The GMAC and ResCap Exchange Offers: Lessons in Love and Fear

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On November 20, 2008 GMAC LLC announced that it had submitted an application to the U.S. Federal Reserve Board of Governors to become a bank holding company under the Bank Holding Company Act of 1956, as amended, 12 U.S.C. § 1841 *et seq*. In connection with that application, GMAC also applied to the U.S. Treasury to participate in the Capital Purchase Program under the Emergency Economic Stabilization Act of 2008, Pub.L. 110-343, conditioned on GMAC becoming a bank holding company.

GMAC is a global finance company originally established to provide General Motors dealerships and their customers with vehicle financing. GMAC expanded its business to offer residential mortgages (through its subsidiary, Residential Capital LLC (ResCap)) and insurance products. On November 30, 2006 General Motors sold a 51 percent controlling interest in GMAC to a consortium of investors led by Cerberus Capital Management, L.P. As a result of the economic crisis that fully manifested itself during the third and fourth quarters of 2008, GMAC experienced significant losses in its auto loan and mortgage businesses. GMAC had effectively become a financing business without access to the capital markets.

In an effort to modify its capital structure to qualify as a bank holding company, simultaneously with its November 20 announcement, GMAC commenced exchange offers with respect to approximately $28.5 billion of its unsecured bonds and approximately $9.4 billion of outstanding unsecured bonds of ResCap. The holders of the various series of GMAC bonds were offered a choice of a limited amount of cash or a package of new GMAC bonds (with a principal amount that reflected a discount to the original principal amount of the old GMAC bonds) and new preferred stock. The holders of the various series of ResCap bonds were offered cash (for certain series) or new GMAC bonds at a discount to the original principal amount of the ResCap bonds.

Under the terms of the exchange offers as originally proposed by GMAC, the new bonds to be issued by GMAC would be guaranteed by certain subsidiaries of GMAC, but the new bonds to be issued by ResCap would not be guaranteed. The exchange offers were initially scheduled to expire on December 18, 2008, with an “early tender” deadline of December 4, 2008. According to various statements by GMAC and its representatives, in order to ensure that GMAC would meet the requirements to qualify as a bank holding company, approximately 75 percent of the GMAC and ResCap bondholders would need to tender. Nevertheless, on December 4, 2008, only 22 percent of the GMAC bonds and only 21 percent of the ResCap bonds had been tendered.

“Neither Loved nor Feared”

There appear to be a number of reasons why the GMAC bondholders did not agree to the initial exchange offer. Fundamentally, the GMAC exchange offer was “neither loved nor feared.” The “carrots” were insufficient to motivate bondholders to tender into the offer, and the “sticks” were insufficient to make holding out unbearable.

First, although the exchange offer was ostensibly being made in order to allow GMAC to qualify as a bank holding company, the original exchange offer was not expressly conditioned on such qualification. As a result, bondholders were effectively being asked to give up a portion of their debt claims without any certainty that the ultimate goal of bank holding company qualification would be achieved, and the uncertainty created a strong disincentive to tendering.

Second, as originally contemplated, the guarantee for the new GMAC bonds to be issued did not provide sufficient protection for the holders of the new bonds, particularly compared to any old GMAC bonds that were not tendered. The original guarantee appears to have been designed to threaten holdouts with the structural priority of the new bonds, but GMAC bondholders were not convinced. Although the original guarantee contained a provision requiring any subsidiary guaranteeing or pledging its assets to secure any additional bonds exchanged for the old bonds be required to equally and ratably guarantee or secure the new GMAC bonds, that provision was viewed as inadequate. The provision was found to be too easy to circumvent, as a subsidiary could simply guarantee or secure the old bonds without an exchange offer. Furthermore, there was nothing to stop GMAC from transferring assets out of the guarantor group. The failure to include provisions addressing such concerns in the original offer simultaneously diluted the threat posed to holdouts by the structural priority of the new bonds and made the new bonds less attractive to the bondholders.

Third, the original offer did not contain any safeguards against GMAC guaranteeing or securing the debt of ResCap. Bondholders apparently did not wish to commingle the credit of ResCap with the guarantor group being constituted for the benefit of the new GMAC bonds. Somewhat ironically, it seems that ResCap had been created in order to insulate the growing residential mortgage business from the traditional automobile financing business.

Fourth, the terms of the originally offered preferred stock were deemed insufficient. The dividend rate was considered to be too low, and the priority and restricted payments provisions were not strong enough to cause bondholders to place much value on the instrument.

Fifth, bondholders perceived that the GMAC equityholders were not being asked to contribute sufficient additional capital to support GMAC's application to become a bank holding company to succeed.

Finally, despite repeated portents of impending bankruptcy and dire consequences for bondholders by GMAC and its dealer-managers, some bondholders appeared not to have given full credence to those statements. Fundamentally, those bondholders seem to have viewed GMAC as being inherently valuable, and they reasoned that the equityholders of the company (which included General Motors itself) would not allow GMAC to go into bankruptcy because of an unwillingness to grant protective covenants and certain economic concessions.

Modifications

Following rejection of the original exchange offer by bondholders, even after a three-day extension of the early tender period, GMAC finally began to negotiate with the bondholder group during the week of December 8.

GMAC is an unusual company for purposes of debt covenant design because it is a finance company, and its subsidiaries borrow money from third parties and secure those borrowings in the ordinary course of business. Furthermore, GMAC and its subsidiaries often need to transfer or otherwise monetize assets among subsidiaries in the ordinary course of business, including through securitization or other complex financing structures, to finance the loans they make. While a "high-yield" covenant package might have addressed most of the concerns bondholders had with the original exchange offer, a standard "high-yield" covenant package would not have enabled GMAC to run its business without very detailed and carefully crafted exceptions that would have required extensive due diligence and explanation by GMAC. In addition, because of the nature of GMAC's business, the guarantee could only come from certain first-tier subsidiaries, as GMAC claimed that most of the various finance subsidiaries and special purpose entities could not be guarantors of the new bonds.

After several days of intense negotiations, on December 12, 2008, GMAC reached an agreement with representatives of the unofficial bondholder committee and amended the terms of the exchange offer (extending the early tender deadline to December 16, 2008 and the expiration date to December 26, 2008).

To address the uncertainty regarding qualification for bank holding company status, GMAC added a condition precedent to the exchange offer that required GMAC to qualify as a bank holding company not later than the time of closing of the exchange offer.

To strengthen the guarantee, GMAC inserted some additional restrictive covenants, including

- A covenant requiring GMAC to equally and ratably secure the new bonds if liens on assets of the guarantors or their subsidiaries are incurred to secure debt of GMAC or debt incurred to exchange or refinance debt of GMAC;
- A covenant requiring any subsidiary of GMAC (other than a guarantor of the new bonds) to guarantee the new bonds if it guarantees any debt of GMAC or debt incurred to exchange or refinance debt of GMAC;
- A limitation on asset sales by guarantors and their subsidiaries; and
- A standard "high-yield" style limitation on transactions with affiliates by the guarantors and their subsidiaries.

The covenants contained a number of tailored carve-outs to permit GMAC to perform various financing activities and asset dispositions in the ordinary course of its business.

To address concerns regarding entanglement with ResCap, GMAC inserted a covenant prohibiting the guarantors and their subsidiaries from either incurring liens to secure debt of ResCap or its subsidiaries or guaranteeing the debt of ResCap or its subsidiaries.

In response to bondholder issues relating to the new preferred stock, GMAC increased the dividend rate on the new preferred stock from 5 percent to 9 percent per annum (decreasing to 7 percent after the raising of additional Tier I capital) and added explicit statements to the effect that the new preferred stock would rank senior to any new equity securities to be issued to the current equityholders and would rank no worse than pari passu with any preferred stock to be issued to the U.S. Treasury under the Troubled Assets Relief Program. A restricted payments covenant was also added, prohibiting all dividends and payments on junior stock for the first five years after the exchange date and limiting such dividends and payments thereafter to 25 percent of cumulative consolidated net income (excluding cancellation of debt income).

To address the request for more contributions from the equityholders, GM and Cerberus agreed to convert $750 million of subordinated loans to ResCap into equity.

GMAC agreed to amend the terms of the guarantee and the preferred stock and to make the exchange offer conditioned on GMAC becoming a bank holding company.

Results

Eventually, approximately 59 percent of the GMAC bonds were tendered and 39 percent of the ResCap bonds were tendered, far short of the stated goal of 75 percent participation. Nevertheless, the Board of Governors of the Federal Reserve approved GMAC's application to become a bank holding company on December 24, and the amended exchange offers closed on December 31.

To a certain extent, the shortfall in participation may have been caused by a large portion of the bonds being held by retail holders. In order to complete the exchange offers in the desired timeframe, GMAC chose to make the offers only to qualified institutional buyers and non-U.S. persons, making participation by retail holders impossible. In addition, because a significant amount of the bonds were very long-term and originally investment-grade when issued, the funds or other vehicles that held those bonds may not have been attentive to the exchange offers.

While a substantial portion of bondholders believed the modified guarantees and other exchange offer consideration to be more valuable than the original consideration offered, it seems that even with the various amendments and modifications, certain GMAC bondholders did not believe that the modified guarantees and other exchange offer consideration were sufficiently valuable to cause them to tender their bonds. It is possible that those bondholders believed that the importance of the auto industry to the U.S. economy made a collapse and bankruptcy of GMAC less likely. Based on the rough equivalence in the trading price of non-tendered GMAC bonds compared to the aggregate trading prices of the exchange offer consideration during the months following the exchange offer, it appears that only time will tell which bondholders were correct in this regard.

The ResCap exchange offer also showed the marked effect that credit default swaps (CDS) could have on bondholder behavior. A significant number of bondholders also were protection buyers under CDS, which gave them a strong disincentive to tender. First, the relevant provisions of the 2003 ISDA Credit Derivatives Definitions applicable to these CDS provide that a debt exchange such as the exchange of GMAC bonds for ResCap bonds would not result in a “Succession Event” and a change in “Reference Entity” from ResCap to GMAC absent a merger, consolidation, transfer of assets or similar event. As a result, bondholders who tendered their ResCap bonds and received GMAC bonds in exchange would not be able to deliver the new GMAC bonds in settlement of their CDS should the CDS subsequently be triggered. Furthermore, tendering ResCap bonds in support of the debt exchange would negatively affect the value of the purchased credit protection, to the extent ResCap bondholders who held short positions on ResCap under CDS viewed the exchange and GMAC’s qualification as a bank holding company as an improvement to ResCap’s and GMAC’s financial condition. GMAC proposed to create a Succession Event and a change in Reference Entity through the transfer of ResCap’s interest in GMAC Bank to GMAC in exchange for the tendered old ResCap bonds, but it appears that a significant number of bondholders were not persuaded to tender by the proposal.

Conclusions

A number of conclusions can be drawn from the process and results of the GMAC exchange offers. First, in order for an exchange offer to be successful, there must be sufficient incentives to tender and sufficient disincentives to holdouts. Because of the increasing sophistication of bondholders and their counsel, to the extent additional provisions or safeguards are offered to bondholders who tender, the additional provisions and safeguards must be real and not easily circumvented. Second, to the extent an issuer is required to complete an exchange offer under a deadline, because bondholders will now often organize well prior to the announcement of an exchange offer, issuers should consider engaging the bondholder group earlier in the process to avoid having to make significant additional concessions because of time pressure. Third, there are times when the threat of bankruptcy is not a sufficient disincentive to bondholders who wish to hold out, particularly where incentives might be affected by events or circumstances that are external to the issuer. Fourth, issuers who require broad participation in an exchange offer and who have a large number of retail bondholders should consider making an exchange offer that is registered under the Securities Act of 1933 (and allocating sufficient time for SEC review). Finally, issuers should attempt to gauge the extent to which bondholders have bought credit protection with respect to the securities to be tendered and should consider whether the existence of CDS will affect bondholder behavior in a significant way.

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