Law360

February 7, 2013

High-Cost Debt Refinance — Is Everybody Going Dutch?

by Steven C. Friend, Steven R. Loeshelle and Michael F. Fitzpatrick Jr.

With interest rates near historic lows, many issuers are seeking ways to refinance high-cost debt. This is particularly true for utility issuers, which typically finance approximately 50 percent of their balance sheet with debt. Unfortunately, in the current low interest rate environment, standard make-whole redemption provisions result in high premiums, eroding or eliminating the economic benefit. An alternative approach is for an issuer to tender for outstanding debt, and a way to minimize the cost of a tender is to introduce the element of competition through a modified Dutch auction.

In the modified Dutch auction, the issuer sets a range of acceptable prices within which a holder may tender its debt securities. The offer is for a specified portion, but not all, of an outstanding series of debt. The issuer ultimately pays the single lowest price (the "clearing price") within the range that will enable the issuer to purchase the amount of securities sought in the tender offer (the "tender cap") to each holder that has tendered their securities at or below such clearing price. The Dutch auction creates an incentive for the tendering holder to offer at a lower price. This is because the holder will want to minimize the risk that if the holder's offer price is not low enough some or all of the holder's securities may not be purchased.

A Dutch auction is "modified" because a range is provided for acceptable tenders. Because the price to be paid is the lowest price at which the issuer can buy all of the securities for which it has solicited a tender, an "any and all" tender offer cannot be conducted on a Dutch auction basis. If the issuer were to tender for all of the debt securities of a series on a Dutch auction basis, at least one holder would certainly tender its securities at the highest price, and therefore the clearing price for an "any and all" tender would always be the highest price in the suggested range.

Most Dutch auction tenders are executed with a small premium that is offered only to holders who tender during the first ten business days or "early period" of the offer. Therefore, under normal circumstances, most if not all of the tenders will be made by the 10th business day of the offer. The issuer, on day 10, is thereby made aware of what is likely to be the final participation levels at various prices.

Legal Framework and Documentation — the Base Case

The legal framework regulating cash debt tender offers is straightforward. The rules for equity tender offers, such as the requirement that all holders receive the same consideration, are not applicable. Since no new security is offered, a registration statement and prospectus are not used.

Instead an "offer to purchase" is provided to holders which sets forth the terms of the tender. Disclosure with respect to the issuer is provided by incorporating the issuer's filings under the Securities Exchange Act of 1934, as amended (the "1934 Act"). Basic antifraud provisions such as Rule 10b-5 under the 1934 Act still apply.

Regulation 14E under the 1934 Act, which is applicable to any foreign or domestic tender offer, does require that an offer be kept open for a minimum of 20 business days. One or more dealer

managers are engaged by the issuer to solicit tenders into the offer. An information agent is responsible for providing the offer documentation, accepting tenders and ultimately calculating the payment due to holders.

Pricing the Offer

If the issuer is unsuccessful in achieving participation in the offer which meets or exceeds the tender cap, then the clearing price of the offer will be the highest price of all of the tenders which are made within the acceptable range.

As an example, if the issuer launches a tender offer for $100 million of a $300 million series, but only succeeds in getting $50 million of participation in the offer, then the "clearing price" will be the highest price of all of the tenders in the acceptable range — and will very likely be the absolutely highest price in the range (as long as at least one holder tendered at such price).

Given this scenario, an issuer should be certain that even the highest price in the range set for the tender is an acceptable price to the issuer. Further, the issuer and counsel should consider including a "minimum condition" in the offering document. This condition would describe to holders a participation level below which the issuer would abandon the tender.

The Oversubscribed Tender

Various options are presented to the issuer when, at the expiration of the early period, the principal amount of securities tendered by holders exceeds the tender cap. In such a scenario, the issuer has the opportunity to increase the tender cap of the offer. The issuer will review the amount of debt tendered above the original cap in order to identify how upsizing the tender cap would affect the clearing price to be paid to holders.

We will use a tender offer with a tender cap of $100 million (for a series with $300 million outstanding) as a hypothetical. If, at the end of day 10 of the offer, $200 million of securities have been tendered, the issuer may upsize the tender cap to $120 million at the associated clearing price of X+1 or upsize even further to $150 million at the associated clearing price of X+2, and so on. Because there is little chance that additional tenders will come in after the early period, the issuer can identify the size of tender it would like to do based on the corresponding clearing price. This allows the issuer to pick a "sweet spot" — the size of deal at a corresponding clearing price. Even if additional tenders are made after the early period, the effect of the additional tenders can only be to further reduce the clearing price.

Increasing the size of the tender cap implicates Rule 14e-1(b) of the 1934 Act, which requires that upon an increase or decrease of the percentage of the class of securities being sought, the tender must remain open for at least 10 business beginning with the date that notice of such increase or decrease is first given to security holders.[1]

---

[1] There is a de minimis exception not to exceed two percent of the class of securities that is the subject of the tender.

However, because the decision to upsize can be made immediately after the expiration of the "early period", there are 10 business days left on the back end of the tender. This allows the issuer to increase the tender cap, without also increasing the overall duration of the tender. Barring some other concurrent change to the terms of the offer, this increase of the tender cap of the offer can be made without any extension of holders' withdrawal rights (which typically expire at the end of the 10-day early period).

One Wrinkle — Prorating the Debt

If the purchase of all the securities validly tendered in the tender offer on or prior to the expiration with a price that is lower than or equal to the clearing price would cause the issuer to accept an aggregate principal amount of securities in excess of the tender cap, then the offer is "oversubscribed." In that case, the securities which are tendered at the clearing price will be prorated. None of the other securities accepted by the issuer, which were tendered below the clearing price, will be prorated.

The Latest Development — The Corporate Dutch Auction Debt-for-Debt Exchange

Although commonly used for tender offers, the Dutch auction format had not in recent memory been used by a corporate issuer to effect a debt-for-debt exchange. Hunton & Williams recently represented the dealer manager on a debt-for-debt exchange conducted on a Dutch auction basis.

Similar to any fixed-spread Dutch auction tender, the total exchange consideration offered for each old note equaled the discounted value of the remaining payments of principal and interest (excluding accrued interest) using a yield of (i) a reference yield plus (ii) the clearing spread, as such clearing spread was determined by the Dutch auction.

The offer was not registered but instead was structured as a private placement under Section 4(a)(2) of the Securities Act of 1933, as amended (the "1933 Act"). The offer was made only to holders which were "qualified institutional buyers," as defined in Rule 144A of the 1933 Act and outside the U.S. to persons other than "U.S. persons" as that term is defined in Rule 902 under the 1933 Act. The dealer manager was responsible for soliciting tenders from existing holders.

Similar to the Dutch auction tender, an information agent was also engaged. An additional obligation of the information agent was to verify that holders submitted a representation letter as to their status as a qualified institutional buyer or non-U.S. person. Only then did the information agent provide the holder information with respect to the offering. Although structured as a private transaction, holders of the new notes were granted registration rights.

If the modified Dutch auction debt tender remains a popular liability management tool in the near future, we expect that the Dutch auction debt-for-debt exchange should be equally popular for similar reasons.

Steven Friend, Steven Loeshelle, and Michael Fitzpatrick are partners in the New York office of Hunton & Williams. Steven Friend's practice focuses on issuers and underwriters in a range of equity and debt offerings, and Steven Loeshelle's practice focuses on assisting clients in raising capital, and working with issuers and underwriters in the full range of public and private securities offerings, as well as with project entities, lessors, lessees and commercial lenders. Michael Fitzpatrick's practice focuses on representing issuers and underwriters in capital markets transactions, principally in the utility and energy arena.