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BOND EXCHANGES AND THEIR IMPLICATIONS

FOR

TODAY'S LEVERAGED LOAN MARKET

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Introduction

As predicted by our colleagues last spring,[1] the last twelve month period has seen a sharp increase in bond exchange offers (some successful,[2] some not[3]) and it is expected that efforts to use exchange offers as a tool to deal with distressed credits in our dislocated capital markets will continue. As explained below, in the current environment exchange offers, in the right circumstances, can be an efficient means of deleveraging a troubled company's balance sheet without resorting to the costs and risks of a bankruptcy proceeding. Indeed, according to Standard & Poor's Leveraged Commentary & Data, through May 5, 2009, ten issuers have successfully used distressed exchanges to extinguish $9.4 billion of debt (not including sub-par open-market bond purchases) so far this year.

This article provides an overview of certain features of bond exchange offers that an investor in the leveraged loan market should be aware of. An exchange offer, depending on its terms, may be beneficial to the company and its creditors, including its senior secured lenders. An exchange offer may also, however, present issues (and possible opportunities) for the senior secured lenders in a capital structure. The first part of this article outlines, in brief terms, the basics of bond exchange offers – how they work and what laws come into play. The second part of the article addresses certain issues that may confront senior secured lenders in connection with exchange offers and examines some of the controversies that have arisen in connection with some recent transactions.

Hypothetical Bond Exchange Candidate

Company X has $300 million of senior secured loans and $200 million of senior subordinated bonds outstanding. The loans and the bonds trade at significant discounts to par. Company X is struggling to meet the total leverage ratio covenant in its credit agreement and to pay cash debt service on its bonds. In addition, the maturity date of the senior secured loans is only one year away and the maturity date of the bonds is only one year thereafter. Company X might be able to secure covenant relief from senior secured creditors, but not in the face of near term maturity and cash interest payments due on the bonds. Failing resolution of its predicament, bankruptcy may be Company X's only option. Is there another alternative? An exchange offer for the bonds that exchanges a significant amount of existing bonds for new debt instruments in a reduced face amount, or with a reduced cash interest requirement and/or a longer dated maturity, may offer hope.

What is an Exchange Offer?

In the simplest terms, an exchange offer is a proposal made by an issuer of bonds to some or all of the holders of a particular series of bonds to repurchase some or all of the bonds they hold in exchange for new debt instruments (together, in some cases, with cash and/or other consideration).[4] As part of a typical exchange, outstanding bonds are voluntarily

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[1] *See* Latham & Watkins' *Client Alert 696, Restructuring High Yield Bonds: Getting Ready for the Next Phase of the Cycle*, released April 21, 2008.

[2] These offers ranged in size from large offers, such as GMAC's offer to exchange $38 billion of GMAC notes and Rescap notes, Ford's successful exchange of $4.3 billion of bonds (as well as $2.2 billion of term loans), Freescale's $1.9 billion loan-for-bond exchange program and Harrah's $1.8 billion of unsecured senior and senior subordinated notes, to smaller offers, such as Acuity Brands' offer to exchange $160 million of 6.00% notes and Triad Financial's offer to exchange $150 million of 11.125% notes.

[3] For instance, Neff Corp.'s exchange offer resulted in a majority of bond holders exchanging their bonds despite legal challenges brought by holders of the issuer's second lien loans, while Station Casino's exchange offer was terminated due to a lack of noteholder participation.

[4] For instance, the consideration offered in the recent GMAC exchange offer consisted of a combination of new notes and preferred stock. CIT's recent exchange offer offered noteholders up to $1 billion of new senior subordinated notes and up to $350 million of cash.

tendered by existing bondholders who are given a new debt instrument in the exchange under the terms and conditions set out in an offer made by the issuer. An exchange offer is typically made to all similarly situated bondholders (in contrast to one-off consensual exchanges). The "old" debt tendered by bondholders pursuant to the offer is then cancelled by the issuer. The issuance of debt as part of the exchange will be considered, for most purposes, the incurrence of new indebtedness, and not characterized as an amendment of the old bonds.

An exchange offer is a consensual transaction. The issuer elects of its own volition to make the exchange proposal to bondholders who can elect, individually, to accept or decline the offer. Thus, in many, if not most, exchange offers, not all of the bonds are exchanged and a portion (referred to colloquially as the "stub") of the old bonds remain outstanding post-exchange. Most bond exchange offers require the holders of a specified minimum percentage of the target bonds (often 90-95%) to accept the offer as a condition to the exchange being consummated. Bondholders who choose not to exchange ("hold-outs") will continue to be entitled to the benefits of their original bonds and consequently may be repaid earlier - and ultimately may be repaid more - than holders of new bonds. Indeed, even those hold-outs who lose covenant protection as a consequence of exit consents (see discussion in text at footnote 4 below) may consider themselves "winners" if an exchange results in long-term improvements to an issuer's capital structure – because a stronger capital structure increases the likelihood that the issuer will be able to pay the higher interest on the stub portion of the old bonds. On the other hand, distressed issuers and senior lenders would prefer that the number of hold-outs be kept to a minimum in order to minimize the cash payments required to be made on the stub bonds and retain cash to fund company operations and support the senior debt. Requiring that a high minimum percentage of bonds be tendered can help minimize the number of hold-outs.

The terms of a bond exchange offer often are structured to incorporate both incentives ("carrots") and disincentives ("sticks"). The offer will always include terms designed to provides incentives for the desired number of bondholders to agree to the exchange on the terms proposed. Such incentives are commonly provided in the form of enhancements to the terms of the new bonds relative to the old bonds. Some common enhancements include the following:

- Better position in capital structure (e.g., moving bonds from holding company to operating company, removal of subordination provisions)
- Collateral or additional collateral
- Increased amortization/earlier maturity
- Some cash compensation in addition to new bonds
- Better cash coupon
- Additional interest in the form of PIK interest, or some other form of deferred compensation
- Equity kicker (e.g., warrants)

Issuers will only pursue an exchange offer if they perceive a benefit. The most common issuer goals include deleveraging, reduction of debt service and extension of final maturity.

Of course, the dynamic between the bondholders and the issuer is a zero sum game in the sense that benefits afforded the bondholders are, in most cases, a detriment to the issuer, and vice versa. The common interest that often resolves this tension is a desire on the part of both the issuer and the bondholders to fix the issuer's capital structure and avoid further distress or bankruptcy. While bondholders may prefer to be offered more in an exchange, they must measure their aspirational demands against what likely would be their recovery if the capital structures were not mended through the exchange offer - and a bankruptcy were to ensue. If the enhancements offered in the exchange are likely to be of greater value than what they would receive in a plan of reorganization, bondholders should be inclined to tender their

bonds in the exchange. On the other hand, exchange offers may fail when bondholders decide that their chances are better in a plan of reorganization. For example, an exchange offer that is launched by an over-leveraged issuer might propose an exchange of $500 of new secured bonds with an extended maturity for each $1,000 in principal amount of the issuer's existing unsecured bonds. If an analysis of the likely recovery in bankruptcy on the outstanding bonds is less than $500 and the new secured bonds are expected to trade at par, the exchange offer may be very attractive to the bondholders. If the likely recovery in bankruptcy on the outstanding bonds is greater than $500, on the other hand, bondholders may not be interested in the exchange offer. In some cases, the terms of exchange offers are modified after the issuer receives reactions from the bondholders as to their willingness to tender.

On the other side of the ledger, many exchange offers also include a so-called "stick" - a feature designed to coerce bondholders not otherwise inclined to exchange to do so - through the use of an "exit consent." [5] Where an "exit consent" is used, the terms of the exchange offer require that bondholders tendering their bonds in the exchange concurrently vote (as they exit the old bonds) to amend the indenture governing the old bonds in a manner that removes from the indenture ("strips") the covenant protection that otherwise would have been applicable to the stub bonds that are not tendered for exchange. Under this arrangement, a bondholder who is not inclined to exchange must analyze the cost of remaining in the original bonds without the protection afforded by the original covenants. [6] Hold-outs may take comfort in the fact that basic economic rights (such as principal payment dates and interest payment terms) cannot be affected by an exit consent. As a result, non-consenting holders may elect to retain the old bonds on the same payment terms despite the specter of exit consents.

Securities Laws

Because bonds are securities, exchange offers require compliance with the securities laws, most notably Section 14(e) of the Exchange Act of 1934 (the "**Exchange Act**") and the rules and regulations promulgated thereunder (the "**Tender Offer Rules**"), as well as the registration requirements of the Securities Act of 1933 (the **"'33 Act"**).

Since almost all exchange offers involve offers to all or a broad set of bondholders, exchange offers are treated as tender offers for purposes of the Tender Offer Rules. The principal requirements of the Tender Offer Rules are that the issuer's offer must remain open for twenty business days and, in the case of certain amendments to the offer, for at least ten business days after the announcement of the amendment. During this period, issuers will work hard to market the proposed exchange to recalcitrant bondholders, while bondholders may attempt to present organized demands for better terms in the exchange.[7]

In the event new bonds are being issued in the exchange, the '33 Act requires that the issuance of such bonds be registered with the SEC unless an exemption from registration can be relied upon. Because of the time and effort required to complete the registration process, many bond exchanges are structured to avoid registration based on the exemptions provided by either Section 3(a)(9) or Section 4(2) of the '33 Act.

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[5] Note that exit consents are not commonly used in exchange offers for less than all outstanding notes and it is understood that holdouts will remain in such exchange offers. Therefore, exchange offers for less than all outstanding notes will have a different dynamic than tender offers for all outstanding bonds.

[6] The absence of covenant protection resulting from an exit consent may mean that there is a limited market for any "stub" notes that remain.

[7] Note that exchange offers for convertible debt securities are subject to additional rules governing equity securities which are beyond the scope of this article.

Section 3(a)(9) provides that "…any security exchanged by the issuer with its existing security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange" is exempt from registration. This restriction on remuneration prevents issuers from paying solicitation agents to solicit exchanges and limits the role of bankers in the exchange. Additionally, to meet the requirements of 3(a)(9), the new bonds must be issued by the same entity that issued the existing bonds. In the event an issuer decides to structure an exchange so that a different entity issues the new bonds, or if it becomes apparent that a solicitation agent is required to manage a complex solicitation process, the exemption under 3(a)(9) will not be available, but an exchange offer may still be accomplished without SEC registration using the exemption provided by Section 4(2).

Section 4(2) exempts from the registration requirements of the '33 Act "transactions by an issuer not involving any public offering." The limits on solicitation found in Section 3(a)(9) do not apply and a different issuer may issue some or all of the new bonds in a Section 4(2) exchange. Many Section 4(2) exchange offers are made only to "qualified institutional buyers" and non-U.S. investors.

Exchange offers consummated pursuant to Section 3(a)(9) or 4(2) are not subject to the stringent liability provisions of Section 11 of the '33 Act, which only apply to registered offerings. However, Rule 10b-5 of the Exchange Act, which imposes liability for material misstatements or omissions made in all securities offerings, as well as in reports and ordinary communications with analysts and investors, does apply. All communications involving the bond exchange, including the exchange offer solicitation documents, must be crafted to avoid Rule 10b-5 liability.

Tax implications:[8]

A. Consequences to the issuer

U.S. federal income tax consequences to the issuer will generally depend on whether the modifications to the terms of the bonds (and, if applicable, the stripping of covenants in an exit consent) constitute a "significant modification" of the bonds, as described below.

1. Significant modification

A significant modification of the bonds results in characterization as an exchange, for U.S. federal income tax purposes, of the original bond for the new bond. In the event that the modifications to the terms of the bonds (and, if applicable, the stripping of covenants in an exit consent) do not constitute a "significant modification," there is no exchange of the bonds for U.S. federal income tax purposes, regardless of the fact that there has been an actual exchange of old bonds for new bonds.

In general, a "modification" to a bond (or other debt obligation) includes any alteration to the legal rights of the issuer or the bondholders,[9] and a modification is a "significant modification" "only if, based on all facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant." Special rules apply with respect to modifications that consist of or result in a change in yield, a change in the timing of payments, a change in obligor or security, a change in the nature of the debt, or a change in accounting or financial covenants (collectively, the "(e)(2)-(e)(6) modifications"). In

[8] The following discussion under "Tax implications" assumes that the issuer of the bonds is a U.S. person for U.S. federal income tax purposes. References to the "Code" refer to the Internal Revenue Code of 1986, as amended.

[9] With certain exceptions, alterations to a bond that occur pursuant to its terms are not "modifications" for purposes of these rules. However, such alterations are outside of the scope of this article.

general, all modifications to a bond, including past modifications, should be considered collectively in determining whether there has been a significant modification. However, when assessing whether a significant modification has been made to a single distinct class of terms that falls within the laundry list of (e)(2) - (e)(6) modifications, the analysis is performed by considering the effect of all changes that have been made to that specific class of terms, and is not performed with reference to the effect of all (e)(2)-(e)(6) modifications collectively.

In general, a change in the yield of a bond is a significant modification if the annual yield on the modified bond, computed in accordance with Treas. Reg. §1.1001-3(e)(2)(iii), varies from the annual yield on the unmodified bond by more than the greater of (a) 25 basis points and (b) 5 percent of the annual yield of the unmodified bond. The annual yield of a bond that pays interest at a floating rate is generally calculated as of the date of the modification. In measuring the change in yield for this purpose, reduction in principal is also taken into account.

A modification that changes the timing of payments on the bond (either by extending the maturity date of the bond or deferring payments on the bond that are due prior to maturity) will constitute a significant modification if, taking into account the relevant facts and circumstances, the modification results in a material deferral of scheduled payments. The Treasury Regulations provide for a safe-harbor pursuant to which the deferral of scheduled payments on a bond will not constitute a significant modification of the bond if the deferred payments are unconditionally payable no later than the date that is the lesser of (a) five years or (b) a period of time equal to 50 percent of the original term of the bond (ignoring any options to extend the original maturity) from the original due date of the first scheduled payment that is deferred.

Other modifications that may constitute a significant modification to the bond and therefore trigger a taxable exchange include the substitution of a new obligor, the addition or deletion of a co-obligor, a change in the security or credit enhancement, a change in priority, or a change in recourse nature. In particular, any modification that alters the collateral for or guarantee of any recourse bond, and any change in the priority of a bond relative to other debt of the issuer, is a significant modification if it results in a "change in payment expectations," as defined under the applicable Treasury Regulations. A modification that adds, deletes or alters customary accounting or financial covenants is not a significant modification. It should be noted, however, that the Treasury Regulations do not define the term "customary accounting or financial covenants."

2. <u>COD income</u>

In addition, in the event that the modifications to the bond constitute a significant modification, the issuer will be deemed to have issued a new bond in satisfaction of the previously outstanding bond. Consequently, the issuer generally will realize ordinary cancellation of indebtedness income ("**COD income**") in an amount equal to the difference between the adjusted issue price of the previously outstanding bond and the issue price of the new bond (plus, if applicable, the amount of cash and the fair market value of any equity kicker given as consideration on the exchange). If the outstanding bond is treated as retired at a premium, such premium may be amortized over the term of the new bond.

a. Issue price of the new bond

In general, the "issue price" of a bond that is issued in exchange for property (such as another bond) will depend on whether either of the previously outstanding bond or the new bond is treated as "publicly traded" for U.S. federal income tax purposes. If the new bond is regarded as being publicly traded, the issue price of the new bond will be equal to its fair market value, and if the previously outstanding bond but not the new bond is publicly traded, the issue price of the new bond will be equal to the fair market value of the previously

outstanding bond, each as determined as of the date of the exchange. If neither the new bond nor the previously outstanding bond is publicly traded, and provided that the new bond bears adequate stated interest (generally, interest that equals or exceeds the applicable federal rate), then in most cases the issue price of the new bond will be equal to its stated principal amount or, in certain circumstances, its stated redemption price at maturity, as defined by the applicable Treasury Regulations.

b. Public trading

In general, a bond will be "publicly traded" for purposes of the rules discussed above if, at any time during the 60-day period ending 30 days after the issue date, the bond either (a) is listed on a national securities exchange, an interdealer quotation system sponsored by a national securities exchange or a specified foreign securities exchange or (b) appears on "a system of general circulation (including a computer listing disseminated to subscribing brokers, dealers or traders) that provides a reasonable basis to determine fair market value by disseminating either recent price quotations (including rates, yields or other pricing information) of one or more identified brokers, dealers, or traders or actual prices (including rates, yields, or other pricing information) of recent sales transactions (a quotation medium)." In addition, unless a safe harbor is met, a bond is considered publicly traded "if price quotations are readily available from dealers, brokers, or traders."[10]

Whether a bond appears on the Trade Reporting and Compliance Engine of FINRA ("**TRACE**"), or any other information service that may qualify as a quotation medium, should be considered in undertaking an exchange offer.

3. The bankruptcy and insolvency exclusion

A corporate debtor that realizes COD income may be permitted to exclude such income from gross income if it is in bankruptcy or insolvent.[11] The bankruptcy exclusion is available if the issuer is under the jurisdiction of the bankruptcy court in a case under Title 11 of the United States bankruptcy code and the discharge of indebtedness is granted by the court or is pursuant to a plan approved by the court. The insolvency exclusion is limited to the amount by which the issuer is insolvent.

Any COD income that is excluded from gross income pursuant to the bankruptcy or insolvency exclusions must be applied to reduce the tax attributes of the issuer. Tax attributes subject to reduction include the issuer's net operating losses, certain tax credits and the basis of depreciable property.

4. Original issue discount and applicable high yield discount obligations

In the event that the modifications to the bond constitute a significant modification and the stated redemption price at maturity of the new bond issued upon the exchange[12] exceeds the issue price of such new bond (as described above under "Issue price of the new bond") by

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[10] Generally, the safe harbor will apply if (1) no other debt instrument of the borrower or any guarantor is treated as publicly traded under the other prongs of the publicly traded definition ("other traded debt") (2) the original stated principal amount of the bond was less than $25 million, (3) the bond is subject to an economically significant subordination provision whereas the borrower's other traded debt is senior or (4) the maturity date of the bond is more than 3 years after the latest date of the issuer's other traded debt.

[11] If the issuer is a partnership (or other entity treated as a partnership for U.S. federal income tax purposes), the bankruptcy and insolvency exceptions apply at the partner level.

[12] This article assumes that the new bond issued upon the exchange is properly characterized as debt rather than as equity for U.S. federal income tax purposes. The determination as to whether the new bond is debt or equity is based on the relevant facts and circumstances.

more than a statutorily defined *de minimus* amount, the new bond will be treated as issued with original issue discount ("**OID**") for U.S. federal income tax purposes.[13] In general, and subject to the limitations described below under "New legislation," the issuer will deduct OID as it accrues, on a constant yield method, until bond maturity. However, if the new bond constitutes an applicable high yield debt obligation ("**AHYDO**"), the issuer will not be permitted to deduct OID accrued on the bond until paid in cash, and the deduction for a portion of the OID (the "disqualified portion") may be permanently disallowed. In general, and subject to the limitations described below under "New legislation," the new bond will constitute an AHYDO if (a) the term of the new bond is greater than five years, (b) the yield to maturity of the new bond equals or exceeds the sum of (i) the applicable federal rate and (ii) five percentage points and (c) the new bond has "significant OID," as defined by Code §163(i)(2).

5. New Legislation

The American Recovery and Reinvestment Tax Act of 2009 (the "**2009 Act**") includes certain notable changes in the current tax law applicable to the modification of debt instruments.

a. Deferral of COD income

The 2009 Act generally permits an issuer to elect to defer COD income arising from an acquisition of a bond in exchange for a new bond (including a deemed exchange of a bond) after December 31, 2008 and before January 1, 2011. Once the election is made, the applicable COD income is deferred until the fifth taxable year (if the deemed exchange occurs in 2009) or the fourth taxable year (if the deemed exchange occurs in 2010), and is includible in gross income ratably over a five-taxable-year period starting with such taxable year.

b. Deferral of deduction for OID

The 2009 Act includes a rule coordinating the deferral of the COD income and the deduction of any related OID. Under such rule, if a bond is deemed exchanged for a new bond and if there is OID with respect to the new bond, no deduction is allowed with respect to the portion of the OID that accrues on the new bond before the first taxable year in which COD income is includible (but only to the extent such OID does not exceed the COD income). The disallowed OID deduction is allowed as a deduction ratably over the five-taxable-year period during which the COD income is included.

c. Effect on other exclusions

If a taxpayer makes the election to defer the COD income, other exclusions from the COD income (such as the bankruptcy or insolvency exclusion discussed above) do not apply to the COD income for the taxable year of the election or any subsequent year.

d. Suspension of AHYDO rules

The AHYDO rules do not apply to certain bonds issued during the period beginning on September 1, 2008 and ending on December 31, 2009, even if the obligation otherwise meets the definition of an AHYDO. This temporary suspension applies only if (1) the obligation is issued in exchange for an obligation that is not an AHYDO, and (2) the issuer (obligor) of the old and the new obligation are the same. The AHYDO for which the rules are suspended is not an AHYDO for purposes of subsequent application of the rule. The temporary suspension does

[13] Note that the stated redemption price at maturity of the bond includes all payments to be made on the bond other than payments of qualified stated interest. Accordingly, certain terms such as the provision of PIK interest could create or increase original issue discount on the new bond.

not apply to contingent interest debt described in Code §871(h)(4) (without regard to (D) thereof) or to any obligation issued to a person related to the obligor (within the meaning of Code §108(e)(4)).

The 2009 Act permits the Secretary of the Treasury to extend the suspension rule beyond 2009 if appropriate. It also permits the Secretary of the Treasury to issue regulations to permit, for obligations issued after December 31, 2009, a rate higher than the applicable federal rate to be used (in lieu of the applicable federal rate) in determining the status as an AHYDO if the Secretary determines that such rate is appropriate in light of distressed conditions in the debt capital markets.

B. Consequences to bondholders

In the event that the modifications to the bond constitute a significant modification, then, unless the exchange of the outstanding bond for the new bond (or, if applicable, the deemed exchange of the outstanding bond for a "stripped" new bond by a non-consenting holder in an exit consent) qualifies as a recapitalization under Code §368(a)(1)(E), the exchange will be taxable and exchanging bondholders that are U.S. persons ("**U.S. Bondholders**") generally will recognize gain or loss in an amount equal to the difference between their adjusted tax basis in the outstanding bond and the issue price of the new bond (as discussed above under "Issue price of the new bond"). If the new bond is issued with OID (as discussed above under "Original issue discount and applicable high yield obligations), a U.S. Bondholder generally will be required to include such OID in income on a constant yield basis in advance of receipt of the cash payments to which such income is attributable.[14]

The exchange of the outstanding bond for the new bond generally will qualify as a recapitalization, provided that (a) the modifications to the bond did not change the obligor under the bond and (b) both the outstanding bond and the new bond are "securities" for U.S. federal income tax purposes. If the exchange qualifies as a recapitalization, a U.S. Bondholder generally will not recognize any gain or loss on the exchange (except that gain will be recognized to the extent that cash or other boot is received in the exchange). If the new bond is issued with OID, a U.S. Bondholder whose adjusted tax basis in the new bond immediately following the exchange was in excess of the issue price of the new bond (such excess, "**acquisition premium**") generally will be able to use such acquisition premium to offset accruals of OID on the new bond.

Preference Risk and Fraudulent Conveyance

Bondholders who tender their bonds in an exchange offer must consider the risk that the resultant exchange may be challenged as a preference under Section 547 of the U.S. Bankruptcy Code or a fraudulent transfer under Section 548 of the U.S. Bankruptcy Code (or applicable state law).

Under federal bankruptcy law, an existing creditor (such as a holder of outstanding bonds) that receives a "transfer" from a debtor in respect of preexisting debt within 90 days of the debtor's bankruptcy is subject to such transfer being avoided in the bankruptcy proceeding (assuming the court determines that the debtor was insolvent at the time of transfer).[15] In such event, the bondholder would be a creditor in bankruptcy and would have a claim equal to the amount of its old notes.[16] Thus, to the degree that in connection with an exchange offer

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[14] If the new bond is an AHYDO, a corporate U.S. Bondholder may be able to take a dividends received deduction with respect to the disqualified portion of the OID.

[15] Insolvency is presumed for the 90-day period. This presumption may be rebutted, but the burden of rebuttal is on the creditor/defendant.

[16] The creditor only has a claim to the extent it returns the preferential payment.

exchanging bondholders receive a benefit to induce them to exchange (e.g., collateral or some other form of benefit not present in the existing bonds), 90 days must pass without a bankruptcy filing before the preference risk is eliminated.

In some exchange offers, another risk to exchanging holders may also apply. If as a result of the exchange, bondholders receive additional benefits from the issuer or its subsidiaries in excess of the value[17] of the old bonds they exchanged and that benefit is provided by an entity that was insolvent at the time,[18] the transactions might be found to be a fraudulent transfer and be subject to avoidance in a subsequent bankruptcy. As an example, a fraudulent transfer may occur if entities who were not obligors under the old bonds guarantee the new bonds. Unlike the 90-day window for preference risk, the risk of avoidance due to fraudulent transfer under Section 548 of the U.S. Bankruptcy Code extends to two years before the date of a bankruptcy filing and longer look back periods under state laws governing fraudulent transfer may apply in certain circumstances.

Implications for Senior Secured Lenders:

Why should senior secured lenders care whether a bond exchange offer takes place?

Depending on the terms of the exchange offer, they may not. If the effect of the debt exchange is solely to reduce outstanding leverage, reduce debt service requirements and/or extend maturity, without effecting other modifications to the bonds as they previously existed, the exchange may be viewed as entirely beneficial from the senior secured lenders' perspective. However, as noted above, to induce bondholders to tender they often must be offered one or more "carrots" as part of the exchange. In the event that such carrots provide bondholders with rights that may compete with senior secured lenders to a greater degree than the old bonds, or transfer additional value to the exchanging bondholders than would otherwise inure to their benefit as holders of the old bonds, senior secured lenders may in fact care a great deal. Moreover, if the issuer incurs COD income as a result of the exchange, additional cash that otherwise would be used to pay down senior secured loans may be needed to pay taxes on that COD income – to the extent that an election to defer such COD income is not made under the 2009 Act. In addition, an exchange offer could be viewed under certain circumstances as "staving off" a default that, if not cured, would have brought senior lenders to the table. To the extent senior secured lenders take this view, a successful bond exchange will only prolong the ultimate resolution of the capital structure that the senior lenders would have expected to have had some voice in controlling. For instance, if the issuer violates a leverage covenant under its senior credit facility, that violation would result in a default under the credit agreement that, if not cured, would be an event of default giving senior lenders the right to accelerate the senior loans. The threat of acceleration would likely compel the issuer to negotiate with the senior lenders since an acceleration would almost certainly drive the issuer into bankruptcy. Depending on the circumstances, senior secured lenders may wish to bring the issuer to the negotiating table sooner rather than later.

Whatever the view of senior secured lenders, their ability to affect the terms of the bond exchange offer will be determined by their rights under the applicable credit agreement. Absent provisions in the applicable credit agreement that restrict the exchange offer, senior secured lenders will likely have no say in the matter.

The typical credit agreement will not contain a specific provision approving or prohibiting an exchange offer as a discreet transaction. Rather, the usual categories of covenants may, depending how crafted, restrict or permit various elements of the exchange.

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[17] The face amount of the old bond, not its "trading price" or "market value," is the measure of value.

[18] The statute also allows avoidance if the transferor was rendered insolvent by the transfer or was left with unreasonably small capital for its business as a result of the transfer.

A typical exchange offer will contain the following elements.

- Repurchase and cancellation of debt
- Issuance of new debt
- Credit enhancements of new debt (i.e., collateral/guaranties)
- Amendment of old bonds
- Possible equity kicker or cash payment as part of consideration

Each of these elements is considered below in light of common covenant constructs in senior secured credit agreements.

It is difficult, of course, to make general statements about what is a typical covenant construct in syndicated leveraged loan documents. 2005-2007 was a period during which what might have been considered standard in years past was abandoned for new paradigms. Accordingly, while the analysis set forth below may be instructive regarding the types of provisions sometimes found in credit agreements with respect to the elements of an exchange offer, the reader should approach the analysis of each credit agreement as *sui generis*.

Incurrence of Indebtedness

A bond exchange offer involves the issuance of new debt – the new bonds issued as part of the exchange. Leveraged loan agreements, almost without exception, restrict the incurrence of new indebtedness. In the case of many loan facilities (particularly vintage 2005-2007 loans), it is not unusual to find exceptions that allow the incurrence of new debt under prescribed terms and conditions. With reference to debt issuances in connection with exchange offers, the exceptions most likely to apply fall into one of two categories:

- Permitted refinancing indebtedness
- Other permitted debt the use of proceeds of which is not generally restricted

Is the debt issued in an exchange offer a "permitted refinancing" of the outstanding bonds under the terms of a credit agreement? Only a careful review of the applicable provisions will tell. Most permitted refinancing provisions come with at least some degree of limitation, most notably limiting the principal amount of the refinancing debt to no more than the principal amount being refinanced. Other formulations are more restrictive, effectively providing that in connection with the refinancing the new debt cannot be superior in terms of specified categories than the debt being refinanced (e.g., collateral, guarantees, maturity). Still other formulations include a general prohibition on any refinancing indebtedness that is materially worse for the borrower or senior secured lenders than the debt being refinanced. Such more restrictive provisions make it difficult to offer enticements to bondholders to exchange without seeking an amendment to the credit agreement.

Even if the terms of the bonds offered in the exchange do not qualify as permitted refinancing indebtedness, there may be other carve outs or baskets in the covenant governing the incurrence of debt that have the effect of permitting the issuance of new debt without senior lender consent. One form of additional debt permitted under some credit agreements may have particular implications for exchange offers and a meaningful affect on senior secured lenders. In recent years, it became common to include in many leveraged credit agreements provisions that allow borrowers to arrange for new additional loans to be added to the credit agreement – which loans were not committed to by the original lenders at the time of the initial fundings under the credit agreement. These arrangements (sometimes referred to as "accordion" or "incremental" facilities) provide for a pre-approved add-on to the outstanding debt under the credit agreement on a *pari passu* basis in terms of creditors' rights relative to those of the existing lenders under the credit agreement. Most incremental facilities are limited in aggregate dollar amount (although some are instead limited by an incurrence based test,

pursuant to which debt may be incurred to the extent a financial test, such as a leverage ratio, is satisfied after giving effect to incurrence of the new loans); some require satisfaction of financial covenant metrics; many have "most-favored nation" pricing protections; others have tailor-made restrictions. Limits on the amount of new debt that may be incurred without violating credit agreement covenants may affect the size of the proposed exchange offer or the amount of proposed discount to the old bonds. Issuers looking to provide a new debt instrument to offer to bondholders may find the use of such an incremental facility very attractive. Why not offer bondholders more junior in the capital structure an opportunity to trade, at a discount, their bonds for a new debt instrument issued under the credit agreement? Under such a trade, bondholders get new debt with much improved creditors' rights (senior secured); issuers reduce the amount of total debt in the capital structure; and interest costs presumably decrease when compared to cash pay old bonds (if the senior secured loans bear interest at a lower rate than the unsecured bonds – which is generally the case).

That was apparently an important component of the issuer's analysis in the exchange offer launched by Realogy in November of 2008. Under the terms of the exchange, holders of Realogy's Senior Subordinated Notes, Senior Notes and Senior Toggle Notes were offered the right to exchange their debt for new "accordion" term loans. $500 million in new term loans were to be issued under the accordion feature of the Realogy Credit Agreement and, unlike the notes for which they were to be exchanged, were to be secured obligations (albeit on a second priority basis). Those holders who tendered in the exchange would receive in exchange for debt more junior in the capital structure senior secured (second lien) loans that would share in the collateral package securing existing loans funded under the credit agreement. The exchange offer would have had a deleveraging effect on Realogy's balance sheet by reducing its outstanding notes by more than twice the amount of the new term loans issued under the incremental facility. The "carrots" for the noteholders to accept the offer were the improved priority for all three tranches (from unsecured status to the second lien security position), the updgrade (from subordinated to *pari passu*) in the priority position of the Senior Subordinated Notes, and the substantial premium of the value of the new second lien term loans offered over the pre-offer trading prices of all the three tranches of notes. The exchange offer was structured such that the $500 million would be rationed among the three tranches, with a "waterfall" feature that gave priority to the holders of the two cash-pay tranches – the net effect of which was designed to maximize the reduction of Realogy's current cash interest obligations. The likely outcome, however, was that the tenders made by holders of the two cash-pay tranches would exhaust the entire $500 million, and no second lien term loans would remain for the holders of the Senior Toggle Notes. That outcome, in turn, would have resulted in the promotion of the Senior Notes ahead of the Senior Toggle Notes and the Senior Subordinated Notes "leapfrogging" ahead of the Senior Toggle Notes in the creditors' rights hierarchy (as a result of the senior and secured status of the second lien terms loans being offered).

Holders of the Senior Toggle Notes challenged the exchange in Delaware Chancery Court, suing Realogy to block the exchange offer on the basis, among other things, that because the accordion loans were to be issued in exchange for the notes, and not funded with cash, they were not "loans" as such term is generally understood or as contemplated by the senior credit facility. In the plaintiffs' view, loans could only be funded in cash.[19] The court rejected what it characterized as "hyper-technical" argument that the common meaning of "loans" and the usage of the term and related procedural and ministerial provisions in the senior credit facility required the conclusion that issuing loans in exchange for notes was impermissible. While the court determined that the Realogy exchange was not permitted under the terms of the applicable documents for other reasons discussed below, the Realogy ruling does suggest that incremental facilities (at least to the extent provided on the terms outlined in the Realogy credit

[19] Note that the bank group did not raise an objection to the exchange offer, presumably because, even though the accordion loans would have been *pari passu* with the existing loans under the credit agreement, the old loans would have retained lien priority over the accordion loans.

agreement) need not be funded in cash in order to be used as part of the consideration in a bond exchange offer. Accordingly, cashless exchanges using incremental facilities may be fair game for bond exchanges under the right circumstances. The outcome of the Realogy case ultimately turned on the court's close textual reading of an exception to an exception to the types of refinancings that are permitted under the credit agreement, combined with its application of general principles of contract interpretation. The court concluded that while the issuer could have incurred the $500 million in secured accordion loans for general corporate purposes, the terms of the credit agreement provisions relating to "permitted refinancings" would not permit an exchange with the unsecured notes – demonstrating the critical importance of clear, detailed drafting to minimize interpretative dilemmas, and of painstaking covenant review in assessing the feasibility of any exchange offer being considered without the benefit of consents from bondholders and other counterparties.

Similar to Realogy, in two exchange offers it completed in March 2009, Freescale Semiconductor, Inc. offered to exchange existing bonds for new secured accordion term loans to be issued under an incremental facility available under its existing credit agreement. Certain of Freescale's lenders filed a complaint in state court in New York alleging, among other things, that Freescale's incurrence of debt under the accordion violated the terms of the credit agreement as a result of the fact that the borrower could not make the required representation that no business MAC had occurred since the time the credit agreement was first entered into. In addition, in what could have a significant *in terrorem* effect, the plaintiff lenders named the participating bondholders as defendants in the complaint on the theory that by inducing and colluding with Freescale to issue the new term loans in violation of the credit agreement, the bondholders are liable for tortious interference with contract.

Incurrence of Liens:

Can an issuer as part of an exchange offer propose to offer exchanging unsecured bondholders a new debt instrument secured by some or all of the issuers' assets? The answer, again, depends upon the nature and scope of the restrictions in the issuer's senior secured credit agreement. While restrictions on grants of collateral are another set of nearly universal restrictive covenants, there are several common exceptions:

- Liens granted in connection with accordion facilities
- Liens granted by non-controlled subsidiaries (unrestricted subsidiaries)
- General basket exceptions that allow a specified amount of debt to be secured
- Specified second lien arrangements

Whether any of these exceptions exists or applies is a function of the specific document and transaction goals. That said, in almost all cases, elevating a competing creditor such as a bondholder from unsecured creditor to secured creditor can have negative implications for the legacy senior secured lenders since, in a workout situation, even junior secured creditors have stronger negotiating power than unsecured creditors.

Restricted Payments:

A well-crafted senior secured credit agreement will usually control voluntary repayments or prepayments of junior capital (e.g., subordinated notes, dividends on common stocks, and, in some cases, senior unsecured notes). As part of an exchange offer, the tendering bondholders will be receiving a payment on their old bonds and, accordingly, under many "restricted payment" covenants will be prohibited unless an exception applies under the applicable document. Two exceptions are commonly found –

- Permission to refinance the junior capital under specific prescribed terms
- Some form of general permission to make voluntary restricted payments on junior debt, subject to specified requirements (e.g., aggregate limit or amount, satisfaction of financial metric)

The requirements necessary to invoke these exceptions are not always clear. For instance, the aggregate limit on, or amount permitted to make, voluntary restricted payments presumably applies to issued consideration rather than the face amount of the tendered bonds. Additionally, if the limitations on restricted payments only apply to cash payments, the exchange offer, in which new bonds are traded for old bonds and no cash changes hands, may not invoke those limitations.

Amendment to Loan Documents to Facilitate Exchange Offers

In some cases, the terms of an exchange offer that would appeal to issuers and bondholders alike may be restricted (or not clearly permitted) under one or more provisions of the applicable credit agreement. While issuers cannot proceed under such circumstances without violating the credit agreement with attendant consequences (i.e., event of default and resulting remedies), there is another potential path – an amendment or waiver under the applicable credit agreement that permits the exchange offer to occur. Typically, the sorts of covenant restrictions outlined above can be amended or waived with the consent of the holders of a majority of the outstanding debt and commitments under the credit agreement. Given recent conditions in the leveraged loan market, issuers have been reluctant to approach senior lending groups for waivers. Given current trading levels for senior secured loans, lenders may be loathe to agree to amendments without considerable compensation. Accordingly, most recent exchange offers have been structured so as not to require amendments. Lenders may show greater willingness to agree to exchange offers if the economy further deteriorates, making successful exchanges more attractive as a method to stave off bankruptcy for issuers.

Financial Covenants

An exchange offer may affect financial covenants applicable to more senior debt in the capital structure. Typically, leverage covenants measure either the amount of total debt or the amount of senior debt or both. In an exchange offer where unsecured notes are tendered for secured notes, the amount of total debt may not change or may be reduced but the amount of senior debt would increase. Increased senior debt could lead to a default in a leverage covenant that measures senior debt rather than total debt.

Some thought should also be given to the impact of the exchange on excess cash flow calculations. For instance, if repayments are included in the calculation of excess cash flow, will the proposed exchange be characterized as a "repayment" for that purpose? Perhaps not, as the definition of excess cash flow may involve a cash repayment and the exchange offer may have no cash component. As always, a careful review of the document is needed to determine the answer. Additionally, when considering an exchange offer that would result in COD income, attention should be paid to the specific provisions of the definition of excess cash flow in the credit agreement to determine the effect of COD income, if any.

Conclusion

Given the current economic environment, more issuers may view exchange offers as an attractive means of deleveraging outside of the context of a bankruptcy proceeding. An exchange offer can be a useful tool, but issuers and leveraged loan investors should understand the options available in an exchange offer and the complexities that can arise. Besides the legal considerations in an exchange, such as the Tender Offer Rules, the availability of

exemptions from registration and possible tax consequences, issuers should review their senior credit facilities to insure that the exchange offer is permitted. Even when legal and contractual barriers to the exchange are resolved, issuers may need to focus on economic considerations that can lead to hold-outs or failed exchange offers. Bondholders and senior lenders will likely consider whether a proposed exchange offer improves their respective economic positions or whether an alternative scenario (often a bankruptcy) is preferred. Exchange offers are likely to continue for the foreseeable future and the success or failure of many offers will turn on the dynamic among issuers, bondholders and senior lenders and the contractual provisions that bind them.