Debt Repurchasing Considerations in an Uncertain Market

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If you have any questions regarding the matters discussed in this memorandum, please contact the attorneys listed on the last page or call your regular Skadden contact.

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In light of the recent downturn and increased volatility in the global financial markets due to the COVID-19 pandemic, a number of companies have raised questions regarding the best practices and desirability of repurchasing their debt. This alert addresses the questions surrounding debt repurchases that companies should consider when evaluating the advantages, disadvantages, legal implications and strategic considerations of debt repurchases in a turbulent market.

Overview

Why should a company repurchase its debt?

There are a number of reasons a company might consider repurchasing its debt, including, but not limited to:

- reducing interest expenses;
- reducing leverage to ensure compliance with covenants under other indebtedness; and
- repurchasing debt securities at a discount to their principal amount when the market price for the securities is below par value.

Companies may see debt repurchases as more attractive than stock repurchases because of the recent negative media coverage of stock buybacks, as well as because debt buybacks are often subject to fewer disclosure and approval requirements.

A company considering a debt repurchase should weigh these potential benefits against the risk that a repurchase of debt — and a repurchase of non-investment grade debt in particular — may result in a ratings downgrade if the repurchase is interpreted as a "distressed exchange" by ratings agencies.

What are the ways a company can repurchase its debt?

The principal ways in which a company can repurchase its debt are:

- issuer tender offers; and
- open market and privately negotiated repurchases.

What threshold issues should a company consider before repurchasing its debt?

A company contemplating a debt repurchase should, after consultation with outside counsel and other advisers, ensure that it has the authority to repurchase its debt and confirm whether it is subject to any limitations or restrictions on repurchasing debt.

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A company should review the contracts governing its existing debt, including credit facilities, indentures and other agreements to confirm that there are no covenants in effect which limit its ability to repurchase its debt. Key provisions to review include determining whether there are:

- limitations on restricted payments or purchases of junior debt, to determine whether lower-ranking debt can be repaid, redeemed or refinanced, and the flexibility afforded to the company to pay dividends or use the cash proceeds for other purposes; or
- limitations on transactions with affiliates, to assess the ability of the company to engage in favorable transactions with affiliates, such as purchases of debt from affiliates.

Should a company's board of directors explicitly approve the repurchase before it is implemented?

Whether board approval of a debt repurchase is required depends on the facts and circumstances unique to the specific company and the proposed repurchase, including the size of the repurchase and management's existing authority to enter into repurchase transactions. Companies should consult with counsel regarding whether board approval is required before initiating a debt repurchase.

Should a company publicly disclose its intention to repurchase debt?

In order to avoid potential liability for insider trading in connection with a debt repurchase, a company often will publicly disclose a repurchase prior to its commencement. Because the extent of the required public disclosure depends on the facts specific to the repurchase, disclosure should be made after consultation with counsel, including what the company has previously said in its periodic reports. If a new program or sizable repurchase is disclosed, this disclosure often will include

- the estimated time period during which the purchases will be made;
- the maximum amount of debt securities proposed to be acquired or the maximum amount of funds to be expended;
- the objectives of the repurchase;
- any plan or proposal relating to the disposition of the debt securities to be purchased; and
- an indication of how the purchases will be made.

The disclosure may be made in a Form 10-Q or 10-K, or by means of a press release or Form 8-K, depending upon timing of the approval and commencement of the repurchase. Companies also may include a blanket disclosure in the liquidity and capital resource section of their "Management's Discussion and Analysis of Financial Condition and Results of Operations" in their annual and quarterly reports stating that they may, from time to time, repurchase outstanding debt securities. The company also should consider publicly announcing any material modifications to a previously described debt repurchase.

As a general matter, any debt repurchase will be reflected in the company's subsequent financial statements.

What are a company's obligations with respect to material nonpublic information and past earnings guidance preceding a debt repurchase?

Under Rule 10b-5, a company generally may not initiate a debt repurchase (or establish a plan under Rule 10b5-1 to do so in the future, as described below) at a time when the company possesses material nonpublic information.[1] To the extent that such material nonpublic information is disclosed to certain persons, Regulation FD requires that the company simultaneously disclose such information to the general public.

To minimize the risk of potential liability under Rule 10b-5 or Regulation FD, a company contemplating a debt repurchase should examine its past earnings guidance to ensure that subsequent developments have not rendered such guidance materially misleading. Close attention should be paid to earnings guidance given in the midst of a turbulent market and uncertain economic conditions as this guidance is more likely to be revealed, in hindsight, to have been based on faulty assumptions.

A company contemplating a debt repurchase should be wary of allowing too much time to elapse between the release of its earnings guidance and the implementation of a debt repurchase program. Initiating a contemplated debt repurchase close in time to the release of earnings guidance reduces the likelihood of subsequent developments retroactively rendering such guidance materially misleading. If developments arise which render a company's prior earnings guidance misleading, the company should consult counsel and update the guidance before proceeding with its debt repurchase.

Issuer Tender Offers

Some companies may elect to conduct a tender offer to repurchase their debt. However, most company debt repurchases are effected over a period of time through open market purchases. Companies also try to avoid having repurchases being characterized as tender offers since companies undertaking tender offers are subject to substantial procedural requirements.

[1] *Master Fund v. Ikon Office Solutions* (S.D.N.Y. 2006) held that because companies do not owe fiduciary duties to their debtholders, they do not have an affirmative duty to disclose material nonpublic information. However, other federal courts are not bound by this decision and issuers may still be found liable under state securities law and for common law fraud.

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What constitutes a tender offer?

The term "tender offer" is not defined in U.S. securities law there is no bright-line test to determine what constitutes one, and neither the SEC nor Congress has defined the term. However, several courts have adopted an eight-factor standard initially proposed by the SEC, consistently ruling that the determination of a tender offer is a fact-based determination. Thus, depending on a company's particular circumstances, the presence or absence of one or more of the following factors will not be dispositive — and one or more of the following factors may be more determinative than the others — in determining a tender offer:

1. an active and widespread solicitation of holders;
2. solicitation of a substantial percentage of the issuer's securities;
3. the offer to purchase is made at a premium over the prevailing market price;
4. the terms of the offer are firm rather than negotiable;
5. the offer is contingent on the tender of a fixed minimum number of securities, often subject to a fixed maximum number to be purchased;
6. the offer is open only for a limited period of time;
7. the offerees are subject to pressure to sell their securities; and
8. public announcements of a repurchase program precede or accompany rapid accumulation of large amounts of the company's securities.

What are the options available for structuring a tender offer?

Issuer tender offers may be structured as a "fixed price" tender offer, a "fixed spread tender offer" or a "modified Dutch auction" tender offer.

In a fixed price tender offer, the company offers to purchase its securities at a fixed price until the holders tender the maximum number or amount of securities the company is willing to purchase.

In a fixed spread tender offer, the price paid by the company is determined by reference to a fixed spread over the current yield on a benchmark security. The price can be determined either each day for securities tendered on that day or on a specific day prior to the termination of the tender offer.

In a modified Dutch auction, the company specifies a price range and holders are invited to tender their securities at any price within the range. The ultimate price is the lowest price that allows the issuer to purchase the number of securities it sought in the tender offer.

What is required of a company contemplating a tender offer?

A company's tender offer must comply with the significant disclosure and substantive requirements of Regulation 14E under the Exchange Act and the rules promulgated thereunder, including:

- the offer must remain open for at least 20 business days following commencement;
  - Pursuant to a no-action letter[2] issued by the SEC staff on January 23, 2015, including the 20-business day period may be abbreviated to five business days if the tender offer:
    - is open for at least five business days;
    - remains open for at least five business days from, and including the date of, an announcement of any change in the consideration offered; and
    - remains open for at least three business days from, and including the date of, and announcement of any material change in the offer other than a change in the consideration offered.
- the offer must remain open for at least 10 business days following any increase or decrease in the offering price or in the percentage of securities sought;
- all payments and securities must be promptly returned after the termination or withdrawal of the offer[3];
- the company must announce any extension to the length of a tender offer and disclose the approximate number of securities deposited to date;
- the company must disclose its position with respect to a tender offer no later than 10 business days from the date the tender offer is first announced[4];
- the company may not conduct a tender offer at any time during which it is in possession of material nonpublic information; and
- the company should not announce its intention to initiate a debt tender offer if the company (a) is making the announcement without the intention to commence the offer within a reasonable time and complete the offer, (b) intends, directly or indirectly, for the announcement to manipulate the market price of its stock, or (c) does not have the reasonable belief that it will have the means to purchase securities to complete the offer.

[2] Please see here for the SEC's no-action letter.

[3] The rule does not define "promptly." However, the SEC has stated that this standard may be determined by the practices of the financial community, including current settlement practices. In most cases, the current settlement practice is for the payment of funds and delivery of securities no later than the third business day after the date of the transaction.

[4] Typically, a company initiating a tender offer for its debt securities will announce that it provides no opinion as to the advisability of participating in the tender offer.

If the tender offer targets debt securities which are convertible into equity securities, additional requirements under Rule 13e-3, Rule 13e-4, Rule 14e-5 and Regulation M-A may apply.

Unlike tender offers for equity securities or convertible debt, there is no SEC filing requirement for tender offers for nonconvertible debt.

Open Market and Privately Negotiated Repurchases

Open market and privately negotiated repurchases are other means for a company to repurchase its debt. In an open market repurchase, a company may repurchase its debt on an exchange or on the over-the-counter market. Alternatively, a company may decide to enter into debt purchase agreements with individual holders.

What are the benefits of open market and privately negotiated repurchases and how are they implemented?

Companies may consider entering into open market or privately negotiated repurchases to effect a debt repurchase as they can provide a means to repurchase a sizable amount of its debt quickly. However, as the number of prospective sellers increases, companies may face significant administrative expenses and potential illegal tender offer concerns. To minimize the likelihood of a transaction being deemed an "unconventional tender offer," issuers should take the following precautions:

- active solicitation of sales and the number of holders solicited should be kept to a minimum;
- any solicitation should be addressed only to institutional and other sophisticated investors;
- the price paid should be negotiable and not involve a substantial premium;
- solicitees should be given a meaningful opportunity to negotiate the transaction; and
- pressure to sell should not be imposed, especially through the use of time limits or minimum/maximum conditions of securities that will be purchased.

Like all debt repurchase programs, open market and privately negotiated transactions also are subject to Rule 10b-5's prohibitions on repurchases made while in possession of material nonpublic information. In privately negotiated transactions, the sellers often provide representations and warranties about, among other things, their financial sophistication and knowledge about the company. Sellers also may waive certain claims against a company in connection with a sale.[5]

Conclusion

Many companies face, and will continue to face, important choices regarding how best to allocate their surplus cash. As an increasing number have chosen to repurchase their debt, itis important for companies to weigh the legal considerations surrounding debt repurchases discussed in this alert so they can make informed decisions. If a company elects to implement a repurchase program, it should take great care to ensure that the individuals tasked with implementing the program understand the applicable legal (and contractual) restrictions and requirements, and that the necessary processes are in place to ensure compliance.

[5] Selling holders may waive their claims against the company in a negotiated agreement that is colloquially referred to as a "big boy letter" (although the relevant provisions could be included in the purchase agreement related to the sale). In the context of a debt repurchase, a big boy letter is an agreement in which the company and a selling holder acknowledge that the company may possess material nonpublic information which it has not disclosed, as well as that they agree to enter into the transaction regardless of the information disparity and the seller agrees to waive any claims related to this information disparity. Big boy letters have received significant attention because while they can aid parties in allocating risk, the case law is mixed on whether they are enforceable in a private action. It is also uncertain whether the letters constitute a violation of Section 29(a) of the Exchange Act, which states "any condition, stipulation, or provision binding any person to waive compliance with any provision of this title or any rule or regulation thereunder, or of any rule of a self-regulatory organization, shall be void." Regardless of a big boy letter's enforceability in a private action, the SEC has taken the position that a big boy letter will not preclude an agency enforcement action.

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