COVID-19: Bond Buybacks and Liability Management in Asia

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As the COVID-19 pandemic continues to take its economic toll, many companies with outstanding bonds worry that they will not have enough cash on hand to repay their bonds on their stated maturity date, or that their bond covenants are, or may soon become, under pressure. These companies may benefit from amending their bonds to defer payment, achieve greater covenant flexibility or make other advantageous changes. For other companies, the decline in the bond markets presents an opportunity to repurchase their bonds at a significant discount.

"Liability management" is an umbrella phrase for a variety of techniques that companies can use to manage their outstanding bonds. These include redemption, open market repurchases, tender offers, exchange offers and consent solicitations. This article provides an overview of key legal considerations applicable to liability management transactions.

Types of Liability Management

Redemption: Bonds that have a call feature and are past their no-call period can be redeemed before their stated maturity date in accordance with the terms of the indenture or trust deed governing the bonds.

Open market repurchases: Open market repurchases are where a company acquires its outstanding bonds by purchasing them on the open market (typically the stock exchange on which they trade, if any) or through privately negotiated transactions with individual bondholders. Open market repurchases are typically used by companies seeking to repurchase only a limited amount of their outstanding bonds.

Tender offer: In a tender offer, the company makes a public offer to purchase all or part of its outstanding bonds, typically (though not always) for cash.

Exchange offer: In an exchange offer, a company makes an offer to its outstanding bondholders to exchange its existing bonds for newly issued debt or equity. This provides companies that do not have the cash necessary to redeem or repurchase their outstanding bonds a way to extend the maturity date and/or amend the principal amount, interest rate, covenants or other provisions of their debt.

Consent solicitation: In a consent solicitation, a company solicits the consent of bondholders to waive or amend the terms of the bonds to make them more favorable to the company, often in exchange for an incentive fee paid to holders. Consent solicitations can be undertaken as stand-alone exercises to introduce new terms to the bond, waive past breaches or provide companies with breathing room by relaxing particular covenants, or they can be combined with tender or exchange offers to incentivize bondholder participation.

Contractual Considerations

As a starting point, companies should review their debt agreements to determine whether the contemplated transaction would breach any of their debt covenants. Most high-yield indentures permit voluntary bond repurchases. However, in addition to the indenture for the bonds to be redeemed or repurchased, companies should also review their other debt agreements, as those may limit the extent to which bonds can be repurchased or repaid. For example, if the bonds are subordinated to other debt, their repurchase would likely constitute a "restricted payment" both under credit agreements and under bond indentures for their senior debt. Moreover, credit agreements for bank debt often prohibit repayment of other debt, even *pari passu* debt, absent specific baskets for this purpose. Further, some credit agreements may require *pro rata* prepayment of the loan upon prepayment of other equally and ratably secured debt.

Note that under a typical high-yield indenture, once notes are repurchased and cancelled, companies may lose the ability to reincur that debt.

Redemption

If a company's bonds contain a call feature and the bonds are past their no-call period, the company can redeem the bonds in accordance with terms of the redemption provision. The process for redeeming the bonds, including the notice period, contents of the notice and the redemption price, will be set forth in the indenture or trust deed for the bonds. The redemption price generally reflects the yield to maturity of the bonds, calculated at their face value plus the present value of future interest payments. Given that COVID-19 has resulted in a broad decline in bond prices, many companies may be able to retire debt more cheaply through open market repurchases or tender offers than through redemption provisions.

Open Market Repurchases

A company seeking to repurchase a limited portion of its bonds may do so through open market repurchases, either directly or by appointing a bank to carry out repurchases on its behalf. Open market repurchases have the advantages of being relatively quick and having low transaction costs. However, companies should be mindful of applicable disclosure requirements and tender offer rules prior to engaging in any open market repurchases.

The anti-fraud provisions of the U.S. federal securities laws, and their counterparts in many foreign jurisdictions, impose restrictions on the purchase or sale of securities while in possession of material nonpublic information. The rules of any stock exchange on which bonds are listed are likely to impose similar restrictions, including Rule 323 of the SGX Listing Manual for bonds listed on the SGX. Some stock exchanges also require specific disclosure of the redemption and cancellation of debt securities over a specified threshold (every 5 percent of the total principal amount at the time of listing, in the case of the SGX).

Prior to making open market repurchases, companies should analyze whether they have material nonpublic information. Such information could include unreleased financial results, unannounced material transactions or, given the ongoing COVID-19 pandemic, the impact or the expected impact of COVID-19 on the company.[1] Companies should take into account their insider trading policies and any associated trading windows in analyzing whether they possess material nonpublic information. Companies should also consider whether the launch of the bond repurchase program is itself material for disclosure. This is a case-by-case analysis that depends on a number of factors including, among others: (i) the amount of bonds that the company intends to repurchase; (ii) the effect of the repurchases on the company's balance sheet; (iii) the possibility and size of any tax liability triggered by the repurchase (see "Tax Considerations" below); and (iv) the effect of the repurchases on the liquidity of the remaining bonds.

Companies should also carefully structure their open market repurchases so that they do not constitute a "creeping tender offer" under the U.S. securities laws, in which case they would be subject to applicable U.S. tender offer rules. There are no bright line rules here, and courts generally consider eight factors (called the *Wellman* test)[2] in weighing whether something constitutes a tender offer. Circumstances that make open market repurchases more likely to be considered a tender offer include:

1. if there is an active and widespread solicitation of bondholders;
2. if the solicitation is made for a substantial percentage of the outstanding bonds;
3. if the repurchases are made at a premium over the prevailing market price;
4. if the terms of the repurchase are firm rather than negotiable;
5. if the repurchases are contingent upon the tender of a fixed minimum principal amount of bonds;
6. if the offer is open for only a limited period of time;
7. if the bondholders are subjected to pressure to sell; and
8. if public announcements of a purchasing program precede or accompany a rapid accumulation of large amounts of the bonds.

As a rough rule of thumb, open market repurchases of up to 25 percent of the aggregate principal amount of a series of notes would likely not be considered a tender offer. This comes from a U.S. case[3] where the court found that a repurchase of *equity* securities of less than 25 percent of the total outstanding did not constitute a tender offer. While there is uncertainty whether courts would apply the same 25 percent threshold to debt securities, and it will necessarily be a case-by-case determination, many market participants nevertheless consider 25 percent a reasonable threshold.

[1] Duane Morris has published a separate *Alert* detailing guidance issued by the Securities and Exchange Commission's Division of Corporation Finance providing the staff's views on disclosure and other securities law obligations that companies should consider with respect to COVID-19.

[2] *Wellman v. Dickinson*, 475 F.Supp. 783 (S.D.N.Y. 1979).

[3] *Hanson Trust PLC v. SMC Corporation*, 774 F. 2d 47 (2nd Cir. NY 1985).

Tender Offers

Cash tender offers allow companies to buy back all or a portion of a series of their bonds. Tender offers generally involve the preparation of a tender offer memorandum describing the terms of the tender offer. While the rules for preparation and review of a tender offer memorandum vary country by country, as a general matter they usually do not require review or approval from stock exchanges or regulatory authorities. In particular, for bonds that are not registered with the SEC, cash tender offers do not require filing a registration statement or a Schedule TO (as is the case for equity tender offers), and for bonds admitted to trading on the SGX, there is no review or approval by the SGX or the Monetary Authority of Singapore. For this reason, debt tender offers are typically quick and cost-effective to execute.

Cash tender offers made to U.S. bondholders are subject to the U.S. tender offer rules set forth in section 14 of the Securities Exchange Act of 1934, as amended, (the "**Exchange Act**") and Regulation 14E thereunder, unless they qualify for an exemption from the U.S. tender offer rules (see "Exemptions from U.S. Tender Offer Rules" below).

For debt tender offers that are subject to the U.S. tender offer rules, section 14(e) of the Exchange Act makes it unlawful to engage in any fraudulent, deceptive or manipulative acts or practices in connection with any tender offer. The SEC promulgated Regulation 14E to prescribe means to prevent such acts or practices. Certain key features of Regulation 14E include the "20-day" rule and the "prompt payment" rule.

1. **20-day rule:** Rule 14e-1 requires that the offer must stay open for at least 20 business days from the date on which the tender offer is first published. Additionally, the tender offer must stay open for at least 10 business days following any amendment to the offer price, the percentage of the class of bonds being sought for tender or the dealer's solicitation fee. In certain instances, the SEC permits an abbreviated five business day tender offer. Conditions to qualify for the five business day tender offer period include, among others: (i) that the offer must be for "any and all" of the bonds of the series in question, (ii) that the consideration must consist only of cash, qualified debt securities (which are securities that are identical in all material respects to the bonds subject to the tender offer, other than changes to the maturity date, interest payment and record dates, redemption provisions and interest rate) or a combination of both, (iii) that there can be no concurrent consent solicitation asking to amend the terms of the bonds, and (iv) that the tender offer cannot be financed by "senior debt."

2. **Prompt payment rule**: Rule 14e-1(c) requires "prompt" payment of the consideration offered for the bonds, typically within two business days (absent unusual circumstances).

Where U.S. holders hold a relatively small percentage of the bonds and their participation is not likely to affect the success of the tender offer, foreign companies often choose to exclude U.S. holders from the tender offer so that it is not subject to the U.S. tender offer rules. To do this, companies must implement measures reasonably designed to prevent participation in the tender offer by U.S. holders.

Exemptions from U.S. Tender Offer Rules

To encourage foreign companies to include U.S. holders in tender offers, the SEC promulgated two exemptions from the U.S. tender offer rules: the Tier I exemption and the Tier II exemption. The Tier I and Tier II exemptions are available for foreign private issuers if, among other things, U.S. holders do not hold more than 10 percent or 40 percent of the class of securities sought in the offer, respectively. The Tier I exemption provides broad relief from the U.S. tender offer rules, including in particular relief from the 20-day rule and the prompt payment rule. The relief available under Tier II is more limited than that under Tier I, and does not include relief from the 20-day rule, limiting its usefulness in distressed situations where time is of the essence.

The SEC has set forth detailed rules describing how to undertake a bondholder analysis to determine U.S. ownership. As a practical matter, it can be time consuming and expensive for companies to comply with these rules and ensure they meet the 10 percent or 40 percent threshold, as companies must "look through" the clearing systems, custodians, nominees and other intermediaries to determine the beneficial owners of the bonds.

Given the time and expense involved in a bondholder analysis, the limited relief available to companies under the Tier II exemption and the relative ease of excluding small numbers of U.S. holders for companies that would qualify for the Tier I exemption, many companies prefer to exclude U.S. holders or comply with the U.S. tender offer rules.

Convertible bonds

Convertible bonds are treated as equity securities under U.S. tender offer rules. While a detailed discussion of the equity tender offer rules is beyond the scope of this *Alert*, as a general matter they are more onerous than those for debt tender offers. In particular, tender offers for convertible bonds must file a Schedule TO with the SEC and must comply with a "best price" rule. Most non-U.S. companies find these requirements, particularly the filing of the Schedule TO, unpalatable. For that reason, where convertible bonds are held by a small number of bondholders, companies often prefer to structure repurchases as privately negotiated transactions to avoid U.S. tender offer rules.

Exchange Offers

Exchange offers allow companies to exchange their bonds either for equity or for new bonds with different terms. When exchanged for new bonds, this allows companies to change the maturity date, interest rate, redemption features, covenants, security/guarantee package and other provisions. Exchange offers may be made for some or all of a company's outstanding bonds. Exchange offers that involve U.S. bondholders are, as with tender offers, subject to the U.S. tender offer rules discussed above. In addition, because exchange offers involve the creation of new securities, their offer and sale must be registered under the Securities Act of 1933, as amended, (the "**Securities Act**") or be exempt from registration thereunder. For non-U.S. companies, this means that exchange offers will typically limit bondholder participation to those who are outside the United States or who are "qualified institutional buyers" as defined in Rule 144A under the Securities Act ("**Rule 144A**"). Foreign laws regarding the offer and sale of securities tend to be more stringent than those regarding cash tender offers, and companies undertaking exchange offers should accordingly be mindful to consider and comply with local laws and regulations in the jurisdictions where their existing holders reside.

Exchange offers typically involve preparation of an exchange offer memorandum describing the terms of the exchange offer and the features of the new bond, as well as an offering circular setting forth detailed disclosure on the issuer (including disclosure as to its business, risk factors, financial statements and other customary sections). Investment banks that are appointed to act as dealer managers for exchange offers typically require due diligence in connection with the offering circular, including legal opinions and auditor comfort letters. Given the documentation requirements for exchange offers, they typically take longer to prepare and execute than tender offers, and involve higher legal and auditor fees.

Consent Solicitations

In a consent solicitation, a company solicits the consent of bondholders to waive or amend the terms of the bonds to make them more favorable to the company, often in exchange for an incentive fee paid to holders. Consent solicitations can be undertaken as stand-alone exercises to introduce new terms to the bond, waive past breaches or provide companies with breathing room by relaxing particular covenants, or they can be combined with tender or exchange offers to incentivize bondholder participation.

The terms of the bonds in question will set forth the voting requirements for making amendments. Most provisions can be amended with consent from a majority of the outstanding principal amount of the bonds (either simple or two-thirds, depending on the provision, and excluding any bonds held by the company or its affiliates). However, changes to the key economic terms of the bond, such as the principal amount, interest rate or maturity date, typically require unanimous bondholder consent. As there are usually some holders who do not accept, either because they do not agree to the terms of the offer or they simply do not respond, it often will not be realistically possible to change the economic terms through a consent solicitation alone, especially if the bonds are widely held.

If a company would like to significantly alter the terms of its bonds, or encourage participation in a concurrent tender or exchange offer, they can combine a consent solicitation with the tender or exchange offer. Through a so-called "exit consent", holders of the old bonds who want to participate in a tender or exchange offer must simultaneously consent to amendments to or waivers of covenants in the old bonds. For example, an exit consent can remove financial ratio, restricted payment and other covenants, lessening the credit protection that holdouts have. While U.S. courts generally find such techniques permissible based on contract law, some foreign courts have expressed skepticism and may consider them impermissibly "coercive" or "oppressive" to minority holders.[4] The availability of covenant stripping via an exit consent therefore depends on the governing law of the bonds.

When combining consent solicitations with tender or exchange offers, companies also have a variety of other techniques available to incentivize bondholder participation. In particular: (i) to discourage holdouts, they may require that a substantial percentage (often 90 percent) of the outstanding securities be tendered or exchanged; (ii) to incentivize early takeup, they may offer an "early bird" premium to those who accept the tender or exchange offer within the first few days; and (iii) if they are seeking to repurchase a portion, rather than a whole series, of debt, they can conduct the tender on a "first-come, first-served" basis. More generally, in an exchange offer, takeup tends to be higher where the terms of the new bonds are more favorable to bondholders than the terms of the old bonds. This can be accomplished, for example, by offering security or guarantees, moving the new bonds up the capital structure to be more senior, or by giving warrants or shares in the company along with the new bonds.

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[4] Compare, for example, the U.S. case of *Katz v. Oak Industries*, 508 A.2d 873 (Del. Ch. 1986) with the English case of *Assenagon Asset Management S.A. and Irish Bank Resolution Corporation Limited (Formerly Anglo Irish Bank Corporation Limited)* [2012] EWHC 2090 (Ch).

[5] Note, however, that some U.S. courts have held in certain instances that the amendments to the terms of the bond were so substantial as to effectively constitute investment in a new security. They have particularly done so where the economic terms of the bonds, such as principal amount, interest rate, and maturity date, have changed. When undertaking a consent solicitation that seeks to change such terms, it would be prudent therefore to execute the consent solicitation as if new securities were being offered. Practically speaking, this means that an offering circular should be prepared containing a detailed description of the company, and the consent solicitation should be structured to meet an applicable exemption from the registration requirements of the Securities Act.

Consent solicitations involve the preparation of a consent solicitation memorandum describing the terms of the consent solicitation. Stand-alone consent solicitations are not subject to the U.S. tender offer rules and generally do not require a full offering circular detailing (and with due diligence performed on) the business of the company.5 Accordingly, stand-alone consent solicitations are relatively quick to execute. When combined with a tender or exchange offer, the offering and documentary requirements of the tender or exchange offer will generally dictate the speed and cost of executing the transaction.

Tax Considerations

A repurchase of a debt obligation at a discount may give rise to taxable cancellation of indebtedness income. Moreover, substantial amendments to debt obligations can change their tax treatment. A company buying back, amending or exchanging its debt should, as with any transaction, seek tax advice.

For Further Information

If you have any questions about this *Alert*, please contact Jamie Benson, Jonathan Crandall, Gerard Hekker, any attorneys in our Capital Markets Group or the attorney in the firm with whom you are regularly in contact.

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