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Counterparty Risk: "Now You See It, Now You Don't"

By Adrian Harris and Jennifer Allen

Introduction

As the Sage of Omaha once said, "In the business world, the rear-view mirror is always clearer than the windshield." There is no better example of the benefits of 20/20 vision in hindsight than the events of the last 18 months or so.

Before the turmoil in the financial markets began, financial institutions contracted with each other and carried on business secure in the knowledge that large, and apparently well capitalized, banks were a safe bet for their dealings. They knew and trusted each other. Counterparty risk was more a factor for the banks to consider in the risk assessment and credit analysis of customers than in relation to each other or by customers in relation to their financial services providers.

During the liquidity-fuelled bull market of the last few years, it would now also seem that little attention was paid to the terms of the contractual agreements underlying those commercial dealings which prescribe (or in some cases fail to prescribe) what should take place when the unthinkable itself happens — the failure of a major bank. The collapse of Lehman Brothers in September last year was a defining moment in the way financial institutions, and the financial world in general, began to see, measure, and ultimately, fear risk. The belief was that if it could happen to the fourth-largest US investment bank, it could happen to any of our great and venerable financial institutions.

The whirling blades of the crisis had no respect for either history or reputation. For Bear Stearns to have been acquired in such haste by JP Morgan Chase; for Merrill Lynch to offer itself up to Bank of America when it undoubtedly saw what was coming during the Lehman Brothers/Bank of America negotiations; and for the last of the large independent investment banks, Goldman Sachs and Morgan Stanley, to seek the safety of registration as bank holding companies in the US and through that, the benefit of access to the federal reserve lending windows — it showed, if anyone really needed the evidence, how extremely powerful and all embracing the financial compression was.

The case of hedge funds, which have their assets stranded with one or more of the Lehman Brothers' entities, or which have other claims / continued page 2

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Counterparty Risk

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against them, is perhaps the starkest example of counterparty risk turning around and showing its teeth.

In this article, we look at the position of Lehman Brothers International (Europe) ("LBIE"), the types of documents used in LBIE's prime brokerage business and some of the issues that both the Joint Administrators and the hedge funds have been grappling with. We then compare the English insolvency regime with that of the US in so far as it affects broker-dealers.

What is Administration?

Administration is the closest insolvency procedure that we have in England to Chapter 11 in the United States. It is a procedure under the Insolvency Act 1986 whereby a debtor company can seek and, if successful, obtain, some breathing space from creditor action in order to resolve its financial difficulties. It is not a prerequisite that the debtor company must be insolvent. Merely the likelihood of insolvency is sufficient.

Both procedures share a protective feature for the debtor company in creating a moratorium. A creditor can neither commence, nor continue, proceedings against the debtor company without either the consent of the Administrators or the Court. This statutory moratorium certainly proved a major hurdle for counterparties of LBIE and the various attempts that were made to have the moratorium lifted in the days and weeks immediately following the Administrators' appointment ultimately failed.

What is the Role of Administrators?

Administrators are licensed insolvency practitioners. They are, by virtue of their appointment, officers of the Court. They have a duty to carry out their functions in the interests of all creditors.

Upon an Administrator being appointed, all property of the debtor company falls under the Administrator's control and, although the directors may remain in office, the Administrator effectively replaces them in running the debtor company's business.

Administration is essentially a two-stage process. During the first stage, an Administrator is required to attempt to rescue the debtor company as a going concern or, failing that, to seek to achieve a better result for the debtor company's creditors as a whole than would be likely if the debtor company were wound up without first being placed into Administration or, failing that, to realize the debtor company's property to make a distribution to its secured or preferential creditors. In general terms, an Administrator is given broad powers to carry on the debtor company's business and to realize its assets. The second stage may arise where the Administrator obtains permission from the Court to make a distribution to unsecured creditors.

What Approach Are the LBIE Administrators Taking?

Administrators are, by the very nature of their role, inherently risk adverse. Although Administrators are required to perform their functions as quickly and as efficiently as is reasonably practicable, they will also avoid taking any steps which would expose them to a professional indemnity claim or other liability to the creditors. Therefore, in the case of LBIE, the Joint Administrators, while focused on returning assets to LBIE's clients as soon as possible, also need to satisfy themselves before doing so that they would not be releasing assets to which the receiving fund is not entitled or that they are not releasing client assets where there is likely to be a shortfall or competing claims to those assets.

It is also important to take into account the scale of the task being faced by the Joint Administrators in the LBIE Administration. For example, they are negotiating with over 90 custodians in various jurisdictions where those custodians have blocked accounts following the appointment of the Administrators on 15 September, 2008. There are also over 1,400 former LBIE clients and approximately 140,000 separate failed trading positions which have required investigation, analysis and reconciliation. Numerous exchanges, through which securities have been traded, revoked LBIE's licenses and the Administrators have also had to enter into complex negotiations with those exchanges in order to seek clarification of the assets held and arrangements for their release.

The Administrators have stated that they are treating the identification and return of client assets and monies as a very important and urgent matter and that they fully appreciate the market issues that are being faced by counterparties. Since October 2008, the Administrators have returned some assets to several clients. These holdings have been returned on terms that seek to ensure that the LBIE estate and the Administrators themselves are adequately protected in the event that competing claims arise or where there is a shortfall. However, in order that the return of assets can be dealt with

on a far larger scale, the Administrators are currently working on proposals for a scheme of arrangement.

On 1 May, 2009, the Administrators made an application to the High Court seeking directions on client money held by, or on behalf of, LBIE. The Administrators have explained that the purpose of the application is to initiate the process that will address the issues relevant to LBIE in order to expedite the return of client money. They have invited clients to review the application, and any supplemental evidence which the Administrators will be adding to the application, and to consider making representations in respect of the issues that may impact them. The Administrators have stated that the answers to some of the questions may affect the money that is available for distribution to the general estate and that, therefore, the application may be of interest to creditors in general.

Hedge Funds and LBIE

Typical Contractual Documentation

The contractual arrangements between hedge funds and LBIE broadly fall into two main categories — first, those which deal with OTC derivatives trades, where there are no custody arrangements and second, the more complex arrangements involving LBIE's prime brokerage business.

Most OTC trades are documented through the standard form ISDA Master Agreement, the Schedule agreed between the parties and the specific Confirmations of any transactions entered into from time to time.

Where LBIE was appointed as the hedge fund's prime broker, there would normally have been a suite of documents, which typically would have included a prime brokerage agreement, securities lending agreement, margin lending agreement, an ISDA Master Agreement, and a repo agreement. There may also have been over-arching or cross-product netting arrangements as well as other documents or side letters which would have been tailored specifically to a fund's particular requirements. These might have included provisions relating to netting arrangements and the segregation of assets into specific and clearly identifiable accounts.

Legal Issues

There are many and varied complex legal issues involved and it is beyond the scope of this article to attempt to deal with all of them or to provide a detailed analysis with a high level of specificity. However, it is clear from a review of documentation entered into between certain hedge funds and LBIE, that in several instances contracts were unilateral in the sense that they only contemplated, and therefore provided for, an event of default occasioned by the insolvency of the fund rather than of LBIE itself. This led to situations where the contractual position of the hedge fund in relation to its various trading positions and prime brokerage arrangements was unclear and consequently a view had to be taken.

It is clear from a review of documentation entered into between certain hedge funds and LBIE, that in several instances contracts were unilateral in the sense that they only contemplated, and therefore provided for, an event of default occasioned by the insolvency of the fund rather than of LBIE itself.

Many hedge funds only became aware of the implications of giving LBIE wide-ranging powers over their assets, (the *quid pro quo* being more cost effective funding) after the appointment of Administrators when their documentation was carefully analyzed. For example, many hedge funds elected to opt out of the FSA's client protection rules in relation to both cash and other assets. Many hedge funds also agreed that ownership of their assets actually passed to LBIE and gave consent for LBIE to exercise a right of use (or rehypothecation) over the hedge fund's assets. In addition, a hedge fund may have authorized LBIE to transfer its assets to a / *continued page 4*

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custodian in another jurisdiction, with the result (following the Administration) that either the custodian may not have acknowledged LBIE's notice to it that the assets were in fact client assets (and therefore should be segregated and protected) or that custodians may, because of the applicable regulatory regime in their jurisdiction, have failed to recognize the proprietary nature of the interest that the fund had in those assets. A worst case scenario in this instance is that the custodian used the fund's assets to set off its own liabilities to LBIE or was attempting to do so.

In terms of client assets, the Administrators have first needed to ascertain whether or not a client is actually entitled to client asset protection. They have then needed to identity persons who have claims to particular securities and then determine whether or not those securities were rehypothecated. One of the key legal issues has been the extent to which a right of use or rehypothecation might extinguish a hedge fund's trust or proprietary interest claim.

The Administrators also recognize that they need to establish how any loss should be shared in the event that there is a shortfall. In addition, the Administrators will need to determine who will bear the cost of distributing client assets.

Close-out netting is also an area which requires a detailed analysis and careful interpretation of the documentation. In general terms, once an Administrator has received permission from the Court to make a distribution to unsecured creditors, the rules in Part 2, Chapter 10 of the Insolvency Rules of 1986 then apply. These rules require an Administrator to give notice of his or her proposal to make a distribution to creditors. Once this notice has been given, the rule as to mutual credits and set-off contained in rule 2.85 applies.

Under this insolvency set-off rule, all sums due from one party to the other in respect of mutual dealings are to be set off against each other. Insolvency set-off is mandatory and self-executing and displaces all other rights of set-off (such as contractual set-off) which have not been exercised prior to insolvency set-off taking effect. Since insolvency set-off is mandatory and self-executing, there is no requirement for either party to take any steps to exercise rights of set-off.

The contractual valuation times and methodologies should be preserved despite the commencement of insolvency proceedings.

Any claims arising out of obligations that are incurred after the date of the Administration would not be eligible for insolvency set-off.

In normal circumstances, the set-off would be effected as at the date of notice that an Administrator proposes to make a distribution to creditors (rule 2.95 notice). However, as already mentioned, the Financial Collateral Arrangements (No.2) Regulations 2003 should nevertheless serve to protect a contractual close-out netting provision in a financial collateral arrangement. The effect of this is that the account of what is due from each party to the other is taken, not at the date of the Administrators' notice, but at the date provided for in the contractual documentation. In other words, the contractual valuation times and methodologies should be preserved despite the commencement of insolvency proceedings.

The only other way in which a right of set-off could be asserted following the commencement of an Administration and before giving a rule 2.95 notice is if the Administrators decided to initiate proceedings against the counterparty for recovery of claims which the insolvent company has against it. Administrators would only be likely to do this, however, if the

process for making a distribution to creditors was so far off that the insolvent company's claims were likely to become time-barred if proceedings were not commenced.

A Comparison with the US Approach

Many of the problems that have arisen with LBIE are due to the fact that English law does not have a special, streamlined legal framework for broker-dealer insolvencies.

Broker-dealer insolvencies fall under the same rules of insolvency that apply to any other business in the UK. The US system, by contrast, has a special architecture which has been designed to facilitate the rapid bulk transfer of fully paid and excess margin customer positions to healthy broker dealers.

Under US law, brokerage customers with margin and non-margin accounts essentially have the same legal creditor status. That said, there is a possible timing and recordkeeping advantage, in the event of a broker's insolvency, to keeping assets in a pure custody account rather than a margin account if the customer does not in fact plan to margin its positions.

The very safest option is to keep the customer's position in "customer name" or in other words, registered in the customer's name rather than in the street name, and not transferable by delivery. While customer name securities positions should be largely without risk in a broker's insolvency, keeping positions in customer name is unwieldy and cumbersome and would make it impossible for the customer to trade those positions quickly. For this reason, substantially all customer assets with US broker-dealers are held in street name.

US law accords a broker's customers priority status to the extent of the net value of their accounts as of the date of the broker's failure. The principal governing US law is the Securities Exchange Act Rule 15c3-3 (the so-called "customer protection rule" or "CPR"). The CPR imposes requirements that are intended to protect customers in the event of their broker's failure. It requires a broker at all times to have physical possession or control of all of its customers' fully paid and "excess margin" securities (securities whose market value plus the cash in an account exceeds 140% of a customer's margin loan balance). The CPR also requires each broker to maintain a special reserve bank account for the exclusive benefit of its customers in an amount equal to the net amount of funds it owes its customers (as determined in accordance with a formula). In addition, the CPR limits a broker's ability to pledge its customers' fully paid securities or to use them in the broker's proprietary businesses, and also limits the amount of a customer's securities that a broker can pledge to a third party to collateralize the margin loans that are owed to the broker.

The CPR should provide a significant measure of protection to the customers of a failed broker. Nevertheless, the fact that the CPR obligates brokers to maintain possession only of "excess" margin securities means that they need not possess securities comprising 40% of margin loan amounts, which gives rise to possible shortfalls. Shortfalls also may result from the insolvent broker's failure to comply with the CPR. Therefore, it is probably inevitable that the CPR alone will not fully protect the customers of a failed broker.

In addition, the CPR does not ensure that customers will be able to retrieve these assets from a failed broker-dealer immediately. Under either Chapter 7 of the US Bankruptcy Code or a liquidation commenced under the Securities Investor Protection Act ("SIPA"), there will be a period of delay during which those assets will be unavailable to customers (and against which customers may be unable to hedge their market exposure). Customer name securities and other customer accounts could be transferred to another healthy broker-dealer expeditiously, giving customers quick access to these assets at the new broker-dealer, and the Securities Investor Protection Corporation ("SIPC") always makes such transfers its first priority in any failure, using its regulatory weight to arrange the immediate transfer of a failed broker's accounts to a healthy one. However, for those accounts not transferred, customers will have to wait while the court-appointed trustee liquidates and distributes the proceeds.

As an example of this process, in the recent failure of Lehman Brothers, Inc. ("LBI"), the SIPC Trustee was able to obtain the requisite court approvals and to transfer substantially all of LBI's non-prime brokerage customer accounts to Barclays within two or three working days after his appointment and customers were able to resume normal access and trading after only a few days. This result was achieved because LBI had been in compliance with the CPR, making an immediate bulk transfer of most non-prime brokerage customer accounts and positions possible.

Although this looks at first sight to have been a smooth and efficient process, the position on the ground looked very different. It has been said that the transfer of some of these accounts was a somewhat slow and opaque process. The sheer size and complexity of the task must have slowed things down, as they have done in LBIE, so would it be fair to say that the UK system is less efficient than that in / *continued page 6*

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the US? Clearly, reforms in the UK are necessary and we have already started that process with the new Banking Act 2009, the Bank Insolvency (England and Wales) Rules 2009 and the Bank Administration (England and Wales) Rules 2009. However, it is important to bear in mind when making any comparison between the Administration of LBIE and the procedures undertaken in relation to its US affiliates, that the LBIE Administrators were brought in at the 11th hour and 59th minute and therefore had little time to get their arms around this financial behemoth and put a plan together prior to their appointment. In addition, many of the problems at LBIE arose on the prime brokerage side of the business where, as already discussed, customers typically freely granted their prime broker various rights of use or rehypothecation, which permitted the broker to use prime brokerage customer assets in their own businesses in return, of course, for a higher rate of return. These rights of use enabled LBIE to use prime brokerage customers' assets in its own business, making it difficult or nearly impossible for customers to assert proprietary rights upon insolvency. So perhaps not really a level playing field?

Upon the failure of a broker, it may be liquidated either pursuant to Chapter 7 under the US Bankruptcy Code or a procedure administered by SIPC under SIPA. The primary difference is that under Chapter 7 all account assets are sold and the customers receive cash, whereas under the SIPC approach the trustee distributes securities to the maximum extent possible.

There are three classes of property to be dealt with under each procedure. First, there are customer securities that are held by the broker and which are in the name of the customer. Secondly there are customer securities that are held in street name and the cash held in customer accounts. Thirdly there is all the broker's other property.

These are subject to the following treatment:

- Under both Chapter 7 and SIPC, assets in the first class are distributable to the customer, subject to prior satisfaction of any amounts owed by the customer to the broker.
- In a Chapter 7, assets in the second class are sold and the proceeds are distributed to customers pro rata in accordance with their respective net account balances. Customers are treated as general creditors of the estate with respect to any shortfall.
- In a SIPC procedure, assets in the second class are divided among the customers in accordance with their respective entitlements. SIPC will satisfy any shortfalls, subject to a maximum of $500,000 per customer (including a maximum of $100,000 in cash held in the customer's account). Customers are treated as general creditors with respect to any remaining shortfall. SIPC insurance does not protect against market price fluctuations during the period before the customer receives its distribution.
- Under both Chapter 7 and SIPC, assets in the third class are used to satisfy any remaining unsecured claims (including remaining customer claims).

Conclusion

Hedge funds were understandably concerned last year to learn that their various positions with LBIE were not as well protected as they had thought. While the fog has now cleared to some degree, the picture is still not pretty and it is obvious that the process to reach a complete resolution of hedge funds' own individual positions will take many more months to work through. The basis on which hedge funds will contract with financial institutions in the future will never be the same again. Recent events have shown that bank customers should now consider counterparty risk in relation to their proposed dealings with banks. One thing is certain, the financial world has changed, perhaps forever and a new paradigm is in play. ◎

Express Rescission Rights to Funds Advanced Do Not Create Implied Trust under Section 541(d)

By Young Yoo

In *Great American Ins. Co. v. Bally Total Fitness*, 2009 Bankr. LEXIS 728 (Bankr. S.D.N.Y. Mar. 27, 2009), the Bankruptcy Court for the Southern District of New York addressed the question of whether an express reservation to a right of rescission, based on alleged misrepresentations, created an implied trust with respect to advanced insurance funds, thereby depriving the estate of an equitable interest in the funds.

After analyzing the parties' written agreement and addressing relevant case law, the Bankruptcy Court held that because

the agreement neither required the debtor to hold the funds, nor return the funds without condition, no implied trust was created and the funds advanced to the debtor prior to its bankruptcy were property of the estate pursuant to section 541(d) of the Bankruptcy Code.

Case Background

The plaintiffs, Great American Insurance Co. ("GAIC"), issued directors' and officers' liability policies to the debtor, Bally Total Fitness ("Bally"), for policy years 6/01-6/02 and 6/02-6/03. The policy amounts were $20,000,000 and $10,000,000, respectively. After the policies were issued, Bally restated its financial results for 2000 and 2001 to reflect billion dollar reductions in stockholder's equity. As a result of this restatement, Bally and its directors were named in numerous securities class actions and shareholder derivative suits and were being investigated by both the Securities and Exchange Commission and the Department of Justice. Seeking coverage to defend the various claims, Bally submitted the claims to GAIC under the policies.

GAIC subsequently asserted that the material misstatements contained in Bally's financial statements gave GAIC the right to rescind the policies under Illinois state law. GAIC eventually agreed to provide coverage if the parties entered into an interim fee advancement and non-waiver agreement (the "Interim Fee Agreement").

Pursuant to the Interim Fee Agreement, GAIC advanced to Bally a small portion of the $20,000,000 limit of the 6/01-6/02 policy and the entire amount under the 6/02-6/03 policy. The Interim Fee Agreement further provided that GAIC reserved its right to bring a rescission action against Bally within an agreed time frame and seek reimbursement of any funds advanced. The agreement neither authorized nor restricted Bally's ability to commingle the funds advanced with its other assets. The agreement was also silent as to whether Bally had to keep funds in suspense or place them in an isolated and separate account.

On August 22, 2006, GAIC filed an action for rescission within the agreed time frame set forth in the Interim Fee Agreement. On December 30, 2008, in the middle of discovery for the rescission action, Bally filed for chapter 11 relief. GAIC subsequently filed an adversary complaint in the bankruptcy case seeking a declaratory judgment that the funds advanced by it to Bally did not include a transfer of equitable title to, or ownership of, the funds from GAIC to Bally. GAIC asserted that Bally acquired, at most, only bare legal title over the advanced funds and that the Interim Fee Agreement created an implied trust that served to carve out the advanced funds from the bankruptcy estate pursuant to section 541 of the Bankruptcy Code. Bally moved to dismiss for failure to state a claim, arguing that the funds were clearly part of Bally's estate.

Bankruptcy Court Ruling

In addressing the issue, the Bankruptcy Court focused on distinguishing the facts of the case from a case that GAIC principally relied on, *Firestone Tire & Rubber Co. v. Goldblatt Bros. Inc.*, 33 B.R. 1011 (N.D. Ill. 1983). GAIC cited that case for the proposition that in Illinois, "the law presumes, when one turns over to another proceeds to be held and later returned... there is a presumption that an implied trust has been created." *Firestone*, 33 B.R. at 1013. The Bankruptcy Court noted, however, that the Interim Fee Agreement did not require Bally to hold the funds or return the funds without condition.

The Bankruptcy Court then noted that the facts of *Firestone* were "easily distinguishable." The license agreement that controlled how Firestone sold Goldblatt's products required Firestone to turn over all of the day's sales to Goldblatt who would in turn deduct royalty fees and remit the remainder to Firestone. This arrangement vested Firestone with an absolute right to the funds, whereas GAIC's only right to the advanced funds were not absolute, but "merely contingent" upon GAIC's successful action for rescission.

The Bankruptcy Court also agreed with Bally's contention in its motion to dismiss that GAIC had the opportunity to tailor the Interim Fee Agreement and stipulate that an express trust relationship existed, but did not. Nor did the agreement provide for segregation of funds or escrow arrangements or other hallmarks resembling trusts. As such, the Bankruptcy Court found that no implied trust over the advanced funds was created that would justify the requested isolation of those funds from the estate pursuant to section 541(d) of the Bankruptcy Code and dismissed the case.

Analysis

The rule of law expressed by the *Bally* decision is fairly straightforward. Implied trusts over funds advanced are created when there is an obligation to hold and then return the funds without condition. This type of obligation is evidence that a transferor has an absolute right to those funds and serves to rebut the presumption that the transferee has both legal and equitable title. In turn, this can / continued page 8

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establish that the transferee is a mere trustee. Here, the transferee, Bally, had no such obligation to hold and then return the funds advanced to it. No evidence existed to rebut the presumption that Bally held both legal and equitable title. Generally speaking, the decision should serve to highlight that when written instruments are involved, careful drafting with clearly contemplated goals is necessary to create rights that are enforceable in the event of a subsequent dispute. ◎

Options for Restructuring Publicly Traded Debt

by Marc M. Rossell, in New York

We live in turbulent financial times. Even companies with relatively stable financial positions face the prospect of restructuring their liabilities.

The absence of a meaningful credit market to refinance maturing indebtedness, the lack of short-term liquidity, or simply the inability to maintain required financial ratios in loan agreements may generate a need to consider a liability management transaction of some kind.

Companies whose debt securities trade publicly at a discount to par or face value may also want to capture some of the discount by purchasing their own securities with available cash.

Companies with bank debt or debt held privately by a few institutions can often deal with their creditors on a consensual basis without worrying about US securities laws. However, companies with outstanding indebtedness or that wish to issue new indebtedness in the form of bonds or other similar debt constituting "securities" must face a series of other issues arising under the securities laws.

This article outlines some of the securities law considerations companies have to take into account when contemplating an out-of-court restructuring of their publicly issued debt securities. For this purpose, "publicly issued" means issued in a public offering or otherwise traded in the institutional capital markets as restricted securities. This article does not include any discussion of equity securities, including convertible debt that is considered equity under the securities laws, nor does it consider issues related to securities issued by a company in a bankruptcy proceeding.

Several Options

Companies with outstanding debt securities can engage in a variety of transactions with holders. The choices depend to some extent on whether or not the company has access to cash.

Where cash is available, either from internal funds, new financing or both, a company can consider an optional redemption, open market purchases or a cash tender offer. Without cash, the most likely alternative is an exchange offer of new securities for the existing securities.

In the case of either a cash tender offer or an exchange offer, there is often a consent solicitation as well to modify the terms of the existing securities. If only a waiver or amendment of existing terms is required, a stand-alone consent solicitation may be an appropriate solution.

Options for Company with Cash

If the agreement governing the indebtedness, typically an indenture, permits the company to redeem bonds prior to maturity, then an optional redemption of the debt securities can be made. However, many indentures restrict such redemptions in the early years of the bond — the so-called "non-call period" — and in later years the exercise of the redemption feature may be subject to payment of an additional premium which may be unattractive. Some indentures allow redemptions at any time subject to payment of a "make-whole" premium based on the recuperation of the yield through maturity, a price that is usually quite high. Where the bonds are trading at a discount to par value, these options will be particularly unappealing.

Most indentures do not restrict the company from repurchasing its own bonds in the open market. If no such restrictions exist, and assuming there are no other applicable contractual or regulatory prohibitions binding on the company, then cash repurchases in the open market can be made through privately negotiated transactions with individual holders, either directly or through the intermediation of a broker.

Most open market debt repurchases can be structured in a manner to avoid the application of the "tender offer" rules under a US securities law called the Exchange Act, but counsel should be consulted prior to undertaking any such program to ensure that such purchases do not amount to a tender offer.

Repurchases that might be recharacterized as a non-compliant tender offer could expose the company to liability and sanctions.

What constitutes a "tender offer"? Neither the US securities laws nor the US Securities and Exchange Commission has defined the term "tender offer," and there is not much case law or SEC commentary on the topic. The following eight factors have generally been cited as evidence of a tender offer: 1) active and widespread solicitation of holders, 2) solicitation for a substantial percentage of the outstanding debt, 3) the offer is made at a premium over the prevailing market price, 4) the terms of the offer are firm and not negotiable, 5) the offer is contingent on a minimum number of tendered securities, 6) the offer is open only for a limited period, 7) the offeree is subject to pressure to sell the securities, and 8) the public announcement of a purchasing program precedes or accompanies rapid accumulation of the securities. A tender offer may be found if fewer than all eight factors are present.

The best way to avoid inadvertently making a tender offer is to solicit only a limited number of holders, preferably sophisticated investors, stretch the repurchases over a long period of time, without deadlines or other pressures, purchase on separately negotiated terms and prices from different holders, and consider limiting the total amount of securities purchased in the open market. If both a repurchase program and an overt tender offer are contemplated, the company should consider undertaking them separately and having some period of time elapse between the two events to avoid the repurchases being considered part of the tender offer.

Indentures typically provide that bonds purchased or otherwise held by the company or an affiliate will not be considered to be "outstanding" for purposes of tabulating votes required for taking action under the indenture such as waivers, consents and amendments. Companies and their affiliates (often controlling shareholders) should be conscious of this limitation if there is any intent to influence the outcome of a vote by acquiring outstanding bonds in the open market or otherwise.

Finally, a company with cash may wish to offer all holders the opportunity to tender their bonds for a cash payment. Overt cash tender offers for debt securities are regulated by section 14(e) of the Exchange Act. These rules generally prohibit fraudulent and manipulative activity and require that the tender offer be kept open for a minimum of 20 business days from commencement and 10 business days from notice of a change in either the percentage of securities sought, the consideration offered or the dealer's soliciting fee.

Since it is often impractical to leave a debt tender offer open for such a long period, the SEC has issued a series of "no-action" letters exempting certain tender offers for investment-grade securities from the 20-business-day rule, subject to certain conditions. Pricing formulations vary, but since the "equal treatment" rules for tender offers of equity securities do not apply to non-convertible debt securities, alternative pricing mechanisms such as Dutch auctions and fixed-spread pricing are available. There are also certain structural features to the offer that can be implemented to incentivize holders to tender early, such as "early bird" premiums to holders who tender before a certain date, thus providing / continued page 10

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greater certainty to the company as to results prior to the expiration of the offer.

The Exchange Act rules do not require the filing of any offering document with the SEC, and there are no specific disclosure requirements that apply. However, an offer-to-purchase document is customarily prepared, and it should be materially accurate and not misleading to avoid liability. If the targeted debt securities are listed or quoted on a securities exchange, then the rules for such exchange must also be reviewed to determine whether any specific disclosure or procedural requirements apply.

Anti-Fraud Liability

Whether the company engages in open market purchases or conducts a cash tender offer, often the most significant legal issue is avoiding liability under the anti-fraud provisions of the securities laws, including Rule 10b-5 under the Exchange Act.

This rule generally prohibits the use of materially misleading statements or omissions in connection with the purchase or sale of a security and otherwise prohibits the use of manipulation or deceptive devices to purchase or sell a security.

The application of Rule 10b-5 in the context of open market debt purchases is not entirely clear. If the company makes statements in the context of a purchase that are materially misleading or inaccurate, then the seller may have a Rule 10b-5 claim.

Where no statements are made but the company has inside information and the purchases are made through a broker, the result is less clear because Rule 10b-5 only imposes liability for omissions where the buyer has a duty to disclose and has failed to do so. Recent decisions have held that companies that are solvent generally have no fiduciary duties to holders of their debt securities and, thus, assuming current public disclosures by the company are correct, there would be no duty to disclose material non-public information in the context of a debt repurchase. However, not all courts might agree with this position and there are other theories, such as common law fraud, that might be used to infer a duty to disclose even in the absence of a fiduciary duty.

Options for Companies Without Cash

A company may not want to use cash or may otherwise need to make an offering of new securities with different terms to its existing holders.

Most indentures provide that unanimous consent is required to change fundamental economic terms of the securities (such as maturity, interest rates or mandatory redemption events). Obtaining such consents is often quite difficult. Any exchange of newly issued debt or equity securities for outstanding debt securities is considered an offer of securities under the Securities Act of 1933 and, thus, it must be registered with the SEC unless an exemption from registration is available. The most common exemptions are the section 3(a)(9) exemption and the so-called “private placement” or section 4(2) exemption. Exchange offers are also considered tender offers and, thus, the Exchange Act rules for tender offers discussed earlier also apply.

Although there is no legal requirement for the company to use the services of an intermediary to solicit exchanges, it is customary in most situations to appoint a dealer-manager for an exchange offer. In that event, due to liability concerns that arise in any new offering of securities, dealer-managers customarily perform due diligence on the company and request

Whether the company engages in open market purchases or conducts a cash tender offer, often the most significant legal issue is avoiding liability under the anti-fraud provisions of the securities laws.

third-party assurances on whatever offering document is prepared, including auditors' comfort letters and lawyers' negative assurances or "10b-5 letters."

Section 3(a)(9) of the Securities Act allows a company to offer and sell new securities to existing holders of its own securities without registration, subject to certain conditions.The offering must be made exclusively by exchange with its existing holders. The issuer of the new securities must also be the same issuer as the issuer of the old securities, a requirement that can present structural challenges if there are parent or subsidiary guaranties involved.

One of the most problematic requirements of section 3(a)(9) is that the company cannot pay a fee to the dealer-managers to solicit tenders that is conditional on the success of the exchange offer. The SEC has issued a series of no-action letters that permit a financial adviser to undertake certain administrative activities in connection with the exchange, including pre-launch discussions with sophisticated holders of bonds, so long as there is no success fee involved. Unconditional fixed fees are permitted but this solution may not be attractive for the company. The restriction on these fee arrangements where active solicitation may be required in an exchange often leads companies to select another form of exchange offer. In a section 3(a)(9) exchange offer, similar to registered exchanges, there is no restriction on general solicitation or advertising, thus allowing unrestricted publicity, and there are no restrictions on the nature of the offerees.

Another exemption available for an exchange offer is the so-called "private placement" exemption under section 4(2) of the Securities Act. With this structure, the offer and sale are made only to accredited investors such as large institutional holders; non-US persons are also often solicited in reliance on Regulation S of the Securities Act under this concurrent exemption. Another important limitation of this exemption is that there can be no general solicitation or advertising, a restriction on publicity that should be taken into account when considering this alternative. However, this exemption does not impose any restrictions on fees for the dealer-manager, so there is more flexibility on that issue.

Because of the limitation on the nature of the offerees, the offering document cannot simply be distributed to all existing holders. Holders must pre-qualify through an eligibility questionnaire before receiving an offering document. In most exchange offers for outstanding debt, there is little if any non-accredited investor participation and, thus, this pre-qualification process mostly affects timing since the offer takes more time to implement.

Another option is a registered exchange offer. A company can file a registration statement on Form S-4 with the SEC to register the offer and sale of the new debt or equity securities to the holders of its existing bonds. Form F-4 must be used if the company is a foreign private issuer.

In a registered exchange offer, there are no structural restrictions or fee limitations as there may be in a section 3(a)(9) exchange and dealer-managers can freely solicit tenders and all holders can participate, including retail investors. However, companies cannot generally use existing "shelf" registration statements to conduct an exchange offer and the SEC may elect to review the new registration statement, a process that can be lengthy and unpredictable. Companies are also subject to heightened liabilities under the Securities Act for disclosures and omissions in the registration statement and prospectus.

Exit Consents

In order to encourage holders to tender their bonds in an exchange offer or cash tender, and to allow the company to avoid the application of restrictive covenants in the indenture for the bonds that the company is attempting to retire or repurchase, companies often seek "exit consents." This refers to the practice of having tendering holders consent to amendments or waivers of covenants or other terms in the existing indenture as a condition to acceptance of the tender or exchange.

The amendments or waivers that are sought are typically those that can be adopted or granted with a simple majority vote of bondholders. Holders tendering their bonds for cash or new securities will generally not be concerned about the protections in the existing indenture and those refusing to tender or exchange their bonds will be left with an indenture without the same protections. In addition, if the tender or exchange is successful, non-tendering holders will be left holding bonds with a more limited trading market which is likely to affect trading prices for the old securities adversely. This also acts as an additional incentive to participate in the tender or exchange.

Companies should consider the application of the "new security" doctrine if a consent to an amendment or waiver relates to fundamental terms of the securities. The SEC has taken the position that consents to amendments to */ continued page 12*

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existing debt securities that fundamentally alter the terms of debt securities have the effect of creating a new security, thus requiring analysis of the consent under the Securities Act similar to what occurs in an exchange offer. In addition, in the context of exit consents included as part of an exchange offer relying on the private placement exemption of section 4(2) of the Securities Act, one issue to be addressed is whether or not a consent is valid if not all holders are given an opportunity to consent. Certain case law has cast some doubt on this point. Because private placements exclude non-accredited investors, to the extent there are any such holders excluded, consideration needs to be given to restructuring the transaction to accommodate this concern by, for example, undertaking a separate consent solicitation outside of the exchange offer to afford all holders the opportunity to participate.

Tax Implications

The tax implications of debt repurchases and exchange offers should be considered; they are usually disclosed to existing holders in any offering document. Although the application of the tax rules to a particular transaction is often fact specific, certain principles generally apply.

A company repurchasing debt at a discount will generally recognize "cancellation of indebtedness" income in an amount equal to the discount. In an exchange offer for new securities, the company will generally recognize this income to the extent that the amount owed on the existing debt exceeds the fair market value of the new securities. In the case of new debt securities, if the fair market value of the new securities is less than the outstanding principal amount of the debt, there will likely be original issue discount that the holders of the new debt will be required to treat as income (with a corresponding interest deduction for the company over the life of the new debt). ◎

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