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Restructuring High Yield Bonds: Navigating the Downturn and Staying Nimble in Response to Market Changes

Issuers face numerous restructuring alternatives, both within and outside the bankruptcy process.

The Big Picture

Issuers of high yield bonds trading at distressed levels can use exchange offers to restructure or modify their outstanding bonds in order to preserve the going concern value of their businesses and potentially avoid bankruptcy. These transactions can reduce cash interest expense, defer near-term maturities, provide security for bondholders, or eliminate or modify existing covenants. Additionally, "prepackaged" plans of reorganization (including those used as a "stick" in connection with an exchange offer) and "pre-negotiated" plans of reorganization can be of value. Debt repurchase programs are covered in detail in our March 24, 2020, *Client Alert* Navigating Debt Repurchases: What You Need to Know.

Common characteristics of high yield bonds that present challenges in any comprehensive debt restructuring include the anonymity of potentially numerous holders, relatively long periods of call protection, and the requirement that amendments to certain economic terms (most notably terms related to payment) cannot be amended without the consent of each affected holder. With the substantial presence of hedge funds, private equity, and other sophisticated financial players in the high yield market, troubled issuers seeking to restructure their bonds should expect to confront an organized and specialized class of investors.

Separately, the restructuring of high yield bonds often requires the consent of lenders under the issuer's senior credit agreement and may implicate agreements governing other debt, which may also need to be amended in connection with any restructuring transaction.

These challenges often lead issuers to retain specialized advisors to assist in any restructuring effort. All major commercial and investment banks have "liability management" teams that specialize in debt restructurings, and many boutique investment banks focus primarily on these types of distressed transactions. These bankers can play a valuable role in helping to structure and broker a deal between a troubled bond issuer and its creditors.

This *Client Alert* examines a few of the restructuring alternatives available to issuers of high yield bonds.

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Exchange Offers: The Most Viable Non-Bankruptcy Alternative

In ordinary circumstances, issuers can restructure their balance sheet in a number of ways, including cash tender offers, open market or privately negotiated debt repurchases, and optional redemptions. However, issuers of bonds trading at distressed prices may find that none of these methods is realistic because each requires a significant amount of cash, which is generally in short supply for troubled credit.[1] In addition, most senior credit agreements limit or prohibit repurchases of junior debt (whether unsecured, subordinated, or secured on a junior lien basis) ahead of its scheduled maturity. Secured bond indentures typically contain similar limitations on repurchases of junior bonds (and such limitations may be even more restrictive than those in the senior credit agreement). As a result, often the only viable option outside of bankruptcy for many distressed high yield issuers is an exchange offer, typically coupled with an exit consent that removes most of the protective covenants from any non-exchanged bonds (and, depending on the level of consents achieved, releasing any liens securing existing secured bonds).

What Is an Exchange Offer and How Does It Work?

An exchange offer is an offer by an issuer to exchange its (or one of its affiliate's) outstanding bonds for new bonds with different terms, which may include reductions in principal, different interest rates, or reduced cash interest burdens (including the addition of pay-in-kind or "PIK" interest provisions), extended maturity dates, tighter covenants, and, in many cases, adding collateral to reflect the issuer's weaker operating performance, liquidity issues, or other deterioration of the credit. Issuers may also seek to reduce their debt burden by exchanging their outstanding bonds for equity securities or for a combination of a reduced principal amount of new bonds and an equity component. In most cases, what little excess cash remains in a distressed issuer's coffers is maintained for working capital and reserved for repayment of non-exchanged bonds at maturity, and in some cases a portion may be offered as part of the consideration to incentivize holders to tender.

Below are a few basic points common to all exchange offers:

Exchange Offers Are Securities Offerings. Unlike cash tender offers, all exchange offers are offerings of securities (*i.e.*, the issuance of the new modified bond or equity in exchange for the old bond). As a result, the exchange offer must be registered under the Securities Act of 1933 (Securities Act) unless it qualifies for an exemption. In addition, the disclosure documents used in exchange offers are subject to the anti-fraud provisions of the US securities laws, including Section 11 and Section 12 of the Securities Act (in the case of registered exchange offers) and Rule 10b-5 under the Securities Exchange Act of 1934 (Exchange Act) (in the case of all exchange offers).

The Carrot-and-Stick Approach. In order to make any exchange offer successful, issuers must create incentives to entice existing bondholders to participate in the exchange offer and disincentives for them to retain their old bonds. Such incentives may include new bonds with a higher interest rate, stronger protective covenants, additional guarantees, and/or collateral. If secured, new bonds will rank effectively senior to old unsecured bonds to the extent of the value of the collateral, and in more complex transaction structures, they may be structurally senior to the old bonds as well by virtue of additional guarantors or obligors. Bondholders — often through an organized group (and often represented by counsel and financial advisors) — will assess these proposed new terms against retaining the payment terms of their old bonds in light of the issuer's prospects, with a close eye on terms being agreed to by other creditors to the extent a broader restructuring is in process. Disincentives to remaining in the old bonds include the looming threat of a bankruptcy filing, being structurally or effectively subordinated to new bonds, or being subjected to an accompanying exit consent. If requisite consents are obtained in the exchange offer, an accompanying exit consent would strip the old bonds of most of their protective covenants and, if the old bonds are secured, their collateral.

The Holdout Problem. Only bondholders who agree to exchange their old bonds for new bonds benefit from (or are bound by, depending on your perspective) the terms of the new bonds. Bondholders who do not participate in the exchange offer are known as "holdouts," and the holdout issue is often the Achilles' heel of exchange offers, as discussed below.

20 Business Days. All exchange offers that constitute tender offers are subject to the US debt tender offer rules. This is true whether the debt was originally issued in a Securities and Exchange Commission (SEC) registered offering or an unregistered offering under Rule 144A or another private placement exemption. The principal requirement of the tender offer rules applicable to exchange offers targeting non-convertible debt securities is that the exchange offer must be kept open for 20 business days. Further, material amendments to the terms of an ongoing exchange offer may require the exchange offer to remain outstanding for up to 10 business days after announcement of that amendment.[2] Exchange offers targeted at holders of convertible debt securities are subject to a thicket of additional tender offer rules, as convertible debt is considered to be an equity security under the US tender offer rules. The equity tender offer rules are not addressed in this *Client Alert*.

The three primary types of exchange offers include: **private exchange offers**, **Section 3(a)(9) exchange offers**, and **registered exchange offers**. Below is a discussion of the nature of each offer.

Private Exchange Offers

Section 4(a)(2) of the Securities Act exempts from the registration requirements of the Securities Act all securities issued in "[t]ransactions by an issuer not involving any public offering." These provisions are most commonly thought of as the basis for private placements, but they are equally applicable to exchange offers. Private exchange offers are by far the most common type of exchange offer. To be clear, these transactions are distinct from privately negotiated open market transactions in which the issuer attempts to capture discount with individual holders. These transactions are discussed more broadly in Latham's *Client Alert* Navigating Debt Repurchases: What You Need to Know. Private exchange offers allow the issuer several advantages and — most importantly — free use of (and payment to) investment bankers or other advisors to assist in both the structuring of the transaction and the solicitation of the bondholders.

Although Section 4(a)(2) does not prohibit an offering to unsophisticated holders if certain requirements are met, in practice most Section 4(a)(2) exchange offers are made only to persons believed to be qualified institutional buyers (QIBs) and non-US investors outside of the US.[3] In order to ensure that a private exchange offer is not made to any ineligible offerees, only those bondholders who have certified their status as QIBs or non-US persons (typically done electronically through the systems of the Depository Trust Company, or DTC) will be eligible to receive the exchange offer materials and participate in the exchange offer. For bonds initially issued as "144A-for-life," most, if not all, are held by QIBs or offshore investors, so this procedure does not typically limit to any meaningful extent the pool of investors eligible to participate in a private exchange offer. However, if the bonds were issued with registration rights and, once freely tradeable to non-QIBs, were subsequently purchased by investors who could not make these certifications, the effectiveness of a private exchange offer could be limited. Similarly, if the indenture governing the old bonds contains an unusually restrictive "payment for consent" covenant,[4] a private exchange offer may be prohibited. There is no "all holders" requirement under the tender offer rules applicable to debt securities; it is permissible to exclude holders from participating in an exchange offer if they do not meet specified qualifications.

Disclosure in the documentation for a private exchange offer is generally comparable to the disclosure that would be included in an offering memorandum for a new money bond offering, including information

concerning the terms of the exchange offer (such as adjusted financial information showing the effect of the exchange offer on the issuer, which often displays a range of outcomes based on different acceptance levels); a description of the issuer, its business, and the risks associated with both the business and accepting and declining the exchange offer; and a description of the new securities being offered. As such, all of the documentation that one would expect to receive in a new money bond offering, including comfort letters, opinions, and the like, are applicable in a private exchange offer.

Private exchange offers that are structured to include common equity as a portion of the consideration are more complicated than debt-for-debt exchanges. If the issuer is a public company listed on national exchanges such as NYSE or NASDAQ, exchange rules may require a stockholder vote for any issuances of equity over 20% of the public float. If the issuer's common stock is trading at low levels (which is fairly common for issuers who are pursuing distressed exchanges), offering highly dilutive common equity as consideration in private exchange offers becomes increasingly difficult without running afoul of exchange rules that require the time and expense of obtaining shareholder approval.

The following table sets forth the principal advantages/disadvantages of a private exchange offer.

Private Exchange Offer	
Advantages	**Disadvantages**
• Quick (no registration or SEC review required) • Less expensive than a registered exchange offer • Issuer may use (and pay) investment bankers to solicit exchanges • Section 11 and Section 12 do not apply (although Rule 10b-5 does apply) • Can use a different issuer for some or all of the new bonds and any equity offered as consideration	• New bonds will be "restricted securities," and thus bondholders may require registration rights • Generally limits offer to QIBs and non-US investors — may not be a viable option if issuance has a material number of "retail" (or non-QIB) holders • Holdout issue • May be problematic to issue common equity as consideration

Section 3(a)(9) Exchange Offers

Section 3(a)(9) of the Securities Act exempts from registration under the Securities Act "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." The Section 3(a)(9) exemption generally has four major requirements:

- No payment may be made by the issuer for solicitation services in connection with the exchange offer.
- The old bonds and the new bonds and any equity offered in the exchange must be issued by the same issuer (the "identity of issuer" requirement).
- Bondholders may not be required to contribute cash or any other property, other than the old bonds, in exchange for the new bonds (although the issuer may offer a mix of cash and new bonds/new equity in the exchange).[5]
- The exchange offer may only be made to existing bondholders, thought there is no limitation on who may participate in the exchange offer. Non-QIBs may participate.

The restriction contained in Section 3(a)(9) upon payment for the solicitation of exchanges does not limit the solicitation itself, but it does prevent an issuer from paying or otherwise compensating a third party for soliciting activities. This is the most significant limitation on the utility of a Section 3(a)(9) exchange offer. Depending on the complexity of the restructuring proposal and the likelihood of bondholders forming a committee,[6] an issuer may determine that it needs to retain a paid financial advisor to act as solicitation agent in order to negotiate and complete the exchange offer successfully, in which case the exemption afforded by Section 3(a)(9) is not available.

While there is no statutory list of permitted and prohibited solicitation activities, several SEC no-action letters[7] provide guidance. Generally, an issuer's directors, officers, and other employees may undertake soliciting activities so long as they are not specially compensated for such activities. These activities should be incidental to their regular duties.[8]

Further guidance from the SEC indicates that an issuer may hire investor relations or proxy solicitation firms as information agents to perform ministerial tasks, such as notifying bondholders of the details of the exchange offer, confirming bondholder contact details and ascertaining that they have received all requisite materials, and reminding bondholders of approaching deadlines. However, such agents may not inform security holders of management's recommendation with respect to the offer or negotiate the terms of the exchange offer.[9]

In addition, the SEC has provided guidance on the role investment bankers can play in a Section 3(a)(9) exchange offer and how they may be compensated.[10] In general, an investment bank:

- Cannot make any recommendation regarding the exchange offer to bondholders or their advisors
- Cannot make any solicitation (direct or indirect) of exchanges or consents
- Can only provide bondholders with information that was included in communications sent directly by the issuer
- May provide a fairness opinion
- May have discussions or negotiations with legal and financial representatives of bondholder committees[11]

In order not to run afoul of the prohibition on payment for solicitation services, bankers are generally paid a fixed advisory fee in Section 3(a)(9) exchange offers, rather than a fee that is contingent upon the success of the exchange offer.

Often bankers have already interacted directly with bondholders prior to their forming a group and hiring representatives. Generally, this forecloses a Section 3(a)(9) exchange offer as an option, unless the issuer is interacting with bondholders through financial advisors focusing on "effecting" rather than "promoting" an exchange.[12]

The "identity of issuer" requirement can also constitute a significant structural impediment in exchange offers, especially issuers that are "fallen angels" (*i.e.*, companies that issued bonds that were formerly rated investment grade) or convertible bonds, as neither of those customarily have the subsidiary guarantees and, in some cases, collateral that bondholders desire. As discussed above, additional guarantees and collateral are often the "stick" used to induce participation by bondholders. An inability to add additional obligors to the new bonds makes the Section 3(a)(9) exchange offer less desirable.

Disclosure in a Section 3(a)(9) exchange offer is generally comparable to the disclosure that would be included in a private exchange offer, and the same considerations around liability and ancillary documentation discussed above apply here.

One thing to keep in mind is that while Section 3(a)(9) exchange offers provide some relief vis-à-vis the requirements of a registered exchange offer, compliance with the Trust Indenture Act of 1939 (TIA) is required. Accordingly, a Form T-3 must be filed upon launch of the exchange offer.[13]

The following table sets forth the principal advantages/disadvantages of a Section 3(a)(9) exchange offer.

3(a)(9) Exchange Offer	
Advantages	**Disadvantages**
• Quick (no registration or SEC review required) • Less expensive than a registered exchange offer • Section 11 and Section 12 do not apply (although Rule 10b-5 does) • Exemption applies regardless of number or sophistication of holders	• New bonds will be “restricted securities” if the old bonds were “restricted”[14] • Prohibition on payment for solicitation services • Requirement that new bonds and any equity be issued by the same issuer as the old bonds • Holdout issue

Registered Exchange Offers

In a registered exchange offer, the issuer prepares and files an exchange offer prospectus in a registration statement on Form S-4 with the SEC.[15] The registration statement is required to include information concerning the terms of the exchange offer (including as adjusted financial information showing the effect of the exchange offer on the issuer, which often displays a range of outcomes based on different acceptance levels) and a description of the issuer, its business, and the risks associated with accepting and declining the exchange offer. Additionally, the prospectus must meet all the disclosure requirements of a Form S-4, increasing the burden on issuers significantly compared with private exchange offer materials. Registered exchange offers are typically used when the old bonds are both registered and widely distributed (*i.e.*, likely in the hands of non-QIBs), or when the indenture governing the old bonds contains an unusually restrictive “payment for consent” covenant that prohibits a private exchange offer. Registered exchange offers are highly unusual in bond restructurings because they generally take longer to complete and require approval from the SEC. In addition, as discussed above, often one of the most common incentives to participation is the granting of collateral. Registered exchange offers implicate Regulation S-X, and thus the granting of collateral, specifically stock of subsidiaries, might cause onerous financial reporting obligations.[16]

The following table sets forth the principal advantages/disadvantages of a registered exchange offer.

Registered Exchange Offer	
Advantages	**Disadvantages**
• Useful in situations in which the old bonds are both registered and widely distributed • New bonds freely transferable • Issuer may use (and pay) bankers to solicit exchanges • All bondholders may participate in the exchange offer • Can use a different issuer/guarantor for some or all of the new bonds and any equity	• Timing may be subject to SEC review and comment before the 20-business-day offer can be commenced • Section 11 and Section 12 securities law liability on content of registration statement • More costly than unregistered deal • SEC disclosure requirements can necessitate creation of guarantor/non-guarantor consolidating disclosures • Release of collateral requires additional reporting obligations • Holdout issue

Why Use an Exit Consent and How Far Can It Go?

In connection with an exchange offer, issuers usually request that holders who tender their bonds for exchange consent to amendments to the indenture governing those bonds. These consents — known as "exit consents" — are distinguished from consent solicitations outside the context of a tender or exchange offer in that they are given by exchanging bondholders who no longer hold the old bonds immediately after closing of the offer. Because exit consents are binding on all holders (including those who do not exchange), they have the effect of penalizing holdouts by stripping the old bonds of most of their protective covenants and events of default. This penalty is intended to incentivize bondholders to participate in the exchange offer.

Exit consents have been widely viewed by the US courts as permissible contract amendments governed only by basic contract law principles.[17] Importantly, however, under Section 316(b) of the TIA and the express terms of most indentures, exit consents cannot amend the maturity date, reduce principal or interest, change the form of payment (such as substituting in-kind payments for cash payments), or make other economic changes to the terms of the bonds held by non-exchanging holders.[18] As a result, holders who are unwilling to agree to new payment terms can "hold out" and retain their old bonds with the same payment terms (albeit without other covenant protections).[19]

The Holdout Problem

The "holdout" bondholders who do not participate in the exchange offer retain their old bonds with the same payment terms, often leaving them (even when the protective covenants are stripped from the old bonds) in a position to have the principal on their bonds repaid earlier than a holder of the new bonds — and at face value rather than at the discount that the exchanging holders likely accepted.

An exchange offer with an exit consent will require, by the terms of the indenture governing the outstanding bonds, holders of at least a majority of the aggregate principal amount of outstanding bonds to tender. However, high "minimum participation" conditions requiring holders of 85% to 90% of the outstanding bonds or more to participate are not uncommon in exchange offers for highly distressed debt — often because they are demanded by the bondholders who agree to participate,[20] as they want to limit the amount of holdouts that can benefit from the actions taken by the exchanging bondholders.[21] These high thresholds are also frequently insisted upon by the distressed issuers themselves, who need

imminent and substantial relief from impending maturities and high cash interest burdens and want to create leverage to incentivize potential holdouts to tender and avoid a failed exchange offer. The high minimum participation condition may also be insisted on by senior lenders, who are usually seeking some kind of concession and are unwilling to see substantial cash payments continue to the holdouts.

Further, when common equity is offered as consideration, exchanging bondholders may require high minimum participation conditions to avoid holdouts from remaining in a senior position (*i.e.*, as debt holders rather than equity holders) in the event that the issuer eventually enters bankruptcy.

Even with the elimination of covenant protections for the old bonds through exit consents,[22] and notwithstanding the "incentives" that may be built into the terms of the new bonds as described above, many exchange offers fail because of this need for a high minimum participation condition. The holdout problem is exacerbated when the issuer seeks to restructure multiple tranches of debt and the senior bondholders (who are usually offered the most valuable new securities in an exchange) condition their exchange on high minimum participation from junior classes of bondholders (who may be offered only nominal recoveries) or from others in their own class when part or all of the consideration is common equity.

Bankruptcy Alternatives for Distressed Issuers

Distressed issuers have a number of alternatives within the bankruptcy process, including a traditional "free fall" Chapter 11 filing, a "prepackaged" or "prepack" filing, and a "pre-negotiated" filing. Distressed issuers can also simultaneously solicit participation in an exchange offer and a prepackaged bankruptcy and determine the path forward once the results are received.

How Prepacks Work

Despite the stigma often associated with bankruptcy proceedings, prepackaged bankruptcies are an elegant solution to the holdout problem encountered in exchange offers. The power of the prepack structure comes from Section 1126(c) of the Bankruptcy Code. This section provides that a plan of reorganization altering the payment terms of a particular class of claims need only be approved by two-thirds in claim amount and more than half in number of the total claims in that class that actually turn out to vote on the plan. So long as these minimum voting thresholds are met for a given issuance of bonds, all dissenters and holdouts are bound by the terms of the plan of reorganization (assuming other requirements for confirmation are met). Section 1126(c) of the Bankruptcy Code overrides the TIA's requirement that each affected holder consent to an amendment affecting payment terms.

In a prepack, the issuer solicits all of the necessary creditor approvals to confirm a Chapter 11 plan of reorganization before actually filing a Chapter 11 petition. In other words, the issuer "packages up" the bankruptcy plan prior to filing for bankruptcy so that the bankruptcy court will approve (and implement) the plan within a matter of weeks after the initial bankruptcy petition is filed. Hence the term "prepackaged."

With this approach, an issuer can avail itself of the magic of Section 1126(c) without all the fuss of a protracted bankruptcy process. For this reason, prepacks were very popular among over-leveraged issuers in the downturn phase of the last credit cycle and will likely be popular again.

Solicitations of creditor approvals in a prepack must still comply with applicable bankruptcy laws and non-bankruptcy rules and regulations, most notably the US federal and state securities laws. There are many potential pitfalls in the applicable securities laws when soliciting support for a prepack. Depending on the nature of the investors holding the applicable classes of securities, the limitations discussed above that

apply to private exchange offers may also apply to pre-filing (or “pre-petition”) solicitations of support — thus potentially preventing an issuer from reaching the applicable thresholds.[23] In some cases, a “straddle” prepack is possible, for which the issuer solicits support from potential participants who do meet applicable exemptions under the securities laws, and then begins a broader solicitation of support from holders post-petition.

A further advantage of a prepack is the ability to amend the payment terms of certain classes of claims even if they do not approve the plan of reorganization, pursuant to a process known as a “cram down.” Section 1129(b) of the Bankruptcy Code (which also overrides the TIA, to the extent applicable) provides that a negative vote by junior creditors cannot block consummation of the plan if the plan is approved by at least one class of senior claims that is being “impaired” in the plan (*i.e.*, is giving up some of its rights) and the junior creditors are getting at least what they would get under a Chapter 7 liquidation (which in most cases is nothing). As a result, a comprehensive restructuring may be possible using the tools available in the Bankruptcy Code with a much lower minimum participation requirement than would be necessary outside of bankruptcy.

Again, compliance with the TIA required, and therefore a Form T-3 must be filed prior to the solicitation of plan approval.

The following table sets forth the principal advantages/disadvantages of a prepack.

Prepacks	
Advantages	**Disadvantages**
• Quicker, cheaper, and less disruptive than a “free fall” Chapter 11 proceeding • Eliminates holdout issue • “Cram down” process can overrule junior creditors that object • Securities issued pursuant to plan are freely tradable[24]	• May be more expensive and more disruptive to issuer than non-bankruptcy alternatives • Pre-petition solicitations of support may be limited by applicable securities laws • Bankruptcy stigma may be unacceptable to management

The Real Deal: Combined Exchange Offer/Prepackaged Bankruptcy Plan

By combining the features of an exchange offer and a prepack, an issuer can have the best of both worlds. In a combined exchange offer and prepack, the issuer simultaneously solicits exchanges of old bonds for new bonds and acceptances of a “prepackaged” Chapter 11 reorganization plan. In other words, a vote for the exchange offer is a vote for the backup prepackaged plan.

In this type of transaction, the issuer conditions the exchange offer upon a high level of acceptances (*e.g.*, 90% or more) so as to minimize the holdout problem. If the issuer receives more than 90%, the exchange offer is completed outside of bankruptcy. If the issuer receives less than 90% in the exchange offer but more than two-thirds in amount and a majority in the number of the claims voting, then the prepack is accepted and the issuer commences a Chapter 11 case to obtain bankruptcy court approval of the prepack. Depending on the types of securities offered in exchange for the outstanding debt, the dynamics in the structuring and negotiation of the exchange offer/prepack with creditors and bondholders can shift. The greater the risk that holdout bondholders remain after the consummation of the exchange (with those bondholders getting eventually paid out at par if the issuer stays out of bankruptcy proceedings), the greater the risk that an agreement among creditors will not be reached outside of court.

The benefit of combining the exchange offer and prepack is that it may provide the potential holdout bondholder with an incentive (avoiding a "free fall" bankruptcy) to participate in the exchange offer, as the recovery in a traditional Chapter 11 bankruptcy may be less favorable than the consideration offered in the exchange/prepack. An issuer can further encourage participation by explicitly providing that the recovery for creditors in the prepack would be less than if the creditors participated in the negotiated exchange offer.

The Pre-Negotiated Plan: The Shortest Distance Between Two Points?

A prepack may not be an available option if the bondholders are broadly dispersed, or if they are not eligible for private solicitations of support, which makes reaching the required levels of support under Section 1126(c) of the Bankruptcy Code difficult or even impossible to achieve. In a pre-negotiated plan, the issuer determines, based on conversations with its key creditors, that a particular plan of reorganization is acceptable to them.

The issuer typically secures "lock-up agreements" or "letter of intent"-style agreements with key creditors promising to vote in favor of a particular plan should the issuer propose it within a designated timeframe. Based on this understanding, the issuer will file for bankruptcy and promptly ask the bankruptcy court to approve solicitation materials so that the formal plan approval process may commence as soon as possible. At this point, the issuer can rely on the securities law safe harbors afforded to it by the Bankruptcy Code to solicit broad support for the plan. The issuer will often have finalized the solicitation materials prior to filing the bankruptcy petition. In other words, a pre-negotiated plan is like a prepack except the vote to approve the plan is conducted in accordance with the Bankruptcy Code under the auspices of the court rather than outside of bankruptcy under the requirements and applicable exemptions of the securities laws (as is the case with prepacks).

An issuer can typically consummate its pre-negotiated plan within a few months following the commencement of the Chapter 11 case — a substantially abbreviated timeline compared with that of a traditional "free fall" bankruptcy.

What Can Go Wrong

Exacerbated Liquidity Issues Upon Announcement of Restructuring

An announcement of a restructuring, including a prepack or a pre-negotiated plan, may adversely affect an issuer's operations, in particular its relationships with trade creditors, suppliers, or customers. If these counterparties cease to provide normal trade credit to the issuer or modify or limit their business with the issuer, the issuer will likely have significant liquidity and/or fundamental business issues. A reduction in liquidity increases the likelihood that the issuer will be forced to file for Chapter 11 before completing the solicitation of acceptances of a prepack or negotiations with its creditors.

Credit Rating Downgrades

Issuers should consider whether a bond repurchase, or the announcement thereof, could trigger negative rating actions. Rating agencies may view significant repurchases as a "distressed exchange," which could result in rating downgrades. Agencies may issue a negative rating if a realistic probability of a default exists and investors receive less value than promised on the original securities as a result of the bond repurchase. Issuers of highly speculative bonds (B-/B3 or lower) are particularly likely to experience a negative rating action as a consequence of a bond repurchase below par.

Disclosure Issues

Exchange offers and prepacks are conducted pursuant to, and must comply with, US federal and state securities laws. Moreover, all discussions with bondholders rising to the level of an "offer" of new bonds must either be registered or exempt from the registration requirements of the Securities Act under exemptions afforded by Section 4(a)(2) or pursuant to Section 3(a)(9). The exchange offer and prepack solicitation documents need to be prepared with an eye toward Rule 10b-5 and good disclosure practices. In addition, private negotiations with creditors can trigger disclosure or other obligations under Regulation FD and MAR, in particular if discussions are conducted with one or more bondholder or lender groups to "test the waters" with respect to a particular restructuring plan in advance of a public announcement. Issuers facing the choices described in this *Client Alert* will likely also be updating the "Liquidity and Capital Resources" discussion in their Exchange Act filings.

EU Market Abuse Regulation

If the issuer of the debt has any equity or debt securities trading on an exchange in the European Union, it will need to consider the impact of the EU Market Abuse Regulation (MAR). It is likely that open-market repurchases of bonds on a "no names" basis, followed by an announcement that the company has retired the debt (*e.g.*, in the next public or bondholder report), or that the sponsors hold the debt, will generally ensure the fair treatment of bondholders, since the buyback is being executed at the most efficient price, and will not trigger MAR concerns.

MAR impact will need to be considered if the issuer has any bilateral conversations with market counterparties (including individual debt investors or private negotiations with creditors). This could arise if a company seeks to actively solicit or negotiate with bondholders in relation to a planned restructuring. In such circumstances, the company should consider a range of options, including announcing the transaction publicly and following a form of wall crossing that complies with the MAR market sounding procedures. In particular, if the information being discussed is price sensitive to the securities trading on an exchange in the European Union, such steps are intended to avoid unlawfully disclosing inside information. In this context and depending on the specific situation, companies may take the view that the information is not price sensitive in the context of any security trading on an exchange in the European Union after taking into account factors such as the amount of the outstanding debt being restructured or the nexus between the restructuring and other securities trading on an exchange in the European Union.

Conclusion

A wide variety and combination of restructuring alternatives are available to issuers, depending on their capital structure and liquidity position. These restructuring alternatives involve a complex web of regulations and issues, including US federal and state securities laws, the provisions of the TIA, stock exchange rules, Financial Industry Regulatory Authority (FINRA) rules and regulations, corporate law issues, tax considerations, general debtor and creditor issues, and applicable bankruptcy rules. In addition, practices that are acceptable and sufficient under US federal securities laws may not be adequate in a bankruptcy context. Financial restructurings require extensive legal analysis and guidance, and advance planning by issuers will help to avoid unexpected consequences.

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Out-of-Court Restructuring Transactions: What's Old Is New Again After Marblegate

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Endnotes

[1] Consent solicitations (whereby issuers solicit amendments to existing indentures) do not necessarily require significant cash outlays and are often used outside of the exchange offer context to amend overly restrictive incurrence covenants. However, any attempt to revise key payment terms such as maturity, interest rate, or type of interest paid (*e.g.*, converting cash interest to pay-in-kind) may be considered the offer and sale of a "new security" under SEC interpretations, which would be treated as an exchange offer for securities law purposes and require the issuer to comply with securities laws applicable to new issuances. See Charles T. Haag and Zachary A. Keller, "Honored in the Breach: Issues in the Regulation of Tender Offers for Debt

Securities," 9 N.Y.U. J.L. & Bus. 199 (2012) (citing Bryant B. Edwards and Jon J. Bancone, "Modifying Debt Securities: The Search for the Elusive 'New Security' Doctrine," 47 BUS. LAW. 571 (1992)).

[2] Regulation 14E under the Exchange Act applies to tender offers for debt securities. Rule 14e-1(a) requires that all tender offers remain open for at least 20 business days. (While a 2015 SEC no-action letter does permit certain tender offers for non-convertible debt securities to be open for as few as five business days, the limitations applicable to such offers make them unavailable for exchanges of the type discussed in this *Client Alert*.) Rule 14e-1(b) requires that a tender offer remain open for at least 10 business days following any change in the offer price or amount of bonds sought. In the context of equity securities, the SEC has indicated there may be other circumstances, such as a material change in the offer's terms or the waiver of a material condition to the offer, that would require that a tender offer remain open for at least five business days from disclosure of the event. See Interpretive Release Relating to Tender Offer Rules, Exchange Act Release No. 34-24296 (April 3, 1987). By analogy, bond issuers may wish to consider whether to extend an exchange offer for a period of less than 10 business days following a change less material than price or amount sought.

[3] A "qualified institutional buyer" is defined in Rule 144A(a) of the Securities Act. Although "accredited investors" are allowed to participate in private exchange offers under certain circumstances, the transaction will be subject to additional (potentially onerous) conditions in order to qualify for applicable exemptions from registration, and there may be "blue sky law" issues in some states if not all of the offerees are QIBs. Because of these complexities, issuers typically elect to limit private exchange offers to QIBs or offshore holders that meet the requirements of Regulation S.

[4] A typical "payments for consent" covenant will require that the issuer offer the payment to all holders and then pay it to any holder that consents to the amendment to the indenture. A more restrictive version of the covenant might require that the payment actually be made to all holders regardless of whether they consent to the amendment.

[5] Subject to a limited exception for equitable adjustments in respect of dividends or interest permitted by Rule 149 under the Securities Act, Section 3(a)(9) prohibits an issuer from requiring holders to contribute any property (including cash) other than the old bonds in a Section 3(a)(9) exchange, but there is no restriction on what an issuer may offer to its holders. Furthermore, Rule 150 under the Securities Act permits an issuer to make payments to existing holders in connection with an exchange of new bonds for old bonds (when such payments are part of the terms of the offer) without losing the benefit of Section 3(a)(9).

[6] Committees can form a unified front, which increases the chances that the exchange offer will be successfully completed without the need for a widespread solicitation. However, committees can cause problems as well, in particular if they are made up of both recent (debt raider or vulture fund) purchasers and long-term holders of the bonds and if they utilize outside counsel to assist in the negotiation. Disagreements among committee members can delay or prevent completion of a restructuring.

[7] See, for example, Klabin S.A., SEC No-Action Letter, 2014 WL 3421149 (July 14, 2014), Ageas SA/NV, SEC No-Action Letter, 2012 WL 1062151 (Mar. 20, 2012), Unocol Corp., SEC No-Action Letter, 1985 WL 55488 (July 5, 1985) and Chris-Craft, Industries, Inc., SEC No-Action Letter, 1972 WL 7393 (Sept. 9, 1972).

[8] See, for example, El Paso Natural Gas Co., SEC No-Action Letter, 1971 WL 8914 (Mar. 11, 1971) relating to an issuer's ability to use its directors, officers, and employees for solicitation activities; see also, Chris-Craft, Industries, Inc. (Sept. 8, 1972) relating to the requirement that the solicitation activities be limited to regular duties. Other letters set forth a variety of circumstances to be considered. See, for example, Klabin S.A., SEC No-Action Letter, 2014 WL 3421149 (July 14, 2014) and Calavo Growers of California, SEC No-Action Letter, 1996 WL 762983 (Oct. 23,1996).

[9] See, for example, Ageas SA/NV, SEC No-Action Letter, 2012 WL 1062151 (Mar. 20, 2012) and Calavo Growers of California, SEC No-Action Letter, 1996 WL 762983 (October 23,1996).

[10] See, for example, SunTrust Banks, Inc., SEC No-Action Letter, 1999 WL 506640 (July 16, 1999); International Controls Corporation, SEC No-Action Letter, 1990 WL 286830 (Aug. 6, 1990); Calton Incorporated, SEC No-Action Letter, 1991 WL 199473 (Sept. 30, 1991); and Seaman Furniture Company, Inc., 1989 SEC No-Action Letter, 1989 WL 246438 (Sept. 29, 1989).

[11] See Seaman Furniture Company, Inc., 1989 SEC No-Action Letter, 1989 WL 246438 (Sept. 29, 1989).

[12] The Seaman no-action letter referenced in notes 10 and 11 above permits attendance at and participation in meetings with bondholders prior to the formation of a bondholders committee by an issuer's paid financial advisor when the financial advisor's activities are meant to "effect" rather than "promote" an exchange. In Seaman, the financial advisor's activities were found to be "effecting" an exchange because no exchange offer had been made, the issuer's financial advisors had not and would not make any recommendation to the debt holders or their advisors with respect to the proposed exchange offer, and it is customary for an issuer involved in a complex financial transaction to engage an investment banker to act as an intermediary among the parties to a negotiation, especially if the other parties are professional legal and financial advisors.

[13] The TIA covers securities issued in exchange for securities of the same issuer in reliance on Section 3(a)(9) of the Securities Act. Therefore, pursuant to Section 306(a) of the TIA, a Form T-3 must be filed upon launch of the exchange offer. See SEC Compliance and Disclosure Interpretations, Trust Indenture Act, Question 101.05.

[14] Generally speaking, when old bonds are exchanged for new bonds in a Section 3(a)(9) exchange offer, the new bonds retain the "restricted" or "unrestricted" character of the old bonds. For example, if the old bonds were publicly tradable, the new bonds will be as well. In the case of restricted bonds, holders should be able to "tack" the holding period pursuant to Rule 144(d)(3)(ii). See Gentiva Health Services, Inc., SEC No-Action Letter, 2001 WL 856460 (July 27, 2001); Terminal Data Corp., SEC No-Action Letter, 1990 WL 304941 (Nov. 19, 1990); Wedgestone Realty Investors Trust, SEC No-Action Letter, 1988 WL 233594 (Jan. 18, 1988); Clevepak Corp., SEC No-Action Letter, 1984 WL 44974 (Mar. 23, 1984).

[15] Rule 162 of the Securities Act permits issuers to commence (for Rule 14e-1 purposes) registered exchange offers for equity securities upon the filing of a registration statement rather than waiting until the effectiveness of the registration statement, but does not help issuers commencing registered exchange offers for non-convertible debt securities.

[16] See Regulation S-X Rule 3-16; Regulation S-X Rule 13-02 (effective Jan. 4, 2021, but voluntary compliance permitted immediately).

[17] A leading case upholding exit consents is *Katz v. Oak Industries*, 508 A.2d 873 (Del. Ch. 1986).

[18] Section 316(b) of the TIA provides that "the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security, on or after the respective due dates expressed in such indenture security, or to institute suit for the enforcement of any such payment on or after such respective dates, shall not be impaired or affected without the consent of such holder." The Second Circuit clarified that the right protected under this provision is not an absolute right to payment and is not infringed in a transaction that neither amended any of the terms of the indenture nor prevented any dissenting bondholder from exercising its legal right to sue to collect on its bonds. *Marblegate Asset Mgmt., LLC v. Educ. Mgmt. Corp.*, 846 F.3d 1 (2d Cir. 2017), *reh'g denied*, No. 15-2124 (2d Cir. Mar. 21, 2017).

[19] In contrast, see the discussion on Section 1126(c) of the Bankruptcy Code, which overrides the TIA's requirement that each affected holder consent to an amendment affecting payment terms.

[20] Current rules permit an issuer to secure a bondholder's agreement to exchange prior to the launch of an exchange offer, but these lock-up agreements must be structured to avoid violations of the Securities Act and the tender offer rules. In addition, the terms of lock-up agreements must be carefully crafted to preserve the ability of locked-up bondholders to serve on creditor committees or take other actions in a bankruptcy. See SEC Division of Corporation Finance, Compliance and Disclosure Interpretations, Securities Act Forms (Interpretation # 139.29) (Aug. 11, 2010), available at http://www.sec.gov/divisions/corpfin/guidance/sasinterp.htm.

[21] The market often tolerates a "stub" amount of old bonds, generally 10% or less of the outstanding issue (determined in part through analysis of the issuer's ability to repay or refinance the stub at their stated maturity).

[22] In addition to holding bonds with no meaningful covenant protection following successful completion of an exchange offer and exit consent, stub bondholders are also faced with a limited public float (which can hamper the liquidity and, consequently, the market price, of their old bonds).

[23] While post-petition offers of securities are afforded a safe harbor under Section 1145 of the Bankruptcy Code, pre-petition solicitations of support (which are likely deemed "offers" of securities under the Securities Act) are not. Therefore, an applicable exemption from registration under the Securities Act will need to be available for such solicitations.

[24] Securities issued in a bankruptcy proceeding are typically exempt from the registration requirements of the Securities Act by virtue of Section 1145 of the Bankruptcy Code and Section 3(a)(10) of the Securities Act.