instruments fall and bond prices rise, the option to redeem or repurchase outstanding debt securities can be very appealing as the issuer, through the repurchase or the redemption, will retire a debt obligation with a low price and a high interest rate and replace it with a debt obligation issued at a higher price and a lower interest rate. Moreover, the rationale for the repurchase or redemption of the outstanding debt securities may also be the change of the maturity profile of the issuer's outstanding debt (for example, by financing a repurchase of short-term debt securities with the issuance of long-term debt securities or long-term bank borrowings). Sometimes, the motivation behind the repurchase or redemption is the need to change the currency or interest rate profile of the issuer's outstanding debt obligations.

2 Redemptions of debt securities in accordance with their terms

In the absence of special provisions in the documentation, holders of debt securities cannot be compelled to accept payment of the principal amount prior to the stated maturity date of the relevant debt security. Nevertheless, an issuer of debt securities may be able to *redeem* early (i.e., prior to the stated maturity date) the outstanding debt securities, in whole or in part, in accordance with their terms (assuming that the right of redemption is expressly granted to the issuer pursuant to the terms and conditions of the securities).[4] The issuer's *right of redemption* is exercised by the issuer by notice to the holders of the subject securities and, if applicable, the intermediary (the *trustee*) that may hold the subject securities in trust for the benefit of the bondholders.[5]

[4] Some types of securities (including securities with short-term maturities or zero-coupon securities) provide full call protection to maturity and are not redeemable at the option of the issuer.

[5] *Optional redemption* (i.e., redemption of the securities at the option of the issuer) leads to the extinguishment of the liabilities represented by the securities to be redeemed and, consequently, it is one of the options for managing financial liabilities. Optional redemption

© in this web service Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
978-1-107-02034-4 - Law and Practice of Liability Management: Debt Tender Offers, Exchange Offers, Bond Buybacks and Consent Solicitations in International Capital Markets
Apostolos Ath. Gkoutzinis
Excerpt
More information

From the perspective of the issuer of the debt securities, the right of redemption may be significant for a number of reasons: business developments may require modifications of the terms of the debt securities that will be unacceptable to the holders of the debt securities, and redemption of the debt securities may be the only viable alternative. Redemption may also be necessary for the completion of a merger, acquisition, or business combination; or a high interest rate debt security may become unduly burdensome and redemption may be the only viable alternative for the financial profile of the issuer.

If less than the whole principal amount of the debt securities is to be redeemed, the amount redeemed must usually be a multiple of the smallest denomination of the debt securities, which varies from as little as $1,000 to $200,000 or the equivalent in euros, sterling, or other international currencies (in debt securities that are designed to be exempt from the prospectus requirements of the Prospectus Directive).[6] Sometimes, the documentation will provide that any partial redemption must be of a prescribed minimum amount (especially in issues of debt securities held by a small number of sophisticated institutions).

The issuer may elect to exercise the right of redemption for the whole or a part of the outstanding principal amount of the subject securities. Payment of the redemption price (i.e., the price at which the issuer redeems the subject securities) is made on the date of redemption, usually between thirty and sixty days after notice of redemption is delivered to the holders

should be distinguished from *mandatory redemption*, which is the mandatory repayment of the relevant securities by the issuer (i.e., the acceleration of the stated maturity of the securities) upon the occurrence of certain events set forth in the relevant terms and conditions. Mandatory redemption is not a liability management transaction and will not be considered further. Optional redemption at the discretion of the issuer should also be distinguished from the repurchase of the debt securities by the issuer *at the option of the holders*. For example, indentures for corporate debt securities often specify that upon the occurrence of certain events (e.g., a change of control or a sale of assets), the issuer is obligated to make an offer to the holders to repurchase any principal amount of debt securities that the holders wish to "put back" to the issuer at their option. This type of repurchase is an option, not an obligation, of the holders and aims to protect holders from fundamental changes in the creditworthiness of the issuer. Any such offer made by the issuer can be rejected by the holders, in which case no further obligation arises. The triggering event causes a mandatory offer as far as the issuer is concerned and an optional tender of the securities to the issuer as far as the holders are concerned. It is not an optional or voluntary transaction of the issuer and cannot be used for liability management purposes.

[6] EU Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading as amended or supplemented (including by Directive 2010/73/EU) (the "Prospectus Directive"), OJ L 345, 31.12.2003, p. 64.

© in this web service Cambridge University Press www.cambridge.org

Cambridge

Cambridge University Press
978-1-107-02034-4 - Law and Practice of Liability Management: Debt Tender Offers, Exchange Offers, Bond Buybacks and Consent Solicitations in International Capital Markets
Apostolos Ath. Gkoutzinis
Excerpt
More information

and, if applicable, to the trustee, the fiscal agent, the paying agent, or such other financial intermediary that performs similar functions. As a contractual matter, the terms of the subject securities provide that, once the notice of redemption is mailed or published, all outstanding debt securities called by the issuer for redemption become due and payable on the date of redemption at the redemption price. Thus, the legal effect of the exercise of the right of redemption is the acceleration of the repayment of the redeemed subject securities on the redemption date; therefore, earlier than the initially contracted maturity date. Upon the payment of the redemption amount on the redemption date, the legal obligations represented by the securities to be redeemed are extinguished.

There are many different variations on the right of the issuer to redeem its outstanding debt securities. The terms of the subject securities may provide that the debt securities are not redeemable during an agreed initial period of time or at all. If the terms of the subject securities establish a right of redemption, they may provide that the right of redemption may be exercised only if the entire outstanding amount of debt securities is called for redemption; alternatively, they may provide for the right to redeem the subject securities in part without limitation or in part but subject to the condition that a partial redemption may only be exercised for an agreed minimum outstanding principal amount.

There is also a great variation on contractual terms calculating the redemption price of redeemable debt securities. The redemption price typically will reflect the expected yield to maturity on the redemption date if the objective is that bondholders will be made "whole." In that instance, the redemption price will be equal to the nominal principal amount of the subject securities, plus the present value of future interest payments, thus leading to the payment of a premium to bondholders over the nominal principal amount of the subject securities. It is common to start with a redemption premium equal to the initial issue price of the debt securities plus an amount equal to the annual interest rate on the securities, which then declines in each year in patterned steps to zero at some agreed date. In most cases, the premium is scaled down to zero one year before the stated maturity date; in other cases it could be set to zero two or even five years before maturity. One reason for allowing some time to redeem without premium is to give the issuer an opportunity to refund the remaining principal amount of the issue in better market conditions. Under some indentures, a permitted redemption may be made on any date

© in this web service Cambridge University Press www.cambridge.org