

Playing around with debt

By **Fred Gander,**
Julio Castro and
Sam Riesenberg of
Dewey & LeBoeuf

The recent financial crisis has caused many companies to consider different options to strengthen their balance sheets. Often, however, these companies have outstanding debt whose covenants significantly restrict their ability to modify the old instrument or raise new debt or capital.

While these covenants are typically negotiated to allow some leeway to issuers, for the most part they do not comport with the magnitude of the issues faced by issuers as a result of the financial crisis, therefore significantly affecting the ability of many companies to shore up their financial position.

One procedure to address these restrictions in respect of publicly traded debt is for the issuer to seek from its bondholders covenant waivers or modifications in so-called consent solicitations. To entice the bondholders to consent to the relevant waiver(s) or modification(s), the company will often offer more lucrative financing terms and/or a one-time fee (a consent fee).

While the issuance of corporate debt and equity routinely raises a host of significant US federal income tax issues, important additional issues must be considered when deciding whether to undertake a consent solicitation. These issues are relevant not only to US issuers and their bondholders, but also to non-US issuers whose bonds are offered or sold to US market participants under rule 144A of the US securities Act of 1933.

The consent solicitation process

Consent solicitations can be divided into three basic types: consent solicitations combined with tender offers; consent solicitations combined with exchange offers and standalone consent solicitations, in other words, those that are not combined with an offer. A consent solicitation combined with a tender offer occurs when the issuer couples the consent solicitation with an offer to acquire the underlying debt for cash. In a consent solicitation combined with an exchange offer, the issuer offers to exchange the existing bonds for new bonds. A consent solicitation including a tender offer or an exchange offer is commonly referred to as an exit consent.

In an exit consent, the issuer will typically limit the tender or exchange offer to bondholders who agree to the accompanying consent. Likewise, in a consent solicitation that is not combined with a tender or exchange offer, any consent fee offered will be limited to those bondholders who consent. In all consent solicitations, furthermore, the receipt by the bondholder of the reward for consenting, whether it be an exchange, tender, consent fee or favourable adjustment to the financing terms, will be conditioned on the bondholders as a class consenting to the requested changes.

US federal income tax treatment

In the simple case of a consent solicitation coupled with a tender offer, holders who accept the tender offer are generally deemed to have retired their debt instrument for the cash received. In that case, the issuer must consider whether such retirement generates cancellation of debt income or repurchase premium and the treatment of any consent fee paid to the bondholder, as discussed below.

Biography



Fred Gander

Dewey & LeBoeuf
London Office
Tel: +44 20 7459 5400
Fax: +44 20 7459 5099
Email: fgander@dl.com
Web: www.dl.com

Fred Gander advises on international tax matters. He is a member of the firm's global executive committee and chairman of the European supervisory committee. Gander has been resident at Dewey & LeBoeuf London since 1991, before which he was in the firm's Washington office from 1986.

Gander advises financial institutions, multinational corporations and private equity and hedge funds on the taxation of their cross-border transactions, business operations and capital markets offerings. In particular, he has broad experience in (i) implementing cross-border structured financing and derivatives transactions; (ii) structuring cross-border reorganisations, joint ventures, mergers, dispositions and acquisitions; (iii) a wide variety of debt and equity capital markets offerings; (iv) creating centralised treasury and foreign exchange management centres in Europe; and (v) developing tax-efficient profit repatriation strategies.

Gander also advises multinational corporations and funds with respect to a wide range of US tax issues, including foreign tax credit utilisation and planning, the subpart F and passive foreign investment company rules, international tax treaty matters and the US taxation of complex financial products and hybrid instruments. Many of his projects involve the coordination of tax advice across several countries. Gander also has an extensive practice advising non-US based corporate groups in respect of their operations and acquisitions in the US.

The US federal income tax consequences of a standalone consent solicitation or one coupled with an exchange offer are less straightforward. In these cases, as further discussed below, there are at least five income tax issues the issuers, holders and underwriters should consider:

- whether the issuer's proposed amendments to the bonds (or an actual exchange, in an exchange offer) will trigger a realisation event under the US debt modification rules;
- whether a constructive or actual exchange of bonds will qualify for tax-free recapitalisation treatment under the US internal revenue code;
- whether, and to what extent, the original issue discount (OID) rules will apply;
- whether the issuer will have cancellation of indebtedness income or a deduction for retirement premium as a result

of a successful consent solicitation; and

- the appropriate tax treatment of consent fees paid to the bondholders.

Debt modification

Generally, a modification of the terms of a bond, including a change or waiver of a covenant, is not a taxable event to the holder for US federal income tax purposes unless the modification is significant. If the modification is significant, the bondholder is treated as exchanging the existing bond for a new bond with the new terms.

Whether a significant modification occurs depends on a variety of factors, but, most importantly, on whether the legal rights that have been modified, and the degree to which they are altered, are economically significant (the general rule). Modifications in yield, timing of payments, financial covenants obligor or security, or the nature of the bond (from recourse to nonrecourse and vice versa) are subject to specific tests. Certain modifications of these terms falling outside some safe harbours will be deemed to result in a significant modification without regard to the general rule.

Changes in yield

Often a key matter is whether a change in yield arising from the consent solicitation, which must take into account consent fees paid, will constitute a significant modification. Generally, a change in yield of a debt instrument that is more than either 25 basis points or 5% of the annual yield of the unmodified bond constitutes a significant modification. In calculating the yield of the modified bond, its adjusted issue price is equal to (i) the adjusted issue price of the unmodified bond, (ii) increased by accrued but unpaid interest, (iii) decreased by accrued but unaccounted bond issuance premium and (iv) decreased by any consent fees received.

The fact that the consent fee reduces the adjusted issue price of the modified bond may play an important part in determining whether consenting bondholders have exchange events due to the change in yield. For instance, assume a consent solicitation is sought with respect to a bond with a \$1,000 face amount (technically, the stated redemption price at maturity) and 10% interest, under which a new interest rate of 10.20% will be set and a \$100 consent fee will be paid to consenting bondholders. If the consent solicitation is successful, all of the bondholders will receive the increase in the interest rate.

In this example, bondholders who do not consent would only enjoy (absent other factors such as bond premium) a 20 basis point change or a 2% change in the interest rate—not enough to constitute a significant modification. For the consenting bondholders, however, the consent fee received will reduce their adjusted issue price in their modified bond by \$100 to \$900, resulting in a yield on the modified instrument for US federal income tax purposes of 11.33% (\$1000 times

10.2% divided by \$900), resulting in a significant modification.

In addition, it is common for issuers to offer higher consent fees to bondholders who consent earlier, and lower consent fees to bondholders who consent later. In such a scenario, the determination of whether a change in yield results in a significant modification will need to be undertaken for each of the early consenting bondholders, late consenting bondholders and non-consenting bondholders.

Other modifications

Depending on the nature of the changes proposed to be undertaken, the general rule or other specific tests may cause a bond to be considered as having undergone a significant modification regardless of the degree of the change in yield and the amount of consent fees. For instance, a material deferral of any scheduled payment on the instrument is deemed to cause a significant modification if the scheduled payment is deferred by the lesser of 5 years or 50% of the original term of the instrument. Therefore, a consent solicitation seeking, for example, a deferral of principal payments by three years on a five-year instrument would automatically constitute a significant modification, if agreed to by the bondholders.

A change in obligor generally constitutes a significant modification if the instrument is recourse, as is typical of publicly issued instruments. Additionally, a change in security or credit enhancement on a recourse instrument or a change in the priority of any instrument is a significant modification if it results in a change in payment expectations. A change of payment expectations, for this purpose, is defined in the applicable US Treasury department regulations as the substantial enhancement of the issuer's capacity to meet payment obligations that was primarily speculative prior to the modification and is expected to be adequate following the modification, or the reverse, the substantial impairment of the issuer's capacity to meet payment obligations that was adequate before the modification and is expected to be primarily speculative following the modification. A change in the nature of the instrument from recourse to nonrecourse may also be a significant modification.

But what if the foregoing types of changes to the instrument do not cause a significant modification, but the issuer also seeks certain changes to the bonds' covenants? For instance, suppose that a bond indenture contains a covenant requiring the issuer to maintain a debt-to-equity ratio (DER) of no more than five-to-one, and the issuer asks the bondholders to amend the indenture to provide for a seven-to-one DER. US Treasury department regulations provide that changes in customary accounting or financial covenants are never significant modifications. A common problem in analysing consent solicitations where the covenant package is asked to be changed (and none of the other specific tests are

Biography



Julio Castro

Dewey & LeBoeuf

London Office

Tel: +44 20 7459 5374

Fax: +44 20 7459 5099

Email: jcastro@dl.com

Web: www.dl.com

Julio Castro's tax practice includes the planning and negotiation of cross-border mergers and acquisitions and the development and implementation of related holding and financing structures, advising US and European investment banks in connection with international structured financing transactions, and structuring international and domestic operations of US, Latin American and European clients. Castro also provides US tax advice to issuers and underwriters in connection with offerings of equity and debt securities.

failed) is determining where the line is drawn for what constitutes a customary accounting or financial covenant. For instance, while in the example above a change in DER could be viewed as a change in a customary covenant, if the issuer had also requested a change of an unusual financial covenant, this may require a facts and circumstances determination of whether the modification is significant.

One final note on modifications that are not addressed by specific tests: typically, a consent solicitation proxy will propose several amendments and waivers of existing covenants. If none of these amendments alone rises to the level of a significant modification, then all of the amendments must be analysed together (with the notable exception of customary accounting or financial covenants) to determine whether together these proposed amendments will constitute a significant modification. Of course, this is a highly factual enquiry, with little guidance available. Advice from investment banks involved may be key.

If the consent solicitation is coupled with an exchange offer, the debt modification analysis is similar to that set forth above. The new bond must be tested against the exchanged bond to determine whether there are any significant modifications between the two. If not, the exchange of the old bond for the new bond is generally treated as a continuation of the old bond for US federal income tax purposes.

The debt modification rules provide a threshold issue: if the conclusion is that a realisation event has not occurred because no significant modification of the debt is deemed to occur, then the only issue left for analysis is the appropriate treatment of the consent fees to the bondholders and issuer. If a significant modification is deemed to occur, however, the

Biography



Sam Riesenberg

Dewey & LeBoeuf

London Office

Tel: +44 20 7459 5365

Fax: +44 20 7459 5099

Email: sriesenberg@dl.com

Web: www.dl.com

Sam Riesenberg practices in the area of US international tax and the taxation of financial products. He has experience in implementing cross-border structured financing and derivatives transactions and in advising on the tax aspects of cross-border acquisitions and capital market transactions.

Riesenberg also advises both US and non-US clients with respect to US international tax issues, including the subpart F and passive foreign investment company rules, tax treaty matters and the US taxation of complex financial products and hybrid instruments.

holders and issuer have a realisation event with respect to the bond. For all US federal income tax purposes, a significant modification results in a deemed exchange of the original instrument for a modified instrument. The issue then becomes how to treat that deemed exchange.

Actual and deemed exchange of notes

If a successful consent solicitation triggers a significant modification of a bond, it must be determined whether the resulting actual or constructive exchange (in other words, a realisation event) is taxable to the bondholders. Generally, debt-for-debt exchanges can qualify as tax-free recapitalisations if the instruments involved are treated as securities.

Therefore, if both the original instrument and the (actual or deemed) new instrument are treated as securities, a significant modification should not result in a taxable event to the bondholders. This tax-free treatment, however, does not apply to other property received by the bondholder in the actual or deemed exchange. Other property for this purpose may or may not include the amount of the consent fee received by the bondholder in connection with the consent solicitation, depending on whether a unified consideration approach or a separate consideration approach, respectively, is used in determining the nature of the consent fee. Under the first approach, the consent fee is treated as part of the consideration received by the bondholder with respect to its bond. Under the separate consideration approach, the consent fee is treated as separate from any consideration received by the bondholder with respect to its ownership of the bond.

If either the old note or the new note is not a security, the tax-free recapitalisation rules do not apply and the exchange following the implementation of the consent solicitation amendments is generally a taxable event to the bondholder. In that case, the bondholder will recognise at the time of the amendment gain or loss, as the case may be, on the original instrument equal to the sum of the fair market value of the amended bond and the amount of any cash received in the deemed exchange, less the bondholder's adjusted US federal income tax basis on the note.

If the unified consideration approach is used, the consent fee will be treated as cash received in the exchange and will increase the amount of gain (or reduce the amount of loss) recognised by the bondholder. If the separate consideration approach is used, the consent fee will be taxable separately as ordinary income and will not affect the computation of the bondholder's gain or loss from the deemed exchange.

The determination of when an instrument is treated as a security is somewhat unclear under US federal income tax law. The most important factor is the term of the instrument: a bond with a ten-year or longer maturity is normally treated as a security. Bonds maturing in less than five years may under certain circumstances constitute securities but the analysis in this case is significantly more complicated.

The term of the instrument is the time period between the date of issuance and the date of its scheduled termination. Therefore, in the consent solicitation context, the term of the original bond is the time period between the date of its issuance and the date of its scheduled maturity date (in other words, its original term). For the modified bond, the term is the time period between the amendment (or, in the case of an exchange offer, reissuance) and its scheduled maturity date. It is unusual to extend the maturity date in a consent solicitation; therefore, the exchange will not typically qualify for tax-free recapitalisation treatment unless there is enough time remaining on the term of the original bond for the modified bond to constitute a security.

Original issue discount and bond premiums

Because the old debt is treated as retired on the modification date, issues such as OID and premium must be reassessed with respect to the new instrument. If there is a deemed exchange, whether or not the deemed exchange constitutes a tax-free recapitalisation, bondholders and the issuer may be subject to the OID and bond premium rules depending on the issue price of the modified instrument.

The determination of the issue price of the modified note depends in part on whether the modified instrument is considered to be traded on an established market within the meaning of applicable US Treasury department regulations. Most US-based market exchanges and many of the European and other major public securities markets are listed as established markets for this purpose (although many important

international exchanges have yet to be added to this list).

If the modified instrument is publicly traded, or is deemed issued for another instrument that is so traded, the issue price is the fair market value of the instrument on its deemed issue date. If the modified instrument is not traded on an established market, nor issued for another instrument that is so traded, the issue price will generally equal its stated principal amount.

If the modified instrument has an issue price below its face amount by more than a minimal amount, this difference is generally treated as OID to the holder and is includable in income over the term of the modified instrument as interest income.

If the amended bond has OID and the bondholder's adjusted tax basis in the amended bond exceeds the amended bond's issue price, the bondholder can amortise the excess as acquisition premium and offset OID deductions. If the bondholder's basis exceeds the bond's face amount, no OID inclusion is required. Where the deemed exchange qualifies as a tax-free recapitalisation, under the unified consideration approach the bondholder's basis in the bond will be equal to its original tax basis decreased by the consent fee and increased by gain recognised in the exchange. In the same scenario but where the separate consideration approach is used, the bondholder's basis in the bond should be the same as in the original bond. Where the actual or deemed exchange does not qualify as a tax-free reorganisation, the bondholder's basis in the amended note will be its issue price.

Subject to the discussion below regarding high-yield instruments, the OID included by shareholders as interest is deductible to the issuer as interest over the remaining life of the bond as the OID accrues.

Cancellation of indebtedness and other considerations, retirement premium, AHYDO considerations

From the issuer's perspective, if the issue price of the modified instrument is less than the stated redemption price at maturity of the original instrument, the issuer will have cancellation of indebtedness (COD) income to the extent of the difference. Generally, this excess will create OID to the issuer, deductible over the remaining term of the instrument. However, the "applicable high yield debt obligation" (AHYDO) rules operate to defer the totality, or permanently disallow a portion, of OID deductions where the remaining term of the debt instrument exceeds five years and other conditions are met.

If the issuer is subject to US federal income tax, the COD income will be ordinary income to the issuer on modification of the bond (except in certain insolvency or bankruptcy cases). The American Recovery and Reinvestment Act of 2009, passed by the US Congress on February 13 2009 (known as the stimulus bill), allows certain businesses that

exchange (or are deemed to exchange) debt after December 31 2008, and before January 1 2011, to defer tax otherwise due on COD income for the first four or five years after the exchange (depending on whether the debt is repurchased in 2009 or 2010) and to include COD income ratably over the following five taxable years. In the case of a debt-for-debt exchange (or deemed exchange), any OID deduction with respect to the newly issued debt instrument that is not in excess of the deferred COD income is also deferred and allowed as a deduction ratably over the same five-year period. Furthermore, under the stimulus bill the AHYDO rules are suspended for any debt instrument issued between September 1 2008, and December 31 2009, in exchange for a pre-existing obligation which is not an AHYDO (including in a deemed exchange resulting from the modification of a debt instrument).

If the issue price is higher than the bond's face amount, the issuer has retirement premium, which generally is deductible if either the old or new debt is publicly traded. If neither the new nor old debt is publicly traded, the issue price from the issuer's perspective is reduced by the amount of retirement premium.

Conclusion

The US tax analysis of consent solicitations requires a broad review of the facts and circumstances surrounding the debt in question, the proposed modifications thereto and the effects to the issuers and their bondholders. As more issuers are faced with the prospect of requesting covenant modifications or waivers to shore up their capital structure, such issues should be considered carefully in connection with the first steps of any consent solicitation process.



DEWEY & LEBOEUF

Leaders and Innovators
in International Tax Law

100 YEARS

DEWEY & LEBOEUF

1909 – 2009

Contacts

Frankfurt: **Hanno Berger** +49 69 3639 3400

London: **Judith Harger** +44 20 7459 5185

Los Angeles: **Sean Moran** +1 213 621 6175

Milan: **Luca Dezzani** +39 02 3030 9330

Moscow: **Anna Lessova** +7 495 737 5114

New York: **Gordon Warnke** +1 212 259 8000

Paris: **Jean Goncalves** +33 1 53 93 75 35

Warsaw: **Tomasz Kacymirow** +48 22 690 6100

Washington, DC: **Abraham Shashy** +1 202 346 7900