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Introduction to Debt Exchange Offers

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Issuers have a variety of tools when dealing with upcoming debt maturities, including using a combination of exchange offers, tender offers, and/or new money issuances and redemptions. As capital structures become more complex, White & Case increasingly advise on transactions utilizing a number of these components simultaneously. This article provides a guide to the options when implementing an exchange offer as well as some of the more recent developments in this area.

Debt Exchange Offers

Debt-for-debt exchange offers are a liability management tool offering issuers a way to capitalize on currently favorable high yield market conditions to refinance existing indebtedness and/or extend maturities. So what is an exchange offer, and why would you consider one?

What is a debt exchange offer?

A debt exchange offer is really at its heart a tender offer, in which the issuer or a third party offers new securities (or sometimes a combination of new securities and cash) to holders of existing debt securities. Among other possible objectives, an exchange offer can be used to extend maturities, reduce coupon payments and, in combination with an exit consent, effectively modify covenants. An exchange offer can also allow an issuer to achieve its liability management objectives with relatively little cash outlay. However, unlike a cash tender offer, an exchange offer includes an offering of new securities, which requires the preparation of an offering memorandum and issue documentation and involves all of the associated securities law issues.

An exchange offer commonly involves an exchange of new for existing debt securities based on the ratio the offered price for the existing security divided by the price for the new security. If the offer will be made to US holders, the prices for the new and existing securities must be determined at the commencement of the offer period. Amounts needed to round down to the nearest denomination of the new securities and accrued interest can be paid in cash. Exchange offers can be subject to conditions as to the minimum acceptance from holders of the existing securities, as well as minimum new issue size, to ensure that there will be sufficient liquidity in the new security and possibly to ensure compliance with criteria for index inclusion. Exchange offers can also be subject to a maximum amount the offeror wishes to exchange, in which case scaling may be required if the amount of securities tendered exceeds the maximum.

As with any such transaction, consideration must be given to the terms of the existing securities which are the subject of the offer, as well as covenants in the issuer’s other financing agreements which may restrict its ability to undertake an exchange offer.

Offer Structures

Where an exchange offer is made to US holders, because the price for the securities must be determined at the commencement of the offer period, there may be significant exposure to market risk. It is possible to mitigate this risk to some extent through careful structuring. A transaction structured as a tender offer combined with a new issue can have a similar effect to an exchange offer, however, the new securities being issued do not need to be priced until the middle of the tender period, thus giving time and momentum to the offer process so that the best price for the issuer can be determined. Two commonly used structures that offer this flexibility are tender offers with priority allocation rights and intermediated exchange offers.

Traditional Exchange Offer

If an exchange offer is being made to US holders, subject to certain exceptions, the offer must remain open for no less than 20 business days. It must also remain open for 10 business days after any change in the compensation to be paid or the percentage of the existing securities sought in the offer. This relatively extended timeframe, combined with the requirement for pricing at the outset of the transaction, are the main reason exchange offers are typically viewed as being subject to market risk. However, features such as an early tender payment (often called an "early bird"), early settlement and pro-ration factors can be used to try to ensure that the offeror will have a high degree of certainty as to the outcome of the transaction following the 10th business day after the commencement of the offer.

Abbreviated Exchange Offer

Subject to certain conditions, an exchange offer may be able to be structured to take advantage of an abbreviated five day offer period as described in an SEC no-action letter from January 2015[1] (the "2015 no-action letter"). The conditions include that (i) the offer must be for any and all of a series of non-convertible debt securities (ii) the offer must be made by the issuer, a wholly-owned subsidiary or a parent company, (iii) in the case of an exchange offer, the consideration must be non-convertible debt securities identical in all material respects to the securities that are the subject of the tender offer except for the maturity date, interest payment and record dates, redemption provisions and interest rate (which must be payable only in cash), and have a longer weighted average life to maturity. Under the terms of the 2015 no-action letter, an abbreviated tender offer cannot be made in a transaction combined with a consent solicitation (exit consent) or in response to, or concurrently with, a change of control or other type of extraordinary transaction involving the issuer. It also cannot be made where the issuer is in default. These considerations in particular can limit the potential usefulness of the 2015 no-action letter for exchange offers.

Tender with Priority Allocation

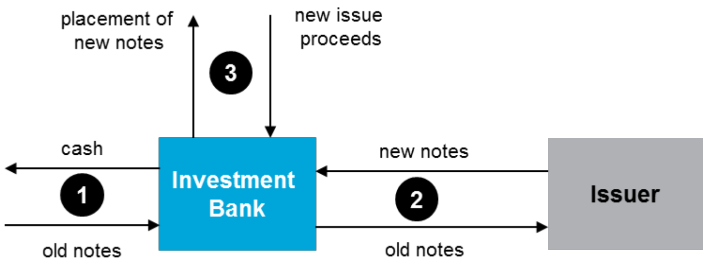
A tender offer with priority allocation rights comprises a separate (but concurrent) tender offer (usually, but not always by the issuer) and issue of new securities. Holders of the existing securities subject to the tender offer are provided the option to request priority in the allocation of the new securities. Priority allocation serves two key purposes: (i) it provides holders of the existing securities an increased degree of assurance that they can maintain their credit exposure to the issuer (though priority allocation can be subject to scaling, particularly where the new issue size will be smaller than the existing issue) and (ii) it provides the issuer a means to trace holders of the existing securities who tender and acquire securities in the new issue, which may allow the issuer to apply certain favorable accounting treatment in respect of those holders, who have effectively exchanged. The tender with priority allocation structure can be preferable to a traditional exchange offer from the perspective of existing holders because it can offer them the option of switching into the new securities, or simply tendering. As there is usually a marketing and bookbuilding process, it may also allow the issuer to optimize pricing on the new issue with a combination of existing holders exchanging into the new securities and new investors.

[1] Pursuant to the SEC's no-action letter dated January 23, 2015 (https://www.sec.gov/divisions/corpfin/cf-noaction/2015/abbreviated-offers-debt-securities012315-sec14.pdf). It is important to note that the no-action letter does not have the force of law, but is commonly understood to provide guidance as to the view the SEC would take in respect of enforcement actions.

Intermediated Exchange Offer

An intermediated exchange offer also comprises a concurrent tender offer and issue of new securities, however, in this case, one of the investment banks acting as dealer manager for the tender offer and as initial purchaser for the issue of the new securities will act as offeror and make the tender offer.

At the same time as the tender offer, the issuer undertakes a marketing process for the issue of the new securities. Shortly after the tender offer expires, the issue of new securities is priced. Upon settlement, the issuer will issue the new securities to the intermediary bank. The intermediary bank will take up and pay for the existing securities tendered in the tender offer and will exchange those for the new securities with the issuer. The intermediary bank will then resell the new securities to the investors and use the proceeds to settle the tender offer. A key issue in an intermediated exchange offer is the length of time during which the intermediary bank must be "on risk" in order to be considered to be acting as principal, rather than agent of the issuer in the exchange.



Exit Consents

In an exchange offer made under a traditional 20 business day timeline, it is not unusual for an issuer to include a consent solicitation process as part of an exchange offer. Common reasons for doing this may include:

- to conform covenants in the existing securities with those in the new securities; and
- to incentivize holders to participate in the exchange by reducing the attractiveness of the existing securities.

Under the terms of the offer, each exchanging holder would usually be required to consent to the amendments and the issuer would normally offer a consent fee to incentivize holders to participate.

Under standard high yield bond documentation, the holders or at least a majority (and sometimes at least two-thirds) of the outstanding principal amount of the securities would be required to consent to amendments to the covenants.

If the existing bond documentation is governed by English law, it may be possible to amend commercial terms with sufficient participation, including, for example, to add a mandatory redemption for securities not tendered in the exchange offer, thereby effecting a sweep-up of any remaining rump of outstanding securities. While careful consideration needs to be given to potential legal issues associated with amending commercial terms of existing securities, we have seen certain recent transactions which have included such a consent process.[2]

Securities Law Exemptions

Consideration must be given to ensuring that appropriate securities offering exemptions are available in each jurisdiction where the offer is made. If the offer will be made to holders in the United States, assuming it is not SEC registered, it would typically be made only to existing holders that are "qualified institutional buyers".[3]

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2 *Assenagon Asset Management S.A. v Irish Bank Resolution Corporation (formerly Anglo Irish Bank Corporation Ltd)* addressed the validity of a consent process where the minority of holders that did not consent to the exchange had the terms of the bonds amended to allow the issuer to call them for nominal consideration. The court found that this consent process, which destroyed substantially all of the value of the bonds, was not valid.

3 As defined under Rule 144A of the US Securities Act of 1933, as amended.

While there are other exemptions which can be used for an exchange, these require compliance with additional conditions.

If an exchange offer is to be made under an abbreviated timeline pursuant to the 2015 no-action letter, the offer must be available to all record and beneficial holders, provided that exchange offers which are restricted to QIBs and non-US persons where holders who are not eligible offer participants are given the option to receive cash in the approximate value of the new securities being offered.

If an exchange offer will be made in a member state of the European Union, typically the denomination of the new securities would be EUR 100,000 or greater (or the equivalent thereof in other currencies) so as to avoid the requirement to produce a prospectus for purposes of a public offer under the Prospectus Directive and to limit the application of certain aspects of the Transparency Directive. If the denomination of the new securities will be less than EUR 100,000 (or the equivalent in other currencies), other exemptions may be applicable.

Accounting Treatment

Under International Financial Reporting Standards, the accounting treatment of a transaction which is considered to be an exchange can be favorable as compared with a transaction which is treated as a separate extinguishment (redemption) and recognition of a new liability. IFRS 9 (*Financial Instruments*) is expected to be mandatory for annual financial periods beginning on or after 1 January 2018. The International Financial Accounting Board has recently confirmed an interpretation of IFRS 9 in respect of a gain or loss flowing from an exchange which may represent a change from current accounting for exchanges. It remains to be seen whether this change will have any effect on structures used to effect exchange offers.

Conclusion

Exchange offers are a useful liability management tool and, with a number of structuring options, can be designed to suit the needs of issuers in a variety of circumstances.

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