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Opportunities for Strategic Debt Repurchases

Eric Sibbitt and Adam Ajlouni*

The authors of this article discuss strategic debt repurchases, which may provide certain companies a cost-effective and efficient means of canceling outstanding debt, capturing discounts to par, reducing interest expense, enhancing flexibility by deleveraging and potentially removing restrictive covenants, or potentially improving the company's debt rating.

In the current environment of heightened market uncertainty and potential interest-rate changes, opportunities are emerging for companies to take advantage of market prices to reduce their liability profile through the strategic repurchase of outstanding debt securities from debtholders seeking liquidity or quicker returns. For companies with available cash holdings or the ability to raise additional debt or equity capital, strategic debt repurchases may provide a cost-effective and efficient means of canceling outstanding debt, capturing discounts to par, reducing interest expense, enhancing strategic flexibility by deleveraging and potentially removing restrictive covenants, or potentially improving the company's debt rating.

HOW BEST TO EFFECT DEBT REPURCHASES

Cash repurchases of debt generally can be structured as open-market or private repurchases, cash tender offers, or redemptions pursuant to the contractual terms of the governing indenture. These methods vary in terms of implementation time, cost, and the portion of a given debt series that can be repurchased at one time. The scale of repurchases and the structure used may also depend on restrictive covenants in the company's indentures and other agreements, as well as the availability of operating losses to offset any taxable gains resulting from the repurchases.

OPEN-MARKET OR PRIVATE REPURCHASES

A company can repurchase debt securities on the open market or through privately negotiated transactions, either directly or through an intermediary. However, such transactions must be structured in terms of timing and quantity

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so as to avoid triggering a *de facto*, or "creeping," tender offer. This method allows companies to benefit from market volatility to repurchase an amount of securities discretely, quickly, and at a discount, with limited or no documentation.

CASH TENDER OFFERS

Initiating a public tender offer allows a company to purchase up to an entire series of debt in a public transaction available to all debtholders, but also requires compliance with a number of regulations under the securities laws. Tender offers can be effected through a variety of structures intended to encourage efficient pricing and investor participation:

- *Early tender premiums*. To incentivize early participation, early-tender premiums can be offered for tenders early in the tender-offer period.
- *Modified Dutch auction*. A company can retain a degree of flexibility in the tender price and quantity by using a "modified Dutch auction," whereby the company specifies a tender price range within which debtholders may tender their securities. The company then decides on a tender price according to the number of securities that debtholders have agreed to tender at that price.
- *Fixed spread*. Alternatively, a company can set the tender price based on a fixed spread over the yield to maturity of a reference security (usually a U.S. Treasury bond) with a corresponding maturity. This provides a degree of protection against interest-rate fluctuation during the time the tender offer is open.
- *Waterfall structure*. Where there are multiple classes of debt securities outstanding, a company can make an offer for a maximum aggregate dollar value of all or select classes of debt with designated priorities.
- *Consent solicitation*. Debt tender offers can also be conducted in connection with consent solicitations, whereby the company's debtholders are solicited to agree to an amendment to restrictive covenants or other provisions of the underlying indenture.

REDEMPTION

The most straightforward, but also generally the most expensive, method of repurchasing debt securities is to exercise the redemption provisions built into the underlying indenture. The pre-agreed procedures in the redemption provisions of the indenture set forth a clear and certain process that can be accomplished quickly and without the need for new documentation.

DISCLOSURE CONSIDERATIONS AND 10b5-1 PLANS

To mitigate potential risks, an issuer needs to consider whether it possesses "material non-public information" ("MNPI") and must be cognizant of the timing of earnings releases and potential corporate developments such as strategic transactions. During a tender offer, these considerations sometimes require a company to delay or accelerate launch, extend deadlines, or provide supplemental disclosures.

One way to provide flexibility in implementing a debt repurchase is to establish a repurchase plan pursuant to Rule 10b5-1 of the Securities Exchange Act (a "10b5-1 repurchase plan"). A 10b5-1 repurchase plan is a written, prearranged plan setting out a schedule for repurchasing securities. As long as a 10b5-1 repurchase plan is adopted at a time when a company is not in possession of MNPI, the automated repurchases carried out pursuant to the plan will not be considered to have been completed on the basis of MNPI, even if the company subsequently comes into possession of MNPI during the course of the plan. Specified limits on repurchases under a 10b5-1 repurchase plan may be included to help avoid triggering a "creeping" tender offer.

TAX CONSIDERATIONS

The repurchase by a company of its outstanding debt securities at a discount generally gives rise to cancellation of debt income ("CODI") and a reduction in net operating losses (subject to certain exceptions for bankrupt or insolvent companies). The amount of CODI is generally the difference between the principal amount of the debt repurchased (or its accreted value, if applicable) and the repurchase price.

SUMMARY OF DEBT REPURCHASE STRUCTURES

	Open-market or private repurchases	Cash tender offer	Redemption
Premium-to-market price	Low to none	High	High (generally equal to outstanding principal plus a premium)
Speed of implementation	Fast	Slow—must stay open for 20 business days, but may include an early settlement date and, in some cases, can be reduced to five business days	Fast, but can only be effected at prescribed times pursuant to the governing indenture

Documentation	Minimal to none	Tender-offer disclosure statement and related documentation	None
Advantages	Flexibility in terms of how much to repurchase and from whom	Allows entire classes of debt to be purchased at once for a designated price	Provides a pre- negotiated procedure for retiring all or a portion of an entire class of debt
Limitations	May only purchase a portion of outstanding debt over a certain period in order to avoid triggering a tender offer	Must comply with tender-offer rules under the securities laws, including offering to all debtholders; convertible debt is subject to additional restrictions	Limited flexibility—must follow procedures laid out in the indenture

Issuers should consult with their financial, legal, and tax advisors to determine the most effective liability-management strategy for a particular company.