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Exchange Offers Can Address Maturing Bond Debt

By Eric Goodison
Paul, Weiss, Rifkind, Wharton & Garrison LLP

One of the hallmarks of the debt capital markets in recent years has been that a bond issuer could assume it would not have to repay its maturing debt out of corporate cash flow or asset sales.

The debt markets would allow the issuer to continually refinance maturing debt with new debt. Often, that refinancing could be done on more favorable covenant and economic terms for the issuer.

But the global collapse of the credit markets during the past year has eliminated the refinancing option for most issuers. Credit markets, for all but the most credit-worthy entities, remain virtually frozen and issuers with maturing debt face the looming prospect of default.

Indeed, issuers may not be the only parties for whom a default is not an economically attractive outcome. Though bondholders want to be paid at par in cash at maturity, they may also want to avoid a maturity default. Reasons for this include avoiding the costs imposed on the issuer, avoiding the risk of value destruction as a consequence of such default and avoiding the delay that a bankruptcy can involve with an uncertain outcome.

With insufficient corporate cash to repay maturing debt — and few, if any, opportunities to issue new debt — many issuers are looking at exchange offers to capture some of the discount at which their debt might be traded or quoted.

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Bondholders will only agree to an exchange offer if they believe it will yield a better result for them than the alternative, which could include bankruptcy.

Accordingly, with insufficient corporate cash to repay maturing debt and few, if any, opportunities to issue new debt, many issuers are looking at exchange offers as a way to address maturity issues. Issuers are also looking at exchange offers as a way to potentially capture some of the discount at which their debt might be trading or quoted.

Successful Offers

An exchange offer will only be successful if it is agreed to by enough of the issuer's bondholders. Bondholders will only agree to an exchange offer if they believe it will yield a better result for them than the alternative, which could include bankruptcy. The ability of any issuer to complete a successful exchange offer will depend on the unique facts and circumstances of that issuer.

They include: its capital structure; the specific terms of all of its debt documents (not just the agreements governing the debt to be exchanged); its projected performance and the ability to comply with the terms of the exchanged debt; and its other outstanding debt and the nature and mix of its bondholders.

The rationale to accept an exchange offer is that the bondholder would be better off accepting the offer than turning it down. It is important that the exchange include attractive terms, however, because bondholders cannot be compelled to accept. There are numerous elements of an exchange offer (both in the form of inducements and in the form of coercion) that can lead a bondholder to believe accepting the offer is a better option.

Elements that improve a bondholder's position include: increased economics in the form of additional interest (in cash or in payment in kind or a combination of both), including a cash payment element (even at a discount to par, but above the current trading level) to the exchange; adding or increasing collateral; and improving the seniority of previously subordinated debt or nonguaranteed debt. An element that can be seen as coercive is including a consent to remove covenants of the old bonds as part of the exchange.

Successfully removing covenants presents a nonconsenting holder with the choice of accepting the offer or continuing to hold the original bonds at the original face amount and maturity and with the original interest rate but without most of the original covenant protection including restrictions on incurring additional indebtedness, granting liens, selling assets and paying dividends.

An issuer considering using any of the foregoing elements must carefully review both the terms of the debt to be exchanged and its other debt documents.

Refinancing Limits

Most debt documentation allows other issuer debt to be refinanced, but may impose limits on the terms of that refinancing. Those limits can include: restrictions on voluntary cash prepayments, granting liens, adding new guarantors or improving the seniority of subordinated debt.

If any of the issuer's other debt includes any of these restrictions it may rule out using one or more of these elements without getting the consent of those other debt holders, which can be a very costly and time-consuming process.

If the bonds to be exchanged are subordinated or unsecured and there is either secured or senior debt elsewhere in the capital structure of the issuer, it is much less likely, although not impossible, that there will be an ability to improve the security or ranking of subordinated bonds to be exchanged.

An exception to this rule is if the issuer was once investment grade. Covenant protection in a formerly investment grade issuer's other debt may not limit the incurrence of additional debt or may allow for a meaningful amount of liens to be granted.

Additionally, an issuer's other debt may limit the interest rate an issuer is permitted to pay to refinance its maturing debt. If there is a limit on the interest rate the issuer is permitted to pay it can severely limit the inducements an issuer has to offer to exchanging bondholders.

Even if there is no limit on the new interest rate, any meaningful increase in interest can make it more difficult for an issuer to meet an interest coverage or fixed charge coverage test contained in any applicable indebtedness.

Continued ability to meet the terms and requirements of its remaining debt and exchanged debt may also impact the ability of an issuer to successfully complete an exchange offer.

On the other hand, if the debt to be exchanged is subordinated or unsecured and the issuer is able to offer secured or senior debt, the bondholders may be inclined to accept, even if they are uncertain of the long-term viability of the issuer.

The exchanging bondholders may view their improved priority position or security as worth having, even if the principal of the new bonds is less than the par of the original debt and even if the issuer is likely to go bankrupt or otherwise engage in a liquidation.

To design and implement a successful exchange offer, an issuer needs to consider the nature and goals of its bondholders.

There are numerous legal and logistical hurdles involved in an exchange offer. There are also tax and accounting issues for the issuer that need to be considered and evaluated.

Obstacles to Consider

Because of the timeframe in which issuers desire to complete an exchange offer (generally there is a minimum offer period of 20 business days), exchange offers are typically done as private placements to certain eligible investors rather than as registered public offerings to all holders.

For most issuers this is not a significant issue because most holders of their bonds are large, sophisticated investors that are eligible to participate in a private exchange offer.

But some issuers, especially well-known consumer retailers, may have individuals as bondholders that are not eligible to participate in a private exchange offer. This will make completing an exchange offer more difficult, as the issuer will need a higher percentage of the eligible bondholders to participate.

It will be incumbent on an issuer considering an exchange offer to identify and understand the composition of its bondholders. This is not as simple as it may sound.

Bonds are customarily issued in book-entry form. In the issuer's records for a book-entry bond there is generally only one holder that acts as custodian for the book-entry system. There are services an issuer can engage that try to identify individual beneficial holders of bonds.

Another technique available to an issuer is to request that the custodian for the book-entry system send a notice to the holders asking that those eligible to participate in a private exchange voluntarily identify themselves so the issuer can send them the exchange offer.

Not all eligible bondholders may choose to identify themselves to the issuer in this fashion. One concern may be that they will receive material nonpublic information from the issuer, which would prevent the bondholder from trading in the issuer's securities until either the information is made public by the issuer or becomes nonmaterial, which can be a significant period of time.

A bondholder may choose not to receive information so as not to be restricted. To overcome this concern, an issuer may need to give assurances (often in the form of a written agreement) that it will "unrestrict" bondholders by disclosing any material information publicly. Alternatively, a bondholder can choose to have the offer sent to all beneficial holders of its bonds, while at the same time disclosing publicly any material nonpublic information in the offer and limiting the offer to only eligible participants.

Beyond identifying eligible holders, an issuer needs to understand the objectives of its various bondholders. While an issuer might assume that bondholders would be happy to receive new instruments that are worth more than their current bonds, that might not always be the case.

Bondholders may not agree with the issuer on the value of the securities being proposed in an offer. There may be bondholders that have invested with a view to acquiring an ownership stake or control of the issuer through a workout of the issuer's debt. Those bondholders may prefer to see an exchange offer fail and a default occur sooner rather than later.

There are numerous legal and logistical hurdles involved in an exchange offer. There are also tax and accounting issues for the issuer that need to be considered and evaluated.

Lastly, the use of derivatives and other hedging strategies by a bondholder may lead a bondholder to prefer a default, as the loss on their bonds may be more than offset by the gain on their hedge.

One example would be a bondholder that bought credit-default protection on the bonds it owns. If a default were to occur that led to a credit event under the swap, the bondholder could expect to receive payment for its bonds from its counterparty in 30 days, which, in all likelihood, would be faster than payment from the issuer and could lead to a higher recovery.

Eric Goodison *(egoodison@paulweiss.com) is a partner in the Corporate Department and a member of the Finance Group at law firm Paul, Weiss, Rifkind, Wharton & Garrison LLP in New York.*