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Convertible Bond Repurchases: Opportunities and Considerations

The credit crunch and turmoil in the financial markets have recently taken their toll on an asset class that for quite some time had been resilient to the broader market misfortunes — convertible bonds. Driven by forced redemptions, increased funding costs, margin calls, diminished liquidity and concerns about their ability to engage in hedging activities, many hedge funds — perhaps the most common convertible bond investors — have been seeking to liquidate their holdings. For many companies, this may create unprecedented opportunities to retire their previously issued convertible bonds on very favorable terms. Not surprisingly, over the course of the past several months, more than 100 companies have disclosed that they had repurchased or intended to repurchase their convertible bonds, and many others are considering taking similar actions.

Companies that are interested in repurchasing convertible bonds have various methods to do so. Common methods include the following:

- ***Open market and privately negotiated cash purchases.*** This popular method for retiring convertible bonds involves a company making opportunistic purchases of its convertible bonds for cash, either in the open market or through privately negotiated transactions.

- ***Common stock exchanges***. Similar to open market and privately negotiated cash purchases, common stock exchanges typically involve an opportunistic retirement of convertible bonds through privately negotiated exchanges of the bonds for the company's newly issued shares of common stock. Such exchanges can be structured using Section 3(a)(9) of the Securities Act to provide holders of freely transferable convertible bonds with freely tradeable common stock. Companies have also used other forms of consideration, such as a combination of stock and newly issued non-convertible debt.

- ***Public tender offers***. A company that is interested in retiring an entire series of its convertible bonds would likely engage in a tender offer. Such tender offers may involve, for example, a payment of cash consideration for the convertible bonds; a registered issuance of shares or debt in exchange for the convertible bonds; or temporary increases in the conversion rate. As discussed below, this approach requires certain filings with the Securities and Exchange Commission and compliance with the rules that apply to debt and equity tender offers.

Other techniques that facilitate the retirement of convertible bonds exist, and new ones are being developed. A company that is considering acquiring its convertible bonds should consult its financial, legal, and accounting advisors in determining the method that is most suited to the company's needs.

If you have any questions regarding the matters discussed in this memorandum, please call your regular Skadden contact.

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Although each method for repurchasing convertible bonds involves a number of unique economic, legal, and accounting considerations, we believe that there are many common issues, generally outlined below, that should be taken into account regardless of which method a company elects to employ:

- ***Tender offer rules***. If a company's repurchases were to constitute a tender offer, the company would need to comply with the applicable tender offer rules under the Securities Exchange Act. Certain tender offer rules — such as the obligation to keep the offer open for 20 business days — apply to all debt tender offers, whether or not the debt is convertible. In addition, tender offers for convertible bonds would implicate the issuer tender offer rules for equity securities under Rule 13e-4 of the Exchange Act. The rules that apply to tender offers for equity securities, including convertible bonds, are rather expansive and require companies, among other things, to make various SEC filings, to provide disclosure materials to holders of the securities to be purchased and to treat all participating holders equally. Although the securities laws do not provide a definition of "tender offer," various guidelines have been developed for determining when a repurchase would constitute a tender offer. These guidelines allow open market repurchases to be structured so that they will not implicate the tender offer rules.

- ***Disclosure of the repurchase***. Even if a company's repurchases do not constitute a "tender offer" subject to the rather strict SEC-mandated disclosure regime described above, careful consideration should be given as to whether pre-commencement and post-acquisition disclosure of purchases is required or advisable. Companies often find disclosure of their general intention to conduct repurchases in their Exchange Act reports before making such repurchases to be adequate. However, depending on the facts and circumstances of a particular repurchase, more specific prior disclosure may be appropriate. Companies should also be mindful of the need to report repurchases in their subsequent periodic Exchange Act reports, and should consider earlier disclosure on Form 8-K.

- ***Material non-public information concerns***. If a company's repurchases are effected through privately negotiated transactions, the company must take special care to ensure that the negotiations do not result in an unintended disclosure of material non-public information to the sellers. Furthermore, companies should be cautious of repurchases while possessing material non-public information. When appropriate, in order to avoid substantial and unpredictable risks of liability under the general anti-manipulation and anti-fraud provisions of the federal securities laws, companies should consider employing a trading plan pursuant to Rule 10b5-1 in connection with their open market convertible bond repurchases.

- ***Tax considerations***. A repurchase of convertible debt trading at a discount would typically result in taxable income in the form of cancellation of indebtedness income. Furthermore, many convertible bonds issued over the course of the past several years are subject to the "contingent payment" tax rules, and retirement of such bonds may result in the recapture of deductions previously claimed. Also, as noted below, call spread transactions often result in various tax benefits that may be discontinued as a result of retiring convertible bonds.

- ***Accounting***. The accounting for convertible bonds has been continually changing. Some of the accounting consequences of a convertible bonds repurchase, such as the elimination of the retired debt from the company's balance sheet, appear rather obvious. Others are less apparent.

For example, the payment of any consideration in connection with the retirement of convertible bonds will likely result in a charge to the company's income statement. Furthermore, following the publication earlier this year by the Financial Accounting Standards Board of Staff Position (FSP) No. APB 14-1, all convertible bonds that, upon conversion, may be settled either fully or partially in cash are required to be bifurcated into debt and equity components, and the debt discount is required to be amortized to interest expense — which results in a reduction in reported income per share. Companies may wish to consider the consequences of repurchases on the accounting for their convertible bonds before engaging in such repurchases.

- ***Call spread considerations***. In the past several years, many companies entered into "call spread" transactions in connection with the issuance of convertible bonds. Call spread transactions provide companies with various benefits, including reduced dilution and, in some cases, tax benefits. These transactions typically involve the purchase by a company of a call option from a broker-dealer (often the underwriter of the convertible bonds) and sale of a call option to the same broker-dealer. The call spread documents for a specific transaction are typically documented on ISDA forms for equity derivatives. Companies should determine whether their call spread agreements require a prior notice to the counterparty about the planned convertible bond repurchases prior to commencing the repurchase, and whether the counterparty has the ability to change the terms of the call spread transactions as a result of the bond repurchase. Furthermore, because the terms of many call spread transactions may result in an automatic reduction in the company's benefits following the repurchases, the company may wish to seek modification of such terms prior to making any bond repurchases. In addition, a repurchasing company should carefully analyze the impact of its convertible bond repurchases and any related modifications to the terms of the call spread transaction on the company's tax and accounting positions.

- ***Share lending agreements***. In connection with issuances of convertible bonds, companies with limited stock available to be borrowed have often entered into share lending agreements with the underwriters of their convertible bonds or their affiliates. In such agreements, the underwriters of the convertible bonds (or their affiliates) borrowed shares of common stock from the issuers and sold such shares into the market. In connection with the repurchase of any convertible bonds, careful analysis is advisable to ensure the corresponding orderly unwind of such share lending agreements. Again, special care must be given to tax and accounting considerations.

- ***Contractual restrictions.*** Existing contractual arrangements may restrict a company's ability to repurchase its convertible bonds. Therefore, prior to engaging in a repurchase, companies must review all existing contractual arrangements, including all debt instruments, to determine whether any of these arrangements restricts or prohibits convertible bond repurchases.

- ***Board authorization.*** In authorizing any repurchase program, a company's board of directors should consider the material features of the repurchase program, including the issues discussed above.