BINGHAM

Not Your Father's Debt Restructuring: Recent Developments in Restructuring Convertible Debt

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Public companies that wish to pursue restructurings of outstanding debt must address a number of legal and business issues prior to launching any restructuring. This is particularly true for restructurings of convertible debt, which can be more complicated to structure and complete than restructurings of non-convertible debt, in part because convertible debt is treated as an equity security for purposes of the U.S. tender offer rules and the possible need for stockholder approval for issuances of new equity or convertible debt in excess of certain thresholds under stock exchange rules. Issuers engaging in exchange offers and other convertible debt restructurings must pay close attention to various Securities and Exchange Commission ("SEC") rules and regulations, including registration requirements and exemptions, tender offer rules and proxy rules.[2] Planning a restructuring without careful consideration of these rules and recent developments may result in a proposed restructuring that cannot be completed or carries significant risk of delay in launching or completing the restructuring.

Developments over the last several years have provided more clarity with respect to certain of the restructuring issues issuers face with convertible debt. In this article, we review these developments by suggesting some initial questions any issuer should address in pursuing a restructuring, discussing recent developments with respect to these issues and providing an overview of implementation issues with respect to any convertible debt restructuring.

Initial Structuring Questions

At the outset of any proposed restructuring involving convertible debt, certain fundamental structuring questions should be addressed including the following:[3]

- How much of the convertible debt must be exchanged for a successful restructuring and how many holders of the convertible debt must participate in order to achieve this goal?
- How much time does the issuer have to complete a restructuring, and how long could the proposed restructuring take?
- Will the exchange offer be treated as a tender offer for U.S. securities law purposes?
- Will the issuer of the new securities need to register the transaction under the Securities Act?
- Can the issuer communicate with bondholders prior to launching the exchange offer and what type of commitments can the issuer obtain from them to participate in the exchange offer?

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[2] We note that at the 2011 SEC Speaks conference, on February 4 - 5, 2011, Michele Anderson, Chief of the SEC's Office of Mergers and Acquisitions stated that the SEC would be providing additional guidance in 2011 with respect to issuer debt tender offers. While she emphasized this would be guidance with respect to tender offers for straight debt securities as opposed to convertible debt, some of the Staff's new guidance may be relevant to convertible debt tender offers as well.

[3] As in any restructuring, there are other issues unrelated to convertible debt an issuer should address at the outset, such as whether the issuer only has capital structure issues to address, or also has operational issues (such as unwanted leases or contracts or significant litigation) that it can only address effectively in a bankruptcy, or whether the issuer has adequate liquidity to support its business.

- Does the issuer need stockholder approval to implement the proposed restructuring? If the issuer needs stockholder approval, what is the likelihood that the issuer will obtain this approval?
- Should the issuer consider a prepackaged or prearranged bankruptcy as part of the process?

Question 1: How many holders will the issuer need to participate in the exchange in order for it to be successful?

At the outset, the issuer and its advisors should consider the goals of the proposed debt restructuring, including the amount of debt sought to be exchanged. Knowing these goals is important because it will frame much of the analysis with respect to subsequent questions such as application of the tender offer rules. As part of this initial analysis, the issuer should also determine to the extent possible the ownership of its outstanding convertible debt. This can be done by engaging a proxy advisory/consent solicitation firm that should be able to determine ownership based on its search processes. In addition to determining the number of holders, it is also useful to determine whether there are any ownership concentrations that would allow an individual or group of bondholders to block the exchange offer and to better inform the issuer about the type of investor holding the convertible debt.

Question 2: How much time does the issuer have to complete a restructuring, and how long could the proposed restructuring take?

The issuer should determine whether it has any outside dates by which it must complete a restructuring. This outside date could be based on the need to complete a restructuring as a condition to completing a new money financing, or the need to address an upcoming interest payment or a looming event of default. The issuer should then compare the anticipated timeline for the proposed restructuring. For example, if the issuer has a deadline 45 days out, a proposed restructuring in the form of a registered exchange offer, which could take 3-4 months, will not work. In this situation, the issuer must address the deadline event or choose a more streamlined restructuring transaction, such as a privately negotiated exchange for a smaller amount of outstanding debt. In addition, the issuer should look at its proposed timeline and determine whether it can provide the requisite financial information (such as audited financials) when required in its SEC filings over the course of the proposed restructuring.

Question 3. Is the transaction a tender offer?

Rule 13e-4.[4] Because convertible debt is considered to be an equity security under the tender offer rules, exchange offers for convertible debt and offers to purchase convertible debt for cash may be subject to the same tender offer rules applicable to tender offers for common stock.[5] If a convertible debt exchange offer by an issuer is determined to be a tender offer, it will be subject to the provisions of Rule 13e-4 promulgated pursuant to the Securities Exchange Act of 1934, as amended (the "**Exchange Act**"), including the following requirements:

- the tender offer must remain open for a minimum period of 20 business days and at least ten business days from the date notice is given of any change in the percentage of the class of securities being sought, the consideration offered or the dealer's solicitation fee;[6]

[4] See 17 C.F.R. § 240.3a11-1 (2010).

[5] Although this article deals primarily with exchange offers, we note that any proposed acquisition of convertible debt for cash should also be analyzed to determine whether it is a tender offer. An exchange offer for non-convertible debt, if determined to be a tender offer, is also subject to a few of the basic tender offer rules contained in Regulation 14E, including the 20 business day requirement. Because most of the rules described above do not apply to exchange offers for non-convertible debt, issuers have much more flexibility in structuring the exchange offer.

[6] 17 C.F.R. § 240.13e-4(f)(1) (2010).

- bondholders must be permitted to withdraw securities tendered in the tender offer at any time during the period when the tender offer remains open and, if tendered securities have not yet been accepted for payment, after the expiration of 40 business days from the commencement of the tender offer;[7]
- if the tender offer is for less than all of the outstanding securities, in the event that more securities are tendered than the issuer is willing to accept, the issuer must accept the securities on a *pro rata* basis;[8]
- the tender offer must also be open to all bondholders of the class of securities subject to the tender offer (sometimes referred to as the "**all holders rule**");[9] and
- the consideration paid to any bondholder for securities tendered in a tender offer must be the highest consideration paid to any other bondholder for securities tendered in the tender offer (sometimes referred to as the "**best price rule**").[10]
- The tender offer rules also contain antifraud provisions prohibiting issuers from, in connection with a tender offer, (i) employing any device or scheme to defraud a person, (ii) making any false statements of material fact or omission of a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading or (iii) engaging in any act or practice that operates or would operate as a fraud or deceit on any person.[11]

Wellman and Hanson Tests. Prior to finalizing the structure of the proposed exchange offer, an issuer must determine whether its proposed exchange offer will constitute a tender offer. The term "tender offer" is not defined in the Exchange Act. However, in *Wellman v. Dickinson*,[12] the court proposed a test consisting of the following eight factors:

- active and widespread solicitation;
- solicitation of the holders of a substantial percentage of the securities;
- the offer is made at a premium over the prevailing market price;
- the terms of the offer are firm and not negotiable;
- the offer is contingent on the tender of a fixed number of securities and may be subject to a maximum number of securities to be purchased;
- the offer is open for a limited period of time;
- the offerees are pressured to sell their securities; and

[7] 17 C.F.R. § 240.13e-4(f)(2) (2010).
[8] 17 C.F.R. § 240.13e-4(f)(3) (2010).
[9] 17 C.F.R. § 240.13-e4(f)(8)(i) (2010). The SEC has, however, indicated that a tender offer may be made for fewer than all outstanding securities, but all bondholders must be eligible to accept the offer if they choose. See Amendments to Tender Offer Rules: All-Holder and Best-Price, Exchange Act Release No. 34-23421, (July 17, 1986). The all-holders rule does not prohibit the issuer from excluding bondholders in any jurisdiction where the tender offer is prohibited by administrative or judicial action after the issuer has made a good faith effort to comply with the applicable statute. See 17 C.F.R. § 240.13e-4(f)(9) (2010).
[10] 17 C.F.R. § 240.13e-4(f)(8)(ii) (2010).
[11] See 17 C.F.R. § 240.14e-1- § 240.14f-1(2010).
[12] *Wellman v. Dickinson*, 475 F. Supp 783 (S.D.N.Y. 1979), aff'd, 682 F.2d 355 (2d Cir. 1982), *cert. denied*, 460 U.S. 1069 (1983) (cited with approval in Commission Guidance on Mini-Tender Offers and Limited Partnership Tender Offers, Exchange Act Release No. 34-43069 64 FR 46581 (July 24, 2000).

- whether the announcement of a purchasing program precedes or accompanies rapid accumulations of the issuer's securities.[13]

The *Wellman* test is the generally accepted test for determining whether an issuer is making a tender offer. All eight factors need not be present and the weight of the various factors will be considered in determining whether a tender offer exists.[14] However, not all courts apply the *Wellman* test. In *Hanson Trust PLC v. SCM Corporation*,[15] the court stated that the true test of the existence of a tender offer is whether there appears to be a likelihood that there will be "a substantial risk that solicitees will lack information needed to make a carefully considered appraisal of the proposal put before them," unless the tender offer rules are followed.[16] Some courts have also declined to find that an offer was a tender offer when the offerees are sophisticated.[17]

Privately Negotiated Exchanges and Creeping Tender Offers. If an issuer is proposing one or more exchange offers limited to institutional investors, the exchange offer may not give rise to a tender offer even though the issuer may be seeking to exchange a significant portion of the securities outstanding. Privately negotiated exchanges are sometimes appropriate when an issuer wants to exchange a portion of a series of securities that is concentrated among a few holders.

However, privately negotiated exchanges will need to be tailored to avoid becoming a "creeping tender offer." In this context, a "creeping tender offer" refers to privately negotiated exchanges or purchases of securities conducted over time where, viewed in the aggregate, the transactions are treated as constituting a tender offer for Exchange Act purposes, accordingly the courts or the SEC determine that the issuer should have complied with the SEC's tender offer rules and prepared and distributed appropriate disclosure materials. There is no bright-line test for when privately negotiated exchange offers or purchases constitute a tender offer. Investment bankers often advise clients that an exchange offer may become a tender offer if more than 25% of the outstanding securities would be exchanged in any quarter or more than 50% in a year.[18] However, various commentators and practitioners believe that, depending on all the specific facts and circumstances, a series of exchanges of up to 80% of the outstanding bonds from 10 to 15 sophisticated investors may be permissible without constituting a tender offer.[19] This issue is a very fact-specific analysis, and any issuer considering a series of private exchanges or private exchanges followed by registered exchange offers should review the case law and SEC positions on integration in tender offers.

Pier 1 Imports—Testing the Boundaries on Exchange Offers. Pier 1 Imports, Inc.'s privately negotiated debt exchanges in 2009 are a good example of how the general rule-of-thumb with respect to exchange offers is applied in transactions.

Background. On July 30, 2009, Pier 1 entered into six separately negotiated exchange agreements with seven institutional bondholders with respect to an existing series of notes and purchased an additional $5 million principal amount of the series for cash from one institutional bondholder.[20] The exchanges

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[13] See *Wellman v. Dickinson*, 475 F. Supp 783 (S.D.N.Y. 1979), aff'd, 682 F.2d 355 (2d Cir. 1982), *cert. denied*, 460 U.S. 1069 (1983). The eighth factor, rapid accumulation following a public announcement, was first articulated in *S-G Securities, Inc. v. Fuqua Inv. Co.,* 466 F. Supp. 1114 (D. Mass. 1978).

[14] See Commission Guidance on Mini-Tender Offers and Limited Partnership Tender Offers, Exchange Act Release No. 34-43069 64 (July 24, 2000).

[15] *Hanson Trust PLC v. SCM Corporation*, 774 F.2d 47 (2d Cir. 1985).

[16] *Id.*

[17] See *In re General Motors Class E Stock Buyout Securities Litigation*, 694 F. Supp. 1119 (D. Del. 1988).

[18] See James Moloney, Glenn Pollner and Matthew Shaw: *Convertible Debt Exchange Offers: Considerations for Distressed Issuers,* Deal Lawyers, September - October 2009.

[19] See *id.*

[20] See Pier 1 Imports Inc., Current Report (Form 8-K) (July 31, 2009).

were all completed in early August 2009. The bondholders party to these transactions collectively held approximately 80.7% of the outstanding notes. Pier 1 and its advisor negotiated separately with each bondholder and all exchanging bondholders were given the most favorable terms negotiated by any bondholder.

SEC Comment Letter. The staff of the SEC (the "Staff") issued a comment letter in October 2009 requesting that Pier 1 provide the Staff with its analysis of why the debt exchanges did not constitute an issuer tender offer under Rule 13e-4.[21] Pier 1 responded in a letter dated November 12, 2009 by providing a detailed analysis of the transactions under both the *Wellman* and *Hanson* tests.[22]

Wellman Analysis. Pier 1 argued that the transactions did not constitute a tender offer under the *Wellman* test because:

- The notes were held by more than ten holders and Pier 1 and its advisor only contacted eight institutional investors with respect to the offer. Each of the institutional investors entered into a confidentiality and standstill agreement prior to Pier 1 providing them with any information about the offer;
- The price in the offer did not represent a premium as the exchanging holders received a reduced principal amount of new securities, although the conversion value of the new securities increased. Pier 1 further noted that while some of the terms of the existing securities were more favorable to the bondholders than the terms of the new securities, some of the terms of the new securities were more favorable to the bondholders than the terms of the existing securities;
- The bondholders had significant opportunity to negotiate the price and terms of the exchange;
- The solicitation did not involve a substantial percentage of securities. To support this position, Pier 1 noted that it was their understanding that the Staff had previously provided oral guidance that in similar circumstances 80% of the existing securities would not constitute a substantial percentage;
- The exchange offer was not contingent on a minimum amount to be tendered nor subject to a maximum amount that the issuer would accept;
- The offer was not open for a limited period of time as the exchange proposals did not have a fixed expiration date;
- The bondholders were not pressured to respond to the offer; and
- Pier 1 did not make any public announcement of the exchange until after the agreements were executed and the cash purchase made and did not acquire any additional securities subject to the transaction after the public announcement thereof.

Hanson Analysis. With respect to the *Hanson* test, Pier 1 argued that the bondholders who participated in the exchanges and cash purchase were not the type of persons that needed the protection of the tender offer rules. The bondholders were accredited investors and sophisticated qualified institutional buyers and were either investment or hedge funds that specialized in investing in distressed debt. Further, each bondholder negotiated its transaction separately for terms in its best interests and with full access to its professional advisors. Pier 1 concluded that there would not have been any appreciable benefit to the bondholders if the company had complied with the tender offer rules.

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[21] See SEC Comment Letter, dated October 28, 2009, *available at* http://www.sec.gov/Archives/edgar/data/278130/000000000009060764/filename1.pdf.
[22] See Pier 1 Imports Inc., SEC Response Letter, dated November 12, 2009, *available at* http://www.sec.gov/Archives/edgar/data/278130/000110465909064497/filename1.htm.

Not Equity Securities. In addition to its analysis of the *Wellman* and *Hanson* factors, Pier 1 also made the point to the Staff, in a footnote, that in its view the convertible notes did not constitute "equity securities" within the meaning of Section 3(a)(11) of the Exchange Act and accordingly Rule 13e-4 did not apply. In making this argument, Pier 1 noted that the convertible notes were not currently convertible, and would only become convertible upon satisfaction of certain conditions, which the company viewed as remote, and even if convertible, would convert primarily into cash, and would only convert partially into common stock and only if the conversion value was high enough.[23]

The SEC did not issue any further comments with respect to the exchange transactions and purchase after Pier 1's response.

The Pier 1 letter appears to confirm the rule-of-thumb that under the right circumstances (including a high concentration of ownership by institutional investors) an issuer can repurchase or exchange a very significant portion of its outstanding convertible debt without triggering the tender offer requirements.

Question 4: Will the transaction have to be registered with the SEC under the Securities Act?

Unless the restructuring involves the purchase of debt solely for cash, the end result of the exchange offer will be the issuance of a new security, and therefore an issuer must either find an exemption from the registration requirements of the Securities Act of 1933, as amended (the "Securities Act"), or file a registration statement with the SEC to register the issuance of the securities to be issued in the exchange offer. Set forth below is a brief discussion of certain common exemptions.

Section 4(2). Section 4(2) of the Securities Act provides an exemption for transactions not involving any public offering. Whether an exchange is a so-called "private placement" is generally subject to a "facts and circumstances" test. An issuer considering utilizing a Section 4(2) exemption should analyze the suitability of the offerees, including their financial sophistication, the availability of sufficient information about the issuer, the manner of the offering and whether there will be a public distribution of securities. The issuer must determine whether each offeree is eligible to participate in the exchange offer prior to sending the offering documents to such bondholder. In order to provide greater certainty that it is conducting a valid private placement, an issuer may choose to take advantage of the safe harbor available under Regulation D.[24] Regulation D contains three principal requirements for an exemption from the registration requirement of the Securities Act. In order for the safe harbor to be available, the exchange offer must be limited to accredited investors and a small number of non-accredited investors and detailed specified information must be provided to any non-accredited investors. Any non-accredited investors participating in the exchange offer must also be "sophisticated." In addition, there can be no general solicitation or advertising and the issuer must file a Form D with the SEC upon completion of the exchange offer. While an exchange offer under Section 4(2)/Regulation D has the advantage of not requiring SEC registration and review and not being subject to Section 11 liability under the Securities Act, the securities issued in the exchange offer will be "restricted securities" subject to holding periods, as discussed in Part II.A below.

Over the last several years, it has become quite common for issuers to effect exchange offers for non-convertible debt with a high level of institutional ownership by limiting the offer to institutional accredited investors and "qualified institutional buyers" (as defined in Rule 144A) and avoiding registration under the Securities Act. However, if an exchange offer for convertible debt is treated as a tender offer, the

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[23] Pier 1 did not cite any support for this argument and we are not aware of any instance where the SEC or courts have accepted this argument.
[24] 17 C.F.R. § 230.501 *et seq.*(2010).

issuer will be required to extend the offer to all holders of the convertible debt because of the all holders rule under Rule 13e-4, which makes it much less likely that the exchange offer can be effected as a private placement under the Securities Act.

Section 3(a)(9). Another possible exemption from the registration requirement is contained in Section 3(a)(9) of the Securities Act. Section 3(a)(9) provides an exemption for an offer to exchange existing securities for new securities that is made by the "same issuer." Conducting an exchange offer in accordance with Section 3(a)(9) provides certain advantages, including no registration with, or review by, the SEC; lower cost than a registered offering; not being subject to Section 11 liability under the Securities Act; no limitation on the number or sophistication of investors; and treatment of the new securities as unrestricted securities if the existing securities were not restricted securities. However, in order to comply with Section 3(a)(9), the transaction must meet several key requirements:

- ***"Same Issuer."*** The new securities must be issued by the same issuer as issued the existing securities.[25] However, the SEC has taken no-action positions in certain situations where the new securities are not issued by the same issuer. For example, the SEC has granted no-action relief in connection with a proposed exchange of guaranteed debt securities of a subsidiary for securities issued by its parent, which had guaranteed the existing securities.[26] The SEC has also granted no-action relief when a parent company assumed joint and several liability for the convertible securities issued by its wholly owned subsidiary and allowed the issuer to rely on Section 3(a)(9) to exchange the common stock of the parent for the subsidiary's securities upon conversion thereof.[27] Finally, the SEC recently took a no-action position with respect to the issuance of new securities by an issuer in exchange for outstanding securities of the issuer that have one or more "upstream" guarantees from the issuer's wholly owned subsidiaries.[28] An issuer wishing to exchange securities for those of a different entity should carefully review the SEC's position with respect to the "same issuer" requirement.
- ***Offer to Existing Bondholders.*** The offer must only be made to existing bondholders. This requirement is generally satisfied unless the issuer is conducting another offering of securities concurrently with the exchange offer, in which case the issuer will need to avoid the integration of the offers in order to conduct the exchange offer using the Section 3(a)(9) exemption. As a corollary, if the issuer is conducting a simultaneous offering of the new securities for cash, the Section 3(a)(9) exemption may not be available.[29] An issuer wishing to complete a Section 3(a)(9) exchange while conducting an offer of securities for cash, or as part of another exchange offer, will need to carefully review the integration issues.[30]
- ***Exclusively by Exchange***. The bondholders must not pay any consideration to the issuer other than the surrender of the existing securities in connection with the exchange offer. There are several exceptions to this requirement. First, Rule 149 under the Securities Act permits bondholders to pay cash to the issuer in addition to the surrender of the existing securities if the payment is necessary "to effect an equitable adjustment in respect of dividends or interest paid or payable on the securities involved in the exchange, as between such security holder and other security holders of the same class accepting the offer of exchange."[31] The Staff has taken no-action positions with

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[25] See Securities Act of 1933 § 3(a)(9), 15 U.S.C. §77c(a)(9) (which exempts securities "exchanged by the issuer with its existing security holders").
[26] See Echo Bay Resources Inc., SEC No-Action Letter (May 18, 1998).
[27] See Financial Corp. of Santa Barbara, SEC No-Action Letter (June 22, 1987).
[28] See Davis Polk, SEC No-Action Letter (January 13, 2010).
[29] See Securities Act Release No. 33-2029 (August 8, 1939).
[30] Detailed discussion of the SEC's position on integration of securities offerings is beyond the scope of this article.
[31] 17 C.F.R. §230.149 (2010).

respect to various payments pursuant to Rule 149, including for the waiver of interest or dividends accrued on the existing securities,[32] the waiver of causes of action or claims against the issuer with respect to the existing securities,[33] and the consent of holders of the existing securities in a consent solicitation.[34] Second, Rule 150 under the Securities Act provides that the issuer may make payments to the bondholders participating in the exchange offer "when such payments are part of the terms of the offer of exchange."[35] The Staff has provided no-action relief pursuant to Rule 150 to allow issuers to pay cash to bondholders for accrued dividends on existing securities,[36] to allow payments to be made in cash or cash equivalents,[37] and to allow an affiliate of the issuer to make the payment.[38]

- ***Paid Solicitation***. The issuer cannot pay anyone, either directly or indirectly, to make solicitations in connection with the exchange offer.[39] The issuer may use its employees to solicit investors to exchange their existing securities for new securities subject to the following restrictions: (i) employees contacting bondholders should have significant additional responsibilities with the issuer other than the solicitation; (ii) employees cannot be paid special bonuses, commissions, fees or other payments in respect of their solicitation activities (other than salary and regular bonuses); and (iii) the solicitation efforts should be made only in addition to the employees' regular duties.[40] Section 3(a)(9) also places significant limitations on the role of financial advisors or agents. Financial advisors or agents may not make any recommendation to any bondholder, its advisors or representatives regarding whether the bondholder should accept or reject the exchange offer[41] and, if the financial advisor is rendering a fairness option, the advisor may not have any contact with bondholders.[42] The financial advisor may engage in the following types of activities: (i) provide general financial advice in connection with the exchange offer; (ii) provide administrative services; (iii) provide functionary services; and (iv) engage in general, non-substantive communications with bondholders.[43] Finally, the financial advisor's fee cannot be based on the success of the exchange offer.[44]

In exchange offers, the limitation on payments to financial advisors often proves to be a key issue for an issuer in structuring a deal, and it may be difficult to retain advisors who are empowered to complete the deal if restrained by Section 3(a)(9) limitations. Note that there is a significant body of SEC no-action letters issued over the years addressing Section 3(a)(9) and these letters should be reviewed as part of any analysis of a proposed transaction.

Interplay between Tender Offer Rules and Securities Act Rules. If the issuer determines that its exchange offer is also a tender offer, it will be required to make the offer to all holders of the outstanding

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[32] See, e.g., Seaman Furniture Co., SEC No-Action Letter, (October 10, 1989). See also SEC Division of Corporation Finance, Compliance and Disclosure Interpretations: Securities Act Sections (#Question 125.04) (Nov. 26, 2008), *available at* http://www.sec.gov/divisions/corpfin/guidance/sasinterp.htm.

[33] See, e.g., *id.*

[34] See, e.g., Bayswater Realty & Capital Corp., SEC No-Action Letter (April 30, 1982).

[35] See 17 C.F.R. § 230.150 (2010).

[36] See, e.g., Steiner Am. Corp., SEC No-Action Letter (May 4, 1973).

[37] See e.g. The News Corporation Limited, SEC No-Action Letter (May 15, 1992) and International Controls Corp., SEC No-Action Letter (Aug. 6, 1990).

[38] See, e.g., Carolina Wholesale Florists, Inc., SEC No-Action Letter (Aug. 17, 1976).

[39] Securities Act of 1933 § 3(a)(9), 15 U.S.C. § 77c(a)(9) (2006) (provides that the exemption applies "where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange").

[40] See URS Corporation, SEC No-Action Letter (May 8, 1975).

[41] See Dean Witter & Co., Inc., SEC No-Action Letter (November 21, 1974) and Stokley-Van Camp, SEC No-Action Letter (March 31, 1983).

[42] See SEC Division of Corporation Finance, Compliance and Disclosure Interpretations: Securities Act Sections (Question 125.07) (Nov. 26, 2008), available at http://www.sec.gov/divisions/corpfin/guidance/sasinterp.htm.

[43] See Seaman Furniture Co., Inc., SEC No-Action Letter (Oct. 10, 1989).

[44] See e.g. Carlton, Inc. and Subsidiaries, SEC No-Action Letter (Sept. 30, 1991).

convertible debt. Given this requirement, it is unlikely that the exchange offer would qualify for the Section 4(2) exemption from registration or the Regulation D safe harbor. If the issuer either cannot or does not wish to comply with the requirements of Section 3(a)(9) with respect to the exchange offer, the issuer may need to register the exchange offer or consider a process involving bankruptcy.

Section 1145. If the issuer is considering a bankruptcy as part of the restructuring, the issuer may also be able to rely on Section 1145 of the Bankruptcy Code to avoid registering the exchange offer. Section 1145 provides that the registration requirements of the Securities Act do not apply to the offer or sale of securities pursuant to a plan of reorganization.[45] In order for the Section 1145 exemption to be available, the exchange must be either wholly in exchange for claims against the issuer or "principally" in exchange for claims against the issuer and partly for cash or property.[46] If the exchange includes a cash component to be paid by existing investors, the issuer should make sure that the cash component is not significant enough that the Section 1145 exemption is not available. The SEC has granted no-action relief with respect to the "principally in exchange" requirement when the value of the existing securities to be surrendered in the exchange exceeds the value of the cash to be provided by exchanging holders.[47] The exemption from registration applies to the issuer and its affiliates, but is not available for underwriters.[48] Securities issued in accordance with Section 1145 are considered to have been issued in a public offering and are therefore not restricted securities.[49] Section 1145 clearly applies to both the offer and sale of securities after a bankruptcy filing has been made. However, there is some uncertainty as to whether the Section 1145 exemption applies to a solicitation made prior to a bankruptcy filing because the text of Section 1145 refers to securities of a "debtor" and an issuer is not technically a "debtor" until after the issuer has filed its bankruptcy petition with the bankruptcy court. At least one staff member at the SEC has indicated that Section 1145 may not be used for the offer of securities prior to a bankruptcy filing as is generally the process for prepackaged bankruptcy plans and the issuer would need to rely on another exemption from registration in order to solicit votes on a prepackaged bankruptcy plan.[50]

Question 5: Can the issuer discuss the proposed exchange offer with bondholders and can bondholders sign lock-ups?

In order to increase the likelihood of an exchange offer's success, an issuer may desire to engage in negotiations with bondholders and possibly have bondholders enter into lock-up agreements whereby the holders agree to tender their securities in the exchange offer and agree to any indenture consent being solicited. If the issuer is contemplating a registered exchange offer, the issuer must be careful not to run afoul of the so-called "gun jumping" prohibitions under the Securities Act with respect to such pre-commencement communications. Gun jumping occurs when an "offer" is made prior to the filing of a registration statement under the Securities Act or "sales" are made prior to the effectiveness of the registration statement.[51] The SEC interprets the word "offer" very broadly; accordingly, the issuer and its

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[45] See 11 U.S.C. 1145 (2006).
[46] See 11 U.S.C. 1145(a)(1) (2006).
[47] See Barry's Jewelers, Inc., SEC No-Action Letter (July 20, 1998) (finding no registration requirement when the value of cash was approximately 55% of the value of the claims). See also Jet Florida Sys., Inc., SEC No-Action Letter (January 12, 1987) (finding no registration requirement when the value of cash was approximately 75% of the value of the claims) and Bennett Petroleum Corp., SEC No-Action Letter (December 23, 1983) (finding no registration requirement when the value of cash was approximately 75% of the value of the claims).
[48] See 11 U.S.C. 1145 (2006). Due to some ambiguous drafting in the statute, the application of Section 1145 with respect to "underwriters" is a complicated issue. For a more detailed discussion see Saggesse & Ranney-Mannelli, *A Practical Guide to Out-of-Court Restructurings and Pre-Packaged Plans of Reorganization* (2000).
[49] See 11 U.S.C. 1145(c) (2006).
[50] See Abigail Arms, *Current Issues and Rulemaking Projects,* 939 PLI/Corp 747, 870-871 (1996). See also Saggesse, Noel & Mohr, *A Practitioner's Guide to Exchange Offers and Consent Solicitations*, 24 Loy. L.A.L. Rev. 527 (1991).
[51] See, e.g., *SEC v. Arvida Corp.*, 169 F. Supp. 211 (S.D.N.Y. 1958) and Guidelines for the Release of Information by Issuers Whose Securities are in Registration, Securities Act Release No. 33-5180 (August 20, 1971).

advisors should be careful in their pre-launch communications with bondholders to avoid violating the registration requirements of the Securities Act.

Pre-Launch Communications—Rules 165 and 166. Rules 165 and 166 promulgated under the Securities Act provide exemptions from the gun jumping prohibitions in connection with certain communications between an issuer and holders of its securities. The rules only apply to "business combination transactions" but the rules define "business combination transactions" to include exchange offers.[52] Rule 166 applies prior to the public announcement of an exchange offer and provides that any communication prior to the announcement is exempt from the prohibition in Section 5(c) of the Securities Act on pre-filing offers, if the participants take all reasonable steps to prevent further distribution or publication of the communication until the transaction is publicly announced or a registration statement is filed. Rule 165 provides that certain communications made after the exchange offer is publicly announced are exempt from Section 5(c) and Section 5(b) of the Securities Act, subject to certain requirements, including the filing of any written communication used. Combined, Rules 165 and 166 allow an issuer to communicate with its bondholders prior to launching an exchange offer in order to assess their receptiveness to various terms and potentially to discuss with certain bondholders the possibility of entering into lock-up agreements.

Lock-up Agreements

An issuer may attempt to get one or more of its bondholders to enter into lock-up agreements ahead of launching an exchange offer to increase the certainty of a successful outcome, which, in turn, may encourage other bondholders to tender in the offer. If the exchange offer is structured as a non-registered exchange offer under Section 4(2)/Regulation D or Section 3(a)(9), there is no prohibition on the issuer entering into lock-up agreements with bondholders. However, in the context of a registered exchange offer, an issuer must ensure that entering into a lock-up agreement with bondholders does not constitute gun jumping or otherwise violate securities laws.

SEC Guidance. In its Compliance and Disclosure Interpretation 139.29 (issued in August 2010) ("**CDI 139.29**"), the SEC states that the execution of a lock-up agreement with a bondholder prior to filing a registration statement in connection with a registered debt exchange offer may constitute a contract under the Securities Act, which would cause an offer and sale of the issuer's securities to be made to the locked-up holders prior to the exchange offer being made to other bondholders. In such cases, the SEC has objected to the filing of a registration statement with respect to the subsequent exchange offer stating that "[a]n exchange offer is a single transaction, and a transaction that has commenced privately must be completed privately."[53] In CDI 139.29, the Staff stated that it will not object to the registration of subsequent offers and sales pursuant to an exchange offer when lock-up agreements have been signed as long as the following conditions are met:

- the lock-up agreements are only signed by accredited investors;
- the persons signing the lock-up agreements own less than 100% of the outstanding principal amount of the relevant series of notes;
- the issuer will make a tender offer to all holders of the relevant series of notes; and

[52] See 17 C.F.R. § 230.165(f)(1) (2010) and 17 C.F.R. § 230.166(b) (2010).
[53] See SEC Division of Corporation Finance, Compliance and Disclosure Interpretations: Securities Act Sections (#Question 139.29) (August 11, 2010), *available at* http://www.sec.gov/divisions/corpfin/guidance/sasinterp.htm.

- all bondholders eligible to participate in the exchange offer are offered the same amount and form of consideration.[54]

In addition, the issuer may not complete the exchange with the persons executing the lock-up agreements prior to the filing and effectiveness of a registration statement. In CDI 139.29, the SEC also cautioned that an issuer should consider whether the execution of lock-up agreements constitutes the commencement of a tender offer for purposes of the tender offer rules.

Rules 165 and 166 combined with CDI 139.29 provide guidelines for how issuers and their advisers can test the waters prior to an exchange offer without limiting the ability of the issuer to subsequently conduct a registered exchange offer. As long as the provisions of Rules 165 and 166 are followed and the conditions of CDI 139.29 are met, an issuer and its advisors should be able to determine whether a significant portion of its bondholders are likely to support a proposed restructuring, or if the terms should be revised prior to publicizing such terms by filing a registration statement. However, CDI 139.29 left open the issue of how far the issuer could go in signing lock-up agreements without tripping one or more of the rules relating to tender offers.

C&D Technologies. Even with the guidance provided in CDI 139.29, it can be difficult for an issuer to determine how far it can go with getting lock-up agreements from bondholders. In addition, as discussed above with respect to Question 3, tender offer rules require that bondholders be granted withdrawal rights during the tender offer period. A lock-up agreement that permits a bondholder to withdraw its tender of securities at any time during the exchange offer would not be effective in giving an issuer comfort that its exchange offer would be successful and would frustrate many of the issuer's goals in entering into the lock-up agreements. However, the structure of C&D Technologies, Inc.'s convertible debt exchange offer suggests that it is possible to sign lock-up agreements with holders of a significant portion of the outstanding convertible debt without granting these holders withdrawal rights.

Background. On October 21, 2010, C&D Technologies launched an exchange offer proposing to exchange all of the company's outstanding 5.25% Convertible Senior Notes due 2025 and 5.50% Convertible Senior Notes due 2026 for shares of the company's common stock. C&D Technologies simultaneously solicited holders of the convertible notes and the existing holders of the company's common stock to approve a prepackaged plan of reorganization as an alternative to the exchange offer.

Support Agreements. In connection with the exchange offer, on September 14, 2010, C&D Technologies entered into a restructuring support agreement with two bondholders holding, through several funds, more than 55% of the aggregate principal amount of the convertible notes subject to the exchange offer at the time they entered into the support agreement. Pursuant to the support agreement, the bondholders agreed, among other things, to support the exchange offer and prepackaged plan by tendering their notes and voting in favor of the prepackaged plan and not withdrawing or revoking their tender or affirmative vote, not to impede or interfere with the restructuring of the company and, unless the company commenced a Chapter 11 bankruptcy case, not to accelerate or support the acceleration of the notes and to each use its commercially reasonable efforts to waive any event of default under the indentures governing the notes. The support agreement also provided that the company would pay all the fees and expenses of the bondholders.[55]

Registration and SEC Correspondence. On October 21, 2010, C&D Technologies filed a registration statement on Form S-4 and a Schedule TO with respect to the exchange offer and the prepackaged plan.

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[54] See *id.*

[55] See Exhibit 10.1 to C&D Technologies, Quarterly Report (Form 10-Q) (Sept 14 2010).

As part of the review process, on November 1, 2010, the Staff issued a comment letter raising a number of comments, including a comment questioning whether the execution of the support agreements violated certain of the tender offer rules.

- ***Sale under the Securities Act***. In the comment letter, the Staff asked C&D Technologies to provide an analysis of whether the execution of the support agreement constituted a sale under the Securities Act. C&D Technologies argued that the support agreement complied with the Staff's position in CDI 139.29 in that the bondholders were accredited investors, the bondholders owned less than 100% of the outstanding securities, C&D Technologies was making a tender offer to all bondholders and the bondholders signing the support agreement received the same consideration as other bondholders. However, C&D Technologies did agree to amend the support agreement to eliminate provisions granting the bondholders certain information rights.[56]
- ***Best Price Rule***. The Staff also asked C&D Technologies to analyze whether the support agreements violated the requirement contained in Rule 13e-4(f)(8)(ii) that the consideration paid to any holder be the highest consideration paid to any holder in the exchange offer. C&D Technologies argued that the bondholders signing the support agreement would receive the same consideration as other bondholders participating in the exchange offer. In a subsequent comment letter issued on November 18, 2010, the Staff questioned whether the payment of the bondholders' fees and expenses violated the best price rule. C&D Technologies responded that the support agreement only provided that the company would pay the bondholders' reasonable out-of-pocket fees and expense and that the payment of such fees and expenses was agreed to after extensive arms' length negotiations and would be paid whether the company pursued an exchange offer or some other restructuring alternative.[57]

The SEC ultimately declared C&D Technologies' registration statement effective with the support agreement in place (after amending the support agreement to eliminate certain information rights as described above). Even though the support agreements did not provide any withdrawal rights to the bondholders, the Staff did not question whether this aspect of the support agreements violated the tender offer rules. This suggests the possibility that, consistent with its approach in issuing CDI 139.29, the Staff is willing to provide some leeway to issuers under the tender offer rules when dealing with sophisticated investors.[58]

Question 6: Will the issuer need stockholder approval for the exchange offer?

Increase in Authorized Shares. It is not unusual in convertible debt exchange offers for issuers to offer more shares as part of the exchange (or new convertible debt with more shares issuable on conversion) than are issuable under the outstanding convertible debt. Prior to commencement of the exchange offer, the issuer must determine whether it has sufficient authorized shares to issue all the shares that could be

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[56] See C&D Technologies SEC Response Letter dated November 9, 2010, *available at* http://www.sec.gov/Archives/edgar/data/808064/000119312510253526/filename11.htm.

[57] See C&D Technologies SEC Response Letter dated November 23, 2010, *available at* http://www.sec.gov/Archives/edgar/data/808064/000119312510267569/filename11.htm.

[58] See also NCI Building Systems, Inc.'s 2009 exchange offer, which was launched prior to the SEC's guidance in CDI 139.29. In connection with the exchange offer, NCI entered into a lock-up and voting agreement with holders of more than 79% of the outstanding principal amount of NCI's convertible notes, pursuant to which the holders agreed to tender their convertible notes in NCI's exchange offer and not withdraw those notes. Each of the holders also granted NCI an irrevocable proxy. See NCI Building Systems, Inc.'s SEC Response Letter dated September 23, 2009, *available at* http://www.sec.gov/Archives/edgar/data/883902/000095012309045275/filename10.htm. In a comment letter dated September 30, 2009, the Staff disagreed with NCI's analysis that the lock-ups and the subsequent exchange offer could be bifurcated into a private transaction and a registered transaction and stated that to the extent the lock-ups constituted an investment decision, the exchange offer commenced at that time. See SEC Comment letter dated September 30, 2009, *available at* http://www.sec.gov/Archives/edgar/data/883902/000000000009055269/filename1.pdf. The Staff allowed the exchange offer to proceed once NCI confirmed that the exchange offer could not be completed in a private transaction.

issued in the exchange offer or upon conversion of the new convertible debt. If the issuer does not have sufficient authorized shares, it will need to obtain stockholder approval to amend its charter to increase the number of authorized shares. The issuer must also review the corporate law of its jurisdiction of incorporation to determine the vote necessary to increase its authorized shares. Delaware law requires the affirmative vote of a majority of the outstanding stock entitled to vote on the proposal,[59] which can be a difficult standard to meet, particularly if there is a large retail stockholder base and the proposed restructuring leaves little value for stockholders. In order to increase the likelihood of obtaining stockholder approval, the issuer will need to work closely with its proxy advisor to ensure that the proposal to increase the authorized shares is treated as a discretionary proposal for purposes of the rules governing proxy voting by brokers so that brokers will be authorized to vote on the proposal even without instructions from their client.[60] Issuers should also review the current proxy voting guidelines published by ISS, a subsidiary of MSCI Inc., to determine whether the requested increase in authorized shares falls within ISS' guidelines for share increases.

When Approval is Required Under Nasdaq Rules. If the issuer is listed on Nasdaq, stockholder approval may be required under Nasdaq Marketplace Rule 5635. Nasdaq requires stockholder approval in three situations:

20% Rule. Nasdaq Marketplace Rule 5635(d) requires stockholder approval of the issuance of common stock, or securities convertible into or exercisable for common stock, equal to 20% or more of the common stock outstanding before the issuance for less than the greater of book or market value of the stock. Rule 5635(d) does not, however, apply to a public offering.[61]

Change of Control. Under Marketplace Rule 5635(b), an issuer is required to obtain stockholder approval prior to the issuance of securities when the issuance or potential issuance would result in a "change of control" as defined by Nasdaq. Nasdaq generally characterizes a transaction whereby an investor or group[62] of investors acquires, or obtains the right to acquire, 20% of more of the outstanding shares or the voting power of an issuer on a post-transaction basis as a "change of control" for purposes of Rule 5635(b).

Equity Compensation. Finally, under Marketplace Rule 5635(c), an issuer is required to obtain stockholder approval prior to issuance of common stock, or securities convertible into or exercisable for common stock, to certain affiliates at a price less than the market value of the common stock, as such issuance is considered a form of "equity compensation."

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[59] See 1 Del. Code. § 242.

[60] See NYSE Rule 452.

[61] In making a determination whether a transaction is a public offering for purposes of Rule 5635(d), Nasdaq staff will consider all relevant factors, including but not limited to, the type of offering, the manner in which the offering is marketed, the extent of the offering's distribution, the offering price, and the extent to which the issuer controls the offering and its distribution. In Nasdaq's interpretative material with respect to Rule 5635, Nasdaq encourages issuers to discuss with Nasdaq whether a particular transaction constitutes a public offering. See IM-5635-3. In making a determination as to whether a transaction constitutes a public offering, Nasdaq generally looks at the type of offering (with firm commitment underwritten offerings more likely to be treated as public offerings), the manner of marketing of the offering, the extent of distribution, the offering price and the level of control of the company over the offering and distribution. *Id.* See also Staff Interpretative Letters 2009-10, 2009-13, 2006-2 and 2006-25. We note that if the outstanding securities were originally issued in an underwritten offering, Nasdaq may permit an exchange offer for these securities to be treated as a public offering for purposes of the public offering exception. See Staff Interpretive Letter 2009-10.

[62] Nasdaq has not defined "group" in the context of Rule 5635(b) but in an FAQ on an unrelated rule, Nasdaq has stated that in order for a group to exist, they must have filed a notice (such as a Schedule 13D) that they are acting as a group. See Nasdaq Corporate Governance Frequently Asked questions - Controlled Companies - What is a Controlled Company?, *available at* https://listingcenter.nasdaqomx.com/Show_Doc.aspx?File=FAQsCorpGov.html#CC1.

The 20% threshold is the test that most often triggers a stockholder vote in connection with an exchange offer. Nasdaq calculates the 20% based on the maximum potential issuance of shares in a given transaction. Therefore, in making a determination as to whether the issuance of convertible securities would require approval pursuant to Rule 5635(d), the issuer should consider all common stock potentially issuable upon conversion of the convertible debt, as well as whether any prior issuance of securities would be aggregated with the exchange offer issuance. In determining whether an equity issuance should be aggregated with any prior equity issuances, Nasdaq will consider the amount of time since the prior transaction(s), whether circumstances have changed since the prior transactions(s), whether the current transaction was contemplated at the time of the prior transaction, and whether the need for the proposed transaction arose after the closing of the prior transaction.[63] If cash is paid in the exchange offer, the issuer will also need to consider how shares will be valued for purposes of determining whether the securities are issued at a price less than the greater of book or market value. Nasdaq has provided guidance in connection with an exchange offer of outstanding debt for cash, new convertible debt and stock or warrants. In that situation, the valuation methodology used to determine the price at which the new shares are deemed to be issued is (i) the face amount of the existing securities tendered <u>less</u> cash received <u>divided by</u> (ii) the total number of shares issued or issuable upon conversion or exercise of the securities acquired in the exchange.[64]

If stockholder approval is required, the proposal must be approved by a majority of the total votes cast on the proposal. Because a proposal for approval pursuant to Rule 5635 is a non-routine matter under the rules governing proxy voting by brokers[65], it is likely that there will be broker non-votes with respect to such proposal. However, because the proposal need only be approved by a majority of the votes cast, broker non-votes are not counted for purposes of determining the total votes cast on the proposal.

When Approval is Required Under NYSE Rules. If the issuer is listed on the New York Stock Exchange ("NYSE"), the issuer should review NYSE Rule 312.03 to determine whether stockholder approval is required. NYSE requires stockholder approval in three situations:

20% Rule. NYSE Rule 312.03(c) requires stockholder approval prior to the issuance or sale of common stock or securities convertible into common stock in any transaction or series of transactions if (i) the shares of common stock or securities convertible into common stock will have upon issuance voting power equal to 20% or more of the voting power outstanding before the issuance of the securities or (ii) the number of shares of common stock or securities convertible into common stock to be issued will upon issuance equal 20% or more of the number of shares of common stock outstanding before the issuance of the securities.

Related Party Transactions. NYSE Rule 312.03(b) requires stockholder approval prior to the issuance or sale of securities in any transaction or series of related transactions to a director, officer or "substantial security holder" of the issuer if the number of shares of common stock, or the number of shares of common stock into which the securities may be converted, exceeds one percent of the voting power of the company before such issuance. An issuer is not required to obtain approval pursuant to Rule 312.03(c) in (i) any public offering for cash, or (ii) any bona fide private financing if the financing involves a sale of securities convertible into or exercisable for common stock, for cash, if the conversion or exercise price is at least as great as each of the book and market value of the issuer's common stock. NYSE has provided guidance that, in order for the exception for a public offering for cash to be applicable, the offering must

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[63] See e.g., Staff Interpretative Letter 2008-29.
[64] See Staff Interpretative Letter 2009-8.
[65] See NYSE Rule 452.

be a firm commitment underwritten offering.[66] NYSE staff have also taken the position that, with respect to an exchange offer of convertible debt for new convertible debt, the 20% test contained in Rule 312.03(c) only applies to an increase in the number of shares issuable under the new convertible debt over the existing convertible debt and that the 20% is not calculated based on the total number of shares issuable under the new convertible debt.[67]

Change of Control. Finally, NYSE Rule 312.03(d) requires stockholder approval prior to an issuance of securities that will result in a change of control of the issuer.

If stockholder approval is required under NYSE rules, the proposal must be approved by a majority of the votes cast and the total number of votes cast must represent more than 50% of all the securities entitled to vote on the proposal.[68]

Financial Viability Exemption. Both Nasdaq and NYSE provide an exemption from the stockholder approval requirements when a delay in containing stockholder approval would "seriously jeopardize the financial viability" of the issuer.[69] An issuer that is interested in proceeding with an exchange offer without stockholder approval should contact the exchange on which its securities are listed and file an application with the exchange. NYSE approval can take a few days but Nasdaq approval may take 7 to 14 days.[70]

Logistics and Timing Implications. If an issuer determines that stockholder approval is required under either Nasdaq or NYSE rules, the issuer will need to call a special meeting of stockholders, unless the timing of its annual meeting makes it possible for a proposal pursuant to the applicable rule to be included on the ballot for the annual meeting. The issuer will need to check its charter and bylaws as well as the laws of its jurisdiction of incorporation to determine how much notice must be given to stockholders of a special meeting and the procedures and timing requirements for setting a record date. The issuer will need to coordinate the scheduling of its stockholders' meeting with the timing of its exchange offer to ensure that stockholders vote on the proposal prior to the expiration of the tender offer.[71]

If stockholder approval is required, one key issue to address is the likelihood of receiving that approval. If the proposed restructuring would leave little value for stockholders, it may be overly optimistic to assume that stockholder approval will be obtained. In this situation, the issuer should consider using the financial viability exemption or a structure that does not require stockholder approval, either because it results in less than 20% of the equity being issued or it is a prepackaged bankruptcy.

Proxy Rules. In order to solicit proxies from stockholders for the approval of the issuance of securities pursuant to the applicable NYSE or Nasdaq rule, the issuer will need to file a proxy statement with the SEC. The principal SEC rules affecting the proxy statement are contained in Regulation 14A of the Exchange Act, which sets out the requirements that apply to a public company's communications that would cause a stockholder to grant, withhold or revoke a proxy. The issuer must deliver a proxy statement

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[66] Dhiya El-Saden and Candice S. Choh, *NYSE Corrects Guidance on Calculating Stockholder Approval Requirement in Convertible Debt Exchange Offers*, Gibson, Dunn & Crutcher LLP, March 26, 2009.
[67] *Id.*
[68] See NYSE Listed Company Manual Rule 312.07.
[69] See NYSE Listed Company Manual Rule 312.05 and Nasdaq Listing Rule 5635(f).
[70] See Sanjay Shirodkar and Michael Reed, *How to Do a Deal Without Shareholder Approval: The Financial Viability Exception*, July 29, 2008.
[71] The SEC requires that any conditions to the consummation of the exchange offer must be satisfied or waived prior to or at expiration of the tender offer period.

to its stockholders prior to soliciting any proxies.[72] The issuer will also need to comply with applicable state laws and its organizational documents with respect to the solicitation of proxies. Once the issuer has filed a preliminary proxy with the SEC, the SEC generally provides comments within 10 to 15 days but occasionally the review period has stretched to 30 days.[73] If the SEC has comments on the proxy, the length of time of the SEC review process will generally depend on the number and type of comments that the SEC has and could last several weeks. Once the issuer has cleared all comments with the SEC, the issuer can file its definitive proxy statement and commence mailing the proxy to stockholders. Issuers should discuss the timing of the stockholder meeting and the mailing of the proxy with its proxy advisors.

Disclosure Implications of Proxies. It is quite common in exchange offers for the issuer to revise the terms of the offer after the initial launch based on discussions with bondholders. If there are changes in the exchange offer after the issuer has filed and mailed a definitive proxy, the issuer will need to determine the appropriate means of communicating the updated information to stockholders[74] and the timing implications thereof. If the changes to the exchange offer are minor, the issuer may determine that a press release announcing the revised terms of the exchange offer, which would be filed with the SEC on a Form 8-K, are sufficient for keeping stockholders informed. However, if the changes are significant, the issuer may need to file and mail supplemental proxy materials. If changes are made to the exchange offer shortly before the special meeting, the issuer should consider whether to adjourn and postpone the meeting in order to allow stockholders sufficient time to consider the revised materials. Issuers should discuss the implications and timing of updated disclosure with their proxy advisors to determine the best course of action. Issuers and their counsel should consult with the Staff regarding any plan to update disclosure to avoid any last minute comments from the Staff which could disrupt the timing of the exchange offer.[75]

Question 7: Should the issuer consider a prepackaged bankruptcy as part of the process?

Problem of Holdout Bondholders. Holdout bondholders often raise serious issues in exchange offers. The holdout problem arises when bondholders have a preference (either real or asserted as a negotiating strategy) for retaining the existing securities. One or more bondholders may decide not to tender in the exchange offer hoping that a sufficient number of other bondholders tender so that the exchange offer is successful, decreasing the odds that the issuer pursues a restructuring in bankruptcy. The non-tendering bondholder would retain ownership of the existing securities, which may have a shorter time to maturity, a higher interest rate or other perceived advantages over the new securities. In addition, if bondholders generally perceive that there is a significant risk that other bondholders will not participate in an exchange offer and "share the pain," these bondholders may be less willing to participate in the exchange offer. A restructuring in bankruptcy can eliminate the holdout problem because, if the requisite votes are obtained, the reorganization will bind all bondholders of that class. Accordingly, depending on the terms of the exchange offer and the level of participation necessary for the successful completion of the exchange offer, the level of participation necessary to approve a bankruptcy plan may be lower, and issuers may want to consider a prepackaged or prearranged bankruptcy plan alternative. In a

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[72] See 17 C.F.R. § 240.14a-3 (2010).

[73] If the issuer has filed a registration statement with respect to the exchange offer, the review period could be longer.

[74] Rule 14a-9(a) requires that an issuer's proxy statement not contain any false or misleading information or omit any information necessary to correct any statement in any early communication with respect to the solicitation of a proxy for the same meeting or subject matter that has become false or misleading. 17 C.F.R. § 240.14a-9(a) (2010).

[75] There is no hard-and-fast rule with respect to the amount of time prior to a stockholder meeting that stockholders would need to receive revised proxy materials. In our experience, the SEC has required that issuers deliver the updated material to stockholders at least several days prior to the meeting. If the issuer is working with a tight timeline, it should consider whether it can expedite the printing, distribution and dissemination of the proxy materials.

prepackaged bankruptcy, the issuer typically solicits the necessary approval of bondholders to confirm a Chapter 11 plan of reorganization before filing a bankruptcy petition, and the required vote is at least two-thirds in amount and a majority in number of claims voting. This course of action allows the bankruptcy court to approve and implement the plan of reorganization in as little as a few weeks of the issuer filing for bankruptcy. In addition, the issuer may want to consider a prepackaged bankruptcy alternative if it thinks there is a significant chance of not obtaining any required stockholder approval because approval of a bankruptcy plan of reorganization does not typically require a stockholder vote. In a prearranged bankruptcy, the issuer does not solicit approval of the plan of reorganization prior to filing the bankruptcy petition, but will obtain the agreement of bondholders to vote in favor of the plan or reorganization once the bankruptcy commences and the debtor initiates the process of soliciting formal approval of the plan of reorganization.

Combination Exchange/Prepackaged Bankruptcy Solutions. Another potential route for an issuer is to combine an out-of-court exchange offer with a prepackaged bankruptcy. In such a situation, the issuer would offer to exchange existing securities for new securities at the same time it solicits acceptances of a prepackaged Chapter 11 reorganization plan. In a combination exchange offer/prepack, the exchange offer will often contain a condition that a high percentage of the existing notes will be tendered in order to minimize the threat of any holdout problem. If the issuer receives the minimum number of tenders, the exchange offer is completed outside of bankruptcy. However, if the minimum condition is not met, but the prepackaged plan receives the requisite approval, then the prepack will be accepted and the issuer will proceed with getting the prepack approved by the bankruptcy court. Combination exchange offer/prepacks are often attempted on the theory that if bondholders realize that the issuer only needs a two-thirds vote and believe the issuer will be successful in getting that vote, they may be more likely to tender in the exchange offer to avoid the costs associated with a restructuring in bankruptcy. Issuers who have recently conducted combination exchange offer/prepacks include subsidiaries of Trico Marine Services, Inc.,[76] C&D Technologies, Inc.[77] and NCI Building Systems, Inc.[78]

If an issuer desires to pursue a combination exchange offer/prepack, the issuer should evaluate separately whether the exchange offer and the prepack must be registered under the Securities Act or if there is an available exemption from registration. The combination exchange offer/prepack can be pursued with either a registered or an unregistered exchange offer.[79] A common exemption for bankruptcy-related plans is Section 1145. However, as discussed above under "Initial Structuring Questions—Question 4: Will the transaction have to be registered with the SEC under the Securities Act—Section 1145," the SEC does not believe that Section 1145 can be used to solicit votes on a bankruptcy plan prior to the issuer filing for bankruptcy. Issuers considering pursuing a prepackaged bankruptcy need to consider what exemption from registration may be available for solicitations of votes on the prepack. One possibility is for the issuer to solicit votes using the Section 3(a)(9) exemption and then completing the exchange pursuant to Section 1145.[80] Relying on Section 3(a)(9) may not be ideal in the combination exchange offer/prepack as the issuer may want to rely on paid solicitation agents to complete the restructuring.

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[76] See Trico Marine Services, Inc.'s Press Release dated March 1, 2011 (restructuring does not involve convertible debt).
[77] See C&D Technologies, Inc., Registration Statement (Form S-4) (October 20, 2010).
[78] See NCI Building Systems, Inc., Registration Statement (Form S-4) (September 10, 2009) (restructuring involved convertible debt).
[79] However, where the debt is convertible debt the issuer will need to determine whether it can solicit the requisite consents without creating a tender offer. If it is treated as a tender offer, then, as described above under "Initial Structuring Questions—Question 4: Will the transaction have to be registered with the SEC—Interplay between Tender Offer Rules and Securities Act Rules" the exchange offer may need to be registered.
[80] See SEC Division of Corporation Finance, Compliance and Disclosure Interpretations: Securities Act Sections (#Question 125.11) (June 4, 2010), *available at* http://www.sec.gov/divisions/corpfin/guidance/sasinterp.htm.

If the issuer can't identify an available exemption for the pre-bankruptcy filing solicitation of votes, the issuer will need to consider whether to register the offering with the SEC or move to another approach such as a prearranged bankruptcy.

Implementation Issues

A) <u>Other Securities Act Considerations</u>

Registration.

An issuer may choose to register an exchange offer where the outstanding securities are too widely held for the issuer to rely on a private placement exemption and where the issuer does not wish to comply with the restrictions on solicitation contained in Section 3(a)(9). An issuer cannot register the new securities on an existing or new S-1 or S-3 shelf registration statement but must instead file a registration statement on Form S-4.[81] If an issuer is eligible to use Form S-3, the issuer will be able to incorporate its prior filings under the Exchange Act into the registration statement on Form S-4 and avoid providing fulsome disclosure with respect to its business, property, legal proceedings, MD&A and certain stockholder matters.[82] The registration statement will include information about the issuer and the terms and conditions of the exchange offer. The description of the exchange offer will usually include:

- the reasons for the exchange offer;
- the conditions to the exchange offer;
- the expiration date and circumstances under which the issuer can amend, extend or terminate the exchange offer;
- the procedures for tendering securities and, if applicable, delivering consents;
- a description of the bondholders' withdrawal rights;
- name and contact information for the exchange agent, information agent and dealer manager;
- the fees and expenses associated with the exchange offer, including any solicitation fees or commissions;
- the terms of the new security; and
- the tax consequences of the exchange and owning the new securities.

If the issuer is seeking the consent of bondholders to modify the terms of the indenture governing the existing securities, the issuer would typically include the following information regarding the consent solicitation:

- a description of the proposed amendments to the indenture;
- the level of consent required to effect the proposed amendments;
- the effect of the proposed amendments on the rights of the bondholders;
- any consent payments; and
- whether the success of the consent solicitation is a condition to the exchange offer.

The issuer cannot commence the exchange offer until the registration statement is on file with the SEC and cannot consummate the exchange offer until the SEC has declared the registration statement

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[81] See General Instruction A to Form S-4.
[82] See Form S-4.

effective.[83] SEC review and clearance of the registration statement can take several months depending on the level of review. As discussed below, an issuer may launch an exchange offer that is a tender offer in which the consideration consists, solely or partially, of registered securities, by delivering a preliminary prospectus to bondholders once the registration statement has been filed with the SEC.[84] Commencing an exchange offer prior to effectiveness of the registration statement has the advantages of starting the minimum 20 business day period required under the tender offer rules prior to SEC clearance of the registration statement, and avoiding the need to file a post-effective amendment or a new registration statement if the exchange offer is amended in any material respect after launch but prior to effectiveness.

Amendments.

It is extremely important for counsel to understand the various scenarios in which the registration statement could be amended, and how these amendments and any associated Staff review could delay the launch or completion of the exchange offer. Any delay or interruption in the offer process increases market risk and general deal risk for the issuer. These amendment issues are discussed below.

Pre-Effective Amendments. If the issuer determines prior to the effectiveness of its registration statement that it is necessary or desirable to change the terms of the proposed exchange offer, the issuer must amend its registration statement and, if it has commenced its tender offer, the Schedule TO. In order to amend its registration statement, the issuer must file a pre-effective amendment to the Form S-4. The pre-effective amendment will generally require the issuer to obtain a new consent of its auditors, which can impact timing. The Schedule TO is amended by filing a revised Schedule TO. The Schedule TO should contain an explanatory note describing the reason for the amendment. If the issuer has filed and mailed a definitive proxy, it must also file and deliver updated proxy materials as discussed above under "Initial Structuring Questions—Question 6—Will the issuer need stockholder approval for the exchange offer—Disclosure Implications of Proxies."

Post-Effective Amendments. If the SEC has declared a registration statement effective and the issuer determines that it is necessary or desirable to amend certain terms of the exchange offer, the issuer may need to file a post-effective amendment to the registration statement. A post-effective amendment is required if material changes have been made to the terms of the securities registered, the terms of the exchange offer, the description of the issuer's business or if the issuer must file additional exhibits.[85] A post-effective amendment filed solely to add exhibits will become effective upon filing.[86] If the post-effective amendment does not become effective upon filing, the SEC must declare the post-effective amendment effective prior to the issuance of new securities pursuant to the exchange offer. Post-effective amendments become effective only upon a determination of the SEC and the issuer cannot file a request for acceleration under Rule 461.[87]

Post-Effective Registration of Additional Securities. Occasionally in a registered exchange offer the issuer will need to register additional securities, either because the issuer has decided to improve the terms of the offer, or increase the percentage of the outstanding securities to be exchanged, or both. If the issuer's registration statement has become effective and the issuer determines that it needs to register an additional amount of the same securities previously registered, it may be able to quickly effect such a registration using a post-effective amendment under Rule 462 under the Securities Act. Under Rule 462, the post-effective amendment will become effective upon filing if: (i) the amendment is for the

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[83] See Securities Act of 1933 § 5(a) and 5(b), 15 U.S.C. §77e(a) and e(b) (2006).
[84] See 17 C.F.R. § 240.13e-4(e)(2) (2010).
[85] See Item 22 of Form S-4.
[86] See 17 C.F.R. §230.462(d) (2010).
[87] See*,* i.e. 17 C.F.R. §230.475 (2010).

registration of additional securities of the same class as were included in the registration statement; (ii) the amendment is filed prior to the time confirmations are sent or given; and (iii) the amendment registers additional securities in an amount and at a price that represent no more than 20% of the maximum aggregate offering price set forth in the "Calculation of Registration Fee" table in the registration statement.[88]

An issuer launching an offer for a maximum number of securities that is less than all of the outstanding securities should consider whether it should register an additional amount of securities up front, in order to allow the issuer to stay within the 20% threshold to use an immediately effective post-effective amendment under Rule 462 if the issuer subsequently amends the offer to include additional securities. This would allow the issuer to increase the size of its offer without incurring the delay and market risk associated with filing a new registration statement for the incremental securities.[89] If the issuer determines that it is necessary to register additional securities but does not fall within the 20% rule, the issuer can register the additional securities on a new registration statement and then rely on Rule 429, discussed below under "Registration of Additional Classes of Securities" with respect to the prospectus.

Registration of Additional Classes of Securities. If the issuer amends the exchange offer to add additional consideration in the form of a new security, such as adding an equity sweetener to a debt-for-debt exchange offer, and the registration statement has not yet been declared effective, the issuer can file a pre-effective amendment to the registration statement adding such security and paying the applicable filing fee.[90] If the registration statement has been declared effective, the new security must be registered on a separate registration statement and cannot be registered through the use of a post-effective amendment.[91] In this case, the issuer can use the prospectus that forms a part of the subsequent registration statement pursuant to Rule 429. If an issuer relies on Rule 429, it must include an explanatory note on the prospectus cover containing the registration number of the initial registration statement and the combined prospectus, upon effectiveness of the subsequent registration statement, will act as a post-effective amendment to the initial registration statement.[92]

Written Communications.

Once the issuer has filed a registration statement relating to an exchange offer, any written communication relating to the exchange offer is not required to satisfy the requirements of Section 10 of the Securities Act as long as the communications are filed in accordance with Rule 425 and the communications contain a prominent legend urging investors to read the documents filed with the SEC.[93] Types of communications covered by this rule include press releases announcing the proposed restructuring and providing additional information with respect to the restructuring and investor slides to be used at roadshows. The issuer can satisfy the requirements of Rule 165 by filing any press releases and other communication relating thereto on a Form 8-K and checking the box to file simultaneously

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[88] See 17 C.F.R. §230.462(b) (2010).

[89] For example, if an issuer is contemplating an exchange offer for a maximum amount of $100 million out of $125 million of outstanding securities, the issuer should consider registering more than the contemplated $100 million maximum in case the issuer later decides to increase the exchange offer to all $125 million of the outstanding securities. In that situation, if the issuer only registered $100 million of securities, it would only be able to increase the offering to $120 million and stay within the 20% threshold. If, however, the issuer registered $104.5 million securities as part of its pre-effective registration, the issuer could subsequently increase the size of the exchange offer to $125 million under Rule 462(b) without delay by filing an immediately effective post-effective amendment to its registration statement.

[90] This is one of the advantages of launching an exchange offer prior to effectiveness of the registration statement as described under "Tender Offer Timing."

[91] See 17 C.F.R. § 230.413 (2010).

[92] See 17 C.F.R. § 230.429(b) (2010). The subsequent registration statement will be subject to SEC review. However, the issuer can relaunch the exchange offer using the preliminary prospectus filed as part of the subsequent registration statement to avoid having to wait until the SEC completes its review to start the tender offer clock running.

[93] See 17 C.F.R. § 230.165 (2010).

under Rule 425. Any communications filed under Rule 425 will also be deemed filed under Rule 13e-4 in connection with an issuer tender offer.[94]

Non-Registered Exchanged Offers—Holding Period for Restricted Securities.

As discussed above with respect to Question 4, securities received in an exchange offer pursuant to Section 4(2) and, in certain circumstances, pursuant to Section 3(a)(9), will be restricted securities. Rule 144 promulgated pursuant to the Securities Act provides an exemption for the sale of restricted securities. Among other requirements, Rule 144 requires that the holder of the securities has held such securities for a certain period of time. If the issuer is subject to the reporting requirements of the Exchange Act and is current in filing its reports with the SEC, the holding period is six months; otherwise the holding period is one year.[95] With respect to an exchange offer pursuant to Section 4(2), the holding period commences on the closing of the exchange offer. Securities received in a Section 3(a)(9) exchange offer will only be restricted if the existing securities were restricted and in that case, the holding period prior to the exchange offer can be combined with the holding period after the exchange offer in order to meet the requirements of Rule 144. Rule 144 permits holders of restricted securities to aggregate the holding periods of prior owners of restricted securities in order to satisfy the holding period. The rule also permits holders to "tack" the holding period of existing securities with the holding period of new securities of the same issuer received in exchange for the existing security.[96]

Additional Guarantors or Collateral.

If the convertible debt to be issued in the exchange offer is guaranteed by one or more of the issuer's subsidiaries or if the subsidiaries provide collateral with respect to the debt, such subsidiaries will be treated as registrants and must be included in the issuer's registration statement. In addition, the inclusion of subsidiary guarantees may trigger the requirement to provide condensed consolidating financial information with separate columns for the parent, the guarantor subsidiaries and non-guarantor subsidiaries set forth in Rule 3-10 of Regulation S-X.[97] If an issuer has not previously prepared such financial information, the preparation and review by the issuer's accountants of such information can cause a substantial delay in the commencement of the exchange offer.

Liabilities under the Securities Act.

In a registered exchange offer, the issuer will be subject to the liability provisions of Section 11 and Section 12 of the Securities Act in addition to liability under Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder. An issuer engaged in an unregistered offering will still have liability under Section 10(b) or Rule 10b-5.[98]

B) Exchange Act Considerations

Schedule TO.

As previously discussed, if the exchange offer is also a tender offer, the issuer must comply with the provisions of Rule 13e-4. Rule 13e-4 requires that the issuer file a tender offer statement on Schedule TO with the SEC as soon as practicable on the date of commencement of the exchange offer. Typically, the issuer would not file a Schedule TO when it files its registration statement but would wait to file a Schedule TO until it is ready to launch the exchange offer. The issuer is also required to file:

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94 See Note 2 to 17 C.F.R. §230.425 (2010).
95 See 17 C.F.R. §230.144(d)(1) (2010).
96 See 17 C.F.R. §230.144(d)(3)(ii) (2010).
97 17 C.F.R. §230.3-10 (2010).
98 Discussion of the Securities Act liability provisions is beyond the scope of this article.

- any written communication relating to the tender offer as soon as practicable on the date of the communication;
- an amendment to the Schedule TO reporting promptly any material changes in the information previously disclosed; and
- a final amendment to the Schedule TO reporting promptly the results of the tender offer.

As discussed above, the issuer can satisfy the requirement to file any written communication relating to the tender offer by filing a Form 8-K and checking the box to file simultaneously under Rule 425. If the issuer makes any pre-commencement communications relating to the tender offer, the issuer must file such communication on Schedule TO, marking the box on the cover to note that such materials are pre-commencement communications. Any pre-commencement communications must include a prominent legend advising bondholders to read the tender offer statement when it becomes available.[99]

Tender Offer Timing.

As described above, the tender offer rules require that tender offers be open for 20 business days.[100] For an issuer attempting to complete a restructuring as quickly as possible, it is important to understand the timing requirements of the tender offer rules and how days are counted for purposes of these rules. A tender offer commences at 12:01 a.m. on the date the issuer publishes, sends or gives bondholders the means to tender.[101] With respect to a registered tender offer, the tender offer is deemed to be published, sent or given to bondholders when a registration statement containing all of the required information has been filed and a preliminary prospectus and letter of transmittal is delivered to bondholders.[102] In cases where the outstanding securities are held through the Depository Trust Company (**"DTC"**), with DTC's nominee, Cede & Co., as the sole registered holder of the securities, it is common practice to treat delivery of a preliminary prospectus along with a letter of transmittal to DTC prior to the close of business as being sufficient to commence the tender offer. An issuer launching a tender offer by delivering a preliminary prospectus should make sure that the preliminary prospectus is a complete prospectus as any material changes will require that the tender offer remain open for an additional period of time. Rule 13e-4(e)(3) requires that the tender offer remain open for (i) five business days for a prospectus supplement containing a material change other than price or share levels, (ii) ten business days for a prospectus supplement that is part of a post-effective amendment or that contains a change in price, the amount of securities sought, the dealer's solicitation fee or other similar significant change, or (iii) twenty business days for a revised prospectus if the initial prospectus was materially deficient. In order to avoid unanticipated inquiries from the Staff late in the tender offer period, if an issuer is in doubt about whether a proposed amendment is a 5 day or a 10 day change, the issuer should consult with the Staff.

In counting the required 20 business days, and any other applicable tender offer time period, the day on which the preliminary prospectus is delivered to the registered holders is counted as the first day of the period as long as the prospectus is delivered prior to the close of business.[103] Otherwise, the following business day would be considered the first day of the tender offer. The tender offer may expire on the 20th business day following commencement as long as it expires at 11:59 p.m. (eastern time) on that day.

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[99] See Instruction 3 to 17 C.F.R. §240.13e-4(c) (2010).
[100] The SEC has, through various no-action letters, noted that tender offers for investment grade non-convertible debt may be conducted in less than 20 business days if certain conditions are met. See, e.g., Times Mirror Co., SEC No-Action Letter, 1994 WL 637182 (Nov. 15, 1994); Goldman, Sachs & Co., SEC No-Action Letter, 1993 WL 497126 (Dec. 3, 1993); and Merrill Lynch, Pierce, Fenner & Smith Inc., SEC No-Action Letter, 1993 WL 270676 (July 19, 1993).
[101] 17 C.F.R. § 240.13e-4(a)(4) (2010).
[102] See 17 C.F.R. § 240.13e-4(e)(2) (2010).
[103] Close of business is generally considered to be 5:30 p.m. eastern time. However, if the issuer is delivering the prospectus to DTC, delivery must be made during DTC's business hours, which means no later than 5 p.m. eastern time.

Since an issuer must announce any extension of the tender offer by 9 a.m. (eastern time) on the day following expiration, an issuer may decide to have its tender offer expire at 5 p.m. (eastern time) on the 21st business day after commencement to give its management additional time to consider an extension.[104]

Variable Pricing Issues.

Typically an issuer will determine prior to the launch of the exchange offer the amount of securities it is willing to exchange and the ratio at which it will accept such securities for exchange. Where the exchange offer is not based on fixed pricing, such as when the exchange ratios are determined using a modified Dutch auction or volume weighted average pricing, the issuer will need to make sure that any variable pricing does not violate Rule 13e-4.

Modified Dutch Auctions. In some cases, an issuer may specify the amount of securities it is willing to accept for exchange but provide for the price to be determined using a modified "Dutch auction" structure. In a modified "Dutch auction," the issuer will set a range of exchange ratios at which a bondholder may tender its securities, and the final exchange ratio will be the ratio at which the issuer can exchange all of the securities it desires to exchange (or such less amount of securities as is tendered). The SEC has provided guidance that modified "Dutch auction" tender offers are permitted under Rule 13e-4 as long as the range of exchange ratios is narrow (as described below) and:

- the tender offer materials disclose the minimum and maximum consideration to be paid;
- the issuer accepts the securities on a pro rata basis with all securities participating equally;
- withdrawal rights are available throughout the tender offer period;
- the issuer announces the exchange ratio promptly, if determined prior to the expiration of the exchange offer; and
- the highest price paid to any bondholder in the tender offer is paid to all bondholders tendering in the offer.[105]

An issuer will need to determine the range of exchange ratios at which it is willing to accept the securities for exchange. The price range is typically narrow, often no more than 15% of the minimum price. However, the SEC has allowed modified "Dutch auctions" to be completed at or in excess of 20% of the minimum price.[106]

Volume Weighted Average Pricing. Alternatively, an issuer may wish to determine the exchange ratio or conversion price based on a volume weighted average of recent trading prices for the issuer's common stock. An issuer should be careful to structure a formula that complies with the requirements for disclosure of tender offer information to bondholders[107] and for the length of time an offer remains open after any material changes.[108] The SEC has taken a no-action position with respect to the use of a volume weighted average mechanism for determining exchange offer pricing so long as, among other requirements:

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[104] Otherwise the issuer's management will need to decide between 11:59 p.m. (eastern time) and 9:00 a.m. (eastern time) whether to extend the exchange offer.

[105] See note 64 in SEC Release No. 34-23421 (July 17, 1986).

[106] See, e.g., Cardiome Pharma Corp. filed on September 1, 2009 (20%); Tucows Inc. filed on May 13, 2009 (25%); B+H Ocean Carriers, Ltd. filed on October 20, 2008 (25%); Cyberoptics Corp. filed on June 30, 2008 (25%); Steven Madden Ltd. filed on February 20, 2008 (21.2%); and Looksmart, Ltd. filed on January 15, 2008 (22.1%).

[107] See 17 C.F.R. § 13e-4(d)(l) (2010).

[108] See 17 C.F.R. § 13e-4(f)(ii) (21010) and 17 C.F.R. § 14e-1(b) (2010).

- the underlying securities are listed on a national securities exchange;
- the formula for determining the offer price is disclosed in the tender offer materials and the formula will remain fixed throughout the duration of the offer or, if there is a change in the formula, the tender offer will remain open for at least 10 business days;
- the purchase price will be subject to a minimum, which will be disclosed in the tender offer materials;
- the tender offer materials will disclose the number of trading days that will be used in determining the volume weighted average and the number of trading days will be at least 10; and
- the final purchase price will be determined at least two business days prior to the expiration of the tender offer and will be announced prior to the opening of trading on the second business day prior to expiration.[109]

Going Private Rules.

In certain situations, a tender offer may also fall within the "going private" rules set forth in Rule 13e-3. A going private transaction is defined as any (i) purchase of any equity security of an issuer by the issuer or an affiliate of the issuer, (ii) a tender offer for any equity security made by an issuer or an affiliate of the issuer or (iii) a solicitation subject to Regulation 14A or the distribution of an information statement subject to Regulation 14C in connection with a merger, consolidation, reorganization or similar corporate transaction that has a reasonable likelihood or purpose of (x) reducing the number of holders of the equity securities below 300 or (y) causing the equity securities to no longer be listed on a national securities exchange.[110] Rule 13e-3 would therefore apply to convertible debt exchange offers if the convertible debt is listed on a national securities exchange.

Issuers contemplating exchange offers that fall within the definition of a going private transaction subject to Rule 13e-3 may be able to rely on the exception set forth in Rule 13e-3(g)(2), which provides that Rule 13e-3 does not apply to any transaction in which the issuer only offers or delivers to bondholders an equity security and:

- the equity security received by the bondholders has substantially the same rights as the equity security that the bondholders are surrendering;
- the equity security received is registered pursuant to Section 12 of the Exchange Act or the issuer is required to file reports pursuant to Section 15(d) of the Exchange Act; and
- if the security surrendered was either listed on a national securities exchange or authorized to be quoted in an interdealer quotation system of a registered national securities association, the equity security received is also either so listed or authorized to be quoted.

The Staff has taken no-action positions in connection with the proposed use of the Rule 13e-3(g)(2) exemption in exchange offers for convertible securities where the new equity security had a higher conversion rate, voting rights equal or superior to and liquidation rights only slightly lower than those of the equity security surrendered[111] and where the new equity security had a different interest rate, maturity date, conversion rate and sinking fund and optional redemption terms but both the new equity securities and the equity securities surrendered would "be entitled to an annual interest payment, convertible into

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[109] See Towers Watson Co., SEC No-Action Letter (May 17, 2010); Thermo Fisher Scientific Inc., SEC No-Action Letter (November 13, 2009); and TXU Corporation, SEC No-Action Letter (September 12, 2004).
[110] See 17 C.F.R. § 240.13e-3(a)(3) (2010).
[111] See Savin Corp., SEC No-Action Letter (June 28, 1988).

[common stock of the issuer], subject to sinking fund requirements, subordinated to Senior Debt…."[112] On the other hand, the Staff has refused to take a no-action position when the equity securities surrendered were currently convertible and the new equity securities would not be immediately convertible upon issuance.[113]

If an exchange offer is subject to Rule 13e-3, the issuer must file a Transaction Statement on Schedule 13E-3 at the commencement of the exchange offer. Schedule 13E-3 contains disclosure requirements similar to those required for an issuer tender offer pursuant to Rule 13e-4 but also requires the issuer to state whether it reasonably believes that the exchange offer "is fair or unfair to unaffiliated bondholders" and discuss "in reasonable detail the material factors upon which the belief….is based."[114] The issuer is also required to state whether the majority of independent directors have retained an independent representative to act on behalf of the unaffiliated bondholders and/or report on the fairness of the exchange offer.[115]

Section 13 Ownership Issues.

Sections 13(d) and 13(g) of the Exchange Act require reporting of beneficial ownership by any "person" with beneficial ownership of more than 5% of any listed equity security. Sections 13(d) and 13(g) define a "person" as including a "group."[116] "Beneficial ownership" includes the contractual right to acquire the underlying securities within 60 days. Accordingly, owning convertible debt may cause the holder to be treated as the beneficial owner of the underlying equity securities. This creates several issues in restructurings of convertible debt, which is discussed below.

Section 13 Group Issues. If an issuer is negotiating with bondholders in advance of or during an exchange offer for convertible debt, the bondholders should remain aware of whether any agreements could be viewed as having created a "group" for Section 13 purposes. A group is formed when two or more persons agree to act together for the purpose of acquiring, holding, voting or disposing of equity securities of an issuer.[117] Any member of a group is deemed to have a beneficial interest in the equity securities held by each other member of the group. If the group owns or acquires ownership of more than 5% of the equity securities, each member of the group must comply with Sections 13(d) and 13(g) of the Exchange Act, which as noted above require reporting of beneficial ownership, and if the group owns or acquires ownership of more than 10% of the equity securities, each member must comply with the short-swing profit rules of Section 16(b).[118] The issuer negotiating with bondholders should be aware that the bondholders will be concerned about entering into any agreements that would make them part of a Section 13 group.

Change of Control Put Rights. Another related issue that issuers must keep in mind is whether any change-of-control triggers in existing indentures or credit agreements or new indentures or credit agreements put in place as part of the restructuring could be triggered. It is common in indentures for convertible debt to provide that holders of the debt will have the right to require the issuer to repurchase the debt if, as a result of any transaction, any "person" or "group" acquires beneficial ownership of more than a specified percentage of the issuer's outstanding stock (for example, 51%). This creates the risk that holders in the exchange will accumulate large enough positions of equity or convertible debt that

[112] See Trans World Airlines, SEC No-Action Letter (Aug. 6, 1980).
[113] See Damson Oil Corp., SEC No-Action Letter (May 4, 1984).
[114] See Schedule 13E-3, Item 8.
[115] See Schedule 13E-3, Item 8.
[116] Securities and Exchange Act of 1934 § 13(d)(3) and 13(g)(3), 15 U.S.C. 78m(d)(3) and 15 U.S.C. 78m(g) (2006).
[117] See Securities and Exchange Act of 1934 § 13(d), 15 U.S.C. §78m(d) (2006).
[118] See Securities and Exchange Act of 1934 § 13(d) and 16(b), 15 U.S.C. §78m(d) and §78p(b) (2006).

they could intentionally or unintentionally trip these provisions. The issuer and its counsel should review its current debt instruments to determine whether any change of control provisions could be triggered based on the accumulation of securities by a group. If the change of control provisions can be triggered by group ownership, the issuer will need to make sure that any agreements entered into by bondholders in connection with the exchange offer do not trigger the change of control provisions. In addition, in order to minimize the risk that post-exchange holders of convertible debt could attempt to create a change of control event by voluntarily forming a Section 13 group with aggregate ownership in excess of the change of control threshold, the issuer should consider amending the change of control definitions in any new indenture to eliminate put rights created solely by "group" status.

Limiting Conversion Rights to Manage Section 13 Issues. If the new securities issued in the exchange offer have a more favorable conversion price than the existing securities, bondholders with large enough positions in the convertible debt may have a significant increase in the beneficial ownership of the underlying security and become subject to Section 13, including the requirement to file a Schedule 13D or 13G. Many times bondholders will not want the additional burden of complying with Section 13 and may be reluctant to participate in an exchange offer that would have this effect. In that case, the issuer and its counsel should consider adding a "conversion blocker" to the indenture governing the convertible debt to be issued in the exchange offer. The conversion blocker would provide that a bondholder cannot convert its convertible debt if such conversion would cause the holder together with its affiliates to become subject to Section 13. The bondholder would be able to convert an amount of debt that would keep it below the applicable threshold and would then be able to convert additional debt after selling all or a portion of its underlying securities.

C) ***Indenture Issues***

Approvals Under Current Indentures

Prior to engaging in an exchange offer, an issuer should review the indentures and credit agreements governing all of its existing debt, including the debt subject to the exchange offer, to determine whether any approvals are needed under the existing indentures or credit agreements in order to issue the new debt in the exchange offer. An existing indenture may, for example, restrict the creation and issuance of new senior debt or new debt with shorter maturity dates than existing debt. If approvals are necessary under one or more existing indenture, the issuer will need to solicit the consent of the holders of such existing debt and the exchange offer should be conditioned upon the receipt of the necessary consents.

Exit Consents

In addition to any required approvals, an issuer may seek to encourage participation in its exchange offer by modifying the provisions of the existing indenture by, for example, eliminating the restrictive covenants or security contained in the existing indenture. Such modification is usually accomplished by conducting a consent solicitation in conjunction with the exchange offer. Prior to undertaking a consent solicitation, an issuer should carefully review the indenture governing the existing securities to determine whether the relevant provisions can be amended and the requisite level of consent required for each of the proposed amendments.[119]

Typically, the issuer will provide that by tendering its securities, a bondholder also consents to the proposed amendments to the indenture governing the existing securities. Therefore, if the requisite

[119] Indentures typically provide that certain provisions may only be amended with unanimous consent. In addition, Section 316(b) of the Trust Indenture Act of 1939, as amended (the "TIA"), prohibits exit consents relating to TIA-qualified indentures from: (i) amending the maturity date; (ii) reducing the principal amount; (iii) changing the form of payment; or (iv) making other economic changes to the terms of the bonds held by non-exchanging bondholders. See Trust Indenture Act of 1939 §316, 15 U.S.C. §77ppp (2006).

principal amount of existing securities are tendered in the exchange offer, the indenture governing the existing securities will be amended as proposed by the issuer. There is no legal requirement for an issuer to compensate its bondholders for consenting to the proposed amendments. However, in certain situations, issuers provide additional incentives to induce the bondholders to approve the proposed amendments, typically in the form of a cash payment or an increase in the interest rate on the new debt. Since exchange offers for convertible debt are often subject to the tender offer rule requirement that the same consideration be paid to all bondholders,[120] an issuer conducting such an exchange offer may not provide for an early consent fee that only provides for payment to bondholders that tender prior to a certain date.

Courts have found consents provided in a consent solicitation to be enforceable in situations where the bondholders that are bound by the amendments have been offered the same consideration.[121] An issue with exit consents may arise in connection with a partial tender offer. Courts upholding the validity of exit consents have done so in connection with offers for all securities of a particular class where a consenting bondholder would not continue to hold the existing security as modified. However, in a partial tender offer, it is possible that a consenting bondholder may be forced to continue to hold the existing security which has been modified by the consent solicitation.[122]

Trust Indenture Act

In a registered exchange offer or an exchange offer exempt pursuant to Section 3(a)(9) or Section 1145 where the consideration consists partially or completely of long-term debt securities, an indenture must be qualified under the TIA. Some issuers may already have in place a qualified open-ended indenture that can be used in connection with the exchange offer; otherwise, the issuer will need to prepare a new indenture and qualify that indenture under the TIA. In order to qualify an indenture, the issuer must file the following documents with the SEC: (i) a registration statement; (ii) a Form T-1 signed by the trustee; (iii) a copy of the applicable indenture; and (iv) a cross-reference sheet showing the location in the indenture of the TIA provisions. The cross-reference sheet is typically included in the indenture. An indenture is deemed to be qualified when the indenture complies with the various requirements of the TIA and the registration statement concerning the debt becomes effective.[123] In an unregistered exchange offer, the issuer must file a Form T-3 signed by the trustee with the SEC. The exchange offer may be launched after filing of the application for qualification.[124]

D) Blue Sky Rules

An issuer also must comply with the "blue sky" securities rules of the various states in which the exchange offer will be made. The issuer will need to either find an exemption in each applicable state or make the required filing. For issuers with publicly listed equity, an exemption should be available in most states.

Accounting and Tax Issues

The issuer should consult its accounting and tax advisors to determine the accounting and tax treatment of the proposed exchange offers. Several issues are noted below.

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[120] See 17 C.F.R. §240.13e-4(f)(8)(ii) (2010).
[121] See, i.e., *Katz v. Oak Industries*, 508 A.2d 873 (Del. Ch. 1986) and *Kass v. Eastern Airlines*, 1986 Del. Ch. LEXIS 486, 12 Del. J. Corp. L. 1074 (Del. Ch. Nov. 1986).
[122] See *Debt Repurchases and Amendments: U.S. Securities Law Considerations*, Linklaters, October 2008.
[123] See Trust Indenture Act of 1939 §309, 15 U.S.C. §77iii (2006).
[124] See Trust Indenture Act of 1939 §306(c), 15 U.S.C. §77fff(c) (2006).

Accounting Issues

Two accounting issues that often arise in connection with convertible debt is the accounting treatment of the exchange offer itself and accounting issues associated with the terms of the convertible debt.

The accounting treatment of exchange offers is often complex. An exchange offer may be considered to be a "troubled debt restructuring"[125] or an extinguishment in which case the issuer will recognize a gain for accounting purposes upon consummation of the exchange offer and may write off the existing securities issuance costs thus reducing the gain recorded. The gain would be equal to the difference between the fair value of the new securities and the carrying value of the securities immediately prior to the consummation of the exchange offer. Alternatively, the transaction may be accounted for as a modification, in which case the new securities would be recorded at the same carrying value as the existing securities and no gain or loss would be recorded.

The accounting treatment of the convertible debt can also be complex. For example, the Financial Accounting Standards Board has issued a Staff Position ("**APB 14-1**") that requires issuers of convertible debt that may be settled partially or wholly in cash to separately account for the liability and the equity components of such debt.[126] Under the APB 14-1, the issuer is required to determine the carrying amount of the liability component by measuring the fair value of a similar liability (including any embedded features other than the conversion option) that does not have an associated equity component and to determine the carrying amount of the equity component represented by the embedded conversion option by deducting the fair value of the liability component from the initial proceeds ascribed to the convertible debt instrument as a whole. These determinations can be difficult and time consuming.

Cancellation of Indebtedness Income

The issuer will need to determine whether the terms of the new securities represent a significant modification of the existing securities. If the new securities represent a significant modification, the exchange generally will be considered a taxable exchange and may trigger cancellation of indebtedness income ("**CODI**") for the issuer. Treasury Regulations generally consider a significant modification to be an economically significant change in the legal rights and obligations under a debt instrument and a determination thereunder is based on a facts and circumstances test.[127] The following changes may be considered to be significant modifications: a change in the interest rate, an extension of the maturity date, a reduction in principal amount or a change in obligors.[128] If the exchange offer is taxable, the issuer generally will recognize CODI in an amount equal to the adjusted issue price of the existing securities minus the issue price of the new securities plus any cash or property paid by the issuer in the exchange if such amount is a positive amount.[129] The amount of CODI has the potential to be substantial and an issuer should consider the impact of any CODI on its financials statements and tax obligations.

Conclusion

As suggested by the introduction to this article, planning is everything when considering a restructuring of convertible debt. Issuers should involve counsel early in the process to assist them in making sure the proposed debt restructuring can be structured in a manner that both maximizes the chances of a successful outcome and complies with applicable securities laws and stock exchange requirements. With

[125] See Accounting Standards Codification 470-60-55.
[126] See Financial Accounting Standards Board Staff Position APB 14-1, adopted on May 9, 2008.
[127] See 26 C.F.R. §1.1001-3(e)(1) (2010).
[128] See 26 C.F.R. §1.1001-3(e) (2010).
[129] See Internal Revenue Code §108(e)(10), 26 U.S.C. §108(e)(10) (2006).

advanced planning and careful execution, issuers can utilize convertible debt exchange offers as an effective way to reduce interest payments and lengthen the maturities of outstanding debt.