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Client Alert

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"Testing the Waters" Ahead of Exchange Offers

"C&DI 139.29, coupled with the Staff's informal interpretation of Rules 165 and 166, offer up helpful new pathways for issuers, and dealer-managers acting on their behalf, to gauge the appetite of debtholders for an exchange offer without foreclosing the possibility of conducting the subsequent exchange offer on a registered basis."

Companies seeking to restructure their debt by means of a registered exchange offer face a difficult challenge. How do they know what terms to offer to their securityholders before commencing the exchange offer? No company facing financial difficulties wants to launch an exchange offer that will be "dead on arrival."[1] But the US federal securities laws prohibit making offers to sell new securities (including by way of an exchange offer) unless an exemption is available or a registration statement has been filed. What is a poor issuer to do?

The answer lies in Securities Act Compliance and Disclosure Interpretation (C&DI) No. 139.29, recently published by the Staff of the Division of Corporation Finance, as well as an understanding of Rules 165 and 166 under the Securities Act of 1933. This *Client Alert* will explore the parameters of C&DI 139.29 and the Rule 165 and 166 safe harbors, and will share our views on how we believe the Staff interprets them.

Exchange Offers and Gun Jumping

In the current economic climate, an exchange offer continues to be a popular tool for companies seeking to restructure their outstanding bonds. Communicating with select influential bondholders prior to launching an exchange offer can substantially increase the probability that the exchange offer will succeed. By "testing the waters" with key bondholders prior to a formal launch, an issuer can gauge the receptiveness of its bondholders to a particular proposal while retaining the flexibility to revisit, revise and refine the proposal prior to public announcement.

For a number of reasons, most debt exchange offers are accomplished in transactions that are exempt from registration under the Securities Act.[2] Exchange offers for convertible bonds may not be eligible for the private placement exemption, however, because of the potential need to offer the exchange securities to all holders of the outstanding convertible bonds.[3] As a result, exchange offers targeting convertible bonds may need to be effected on a registered basis.

"Testing the waters" in advance of a private exchange offer is not an issue if done properly. Testing the waters prior to a registered exchange offer can be more problematic. Section 5(c) of the Securities Act prohibits offers of securities prior to filing a registration statement. The term "offer" is defined broadly. Offers in violation of Section 5's restrictions are commonly referred to as "gun jumping." Consequently, issuers and their representatives (typically including an investment bank acting as a dealer-manager) have generally had a very limited ability to test the waters prior to filing a registration statement for a registered exchange offer.

Historically, issuers seeking to effect a registered exchange offer as part of a debt restructuring program have found themselves between a rock and a hard place. We are happy to report, however, that C&DI 139.29 and our understanding of the Staff's view of C&DI 139.29 give us reason not to despair.

C&DI 139.29 as a Game-Changer?

In C&DI 139.29, the Staff stated that it will not object to lock-up agreements or agreements to tender debt securities[4] in an exchange offer entered into prior to the filing of a registration statement with respect to that exchange offer if the following conditions are met:

- The lock-up agreements are signed only by accredited investors
- The persons signing the lock-up agreements collectively own less than 100 percent of the outstanding principal amount of the particular series of debt securities[5]
- A tender offer will be made to all holders of the particular series of debt securities
- All debtholders eligible to participate in the exchange offer will receive the same amount and form of consideration

C&DI 139.29 is significant because it represents an important relaxation of the gun-jumping restrictions of Securities Act Section 5 that have previously been thought to apply on these facts. As a result of this C&DI, communications with accredited investors about a future registered exchange offer made prior to filing a registration statement are effectively exempted from Section 5(c), even if those communications might be considered to constitute an "offer." Even more dramatically, communications that go so far as to result in a signed lock-up agreement — *i.e.*, that might have otherwise been considered a "sale" under the Securities Act — are also exempt. This is no ordinary C&DI. This is a policy change of real note.

Despite all its benefits and the clarity it provided, C&DI 139.29, by itself, left some important questions unanswered. For example, would a communication *short of a lock-up* be allowed — in other words, would the Staff view testing the waters as permissible even if the issuer did not obtain a lock-up? Is the exemption available only to issuers, or would persons acting on their behalf (such as dealer-managers) be able to take advantage of it? And, finally, does the reference to "debt securities" include convertible securities?

The Staff has informally noted to us that:

- There is no need to obtain a lock-up agreement in order for C&DI 139.29 to apply, and the Staff is not focused on the precise form of any agreement that is obtained[6]
- Persons acting on behalf of an issuer, including dealer-managers, benefit to the same extent as an issuer from the policy exemptions provided by C&DI 139.29
- C&DI 139.29 is intended to apply to registered exchange offers for all types of debt securities, including convertible debt securities

C&DI 139.29 is certainly helpful. Perhaps even better, it turns out not to be the only way to go about testing the waters ahead of registered exchange offers. We believe that the Staff's informal interpretation of Rules 165 and 166 — which might on their face seem to apply only in the M&A context — provides an additional avenue for issuers, and dealer-managers acting on their behalf, to communicate with debtholders prior to launching a registered exchange offer.

Securities Act Rules 165 and 166

Securities Act Rules 165 and 166 are exemptions from the gun-jumping provisions of the Securities Act for certain communications between issuers and securityholders in connection with

"business combination transactions." In those Rules, the term "business combination transaction" is defined to include certain kinds of "exchange offers." However, Rules 165 and 166 have not historically been utilized in the context of simple debt restructurings.

There are several reasons for this. First, the text of these Rules implies they can *only* be used for third-party exchange offers in connection with mergers and acquisitions. Rule 165(c)(2) limits the availability of the Rule 165 safe harbor to exchange offers conducted in accordance with Exchange Act Rules 14d-1 through 14e-8 — *i.e.*, the SEC rules governing *third-party* tender offers — and does not mention Exchange Act Rule 13e-4, the SEC rule governing *issuer* self-tenders. As a result, a simple reading of Rules 165 and 166 would suggest that they were not available for simple issuer exchange offers such as the kind used in most debt restructurings.

Second, the preliminary note to both Rules states that they are not available to protect communications "in technical compliance with" the Rules that "have the primary purpose or effect of conditioning the market for another transaction, such as a capital-raising or resale transaction." This note introduces some uncertainty into the scope of the safe harbor. For example, would the SEC regard an exchange offer for a company that involved a restructuring of existing obligations as a capital-raising transaction?

The Staff has informally noted to us that Rules 165 and 166 are intended to provide a safe harbor for all exchange offers, *even if occurring outside of the traditional business combination context*. (The omission of a reference in Rule 165(c)(2) to issuer self-tenders is viewed as a drafting oversight.[7]) As a result, Rules 165 and 166 would be available in connection with issuer self-tenders governed by Rule 13e-4.

The Practical Impact

Here is a brief summary of Rules 165 and 166:

- Rule 166 applies prior to the first public announcement of a transaction, while Rule 165 only applies after the transaction is announced.
- Under Rule 166, *any* communication prior to announcement is exempt from Section 5(c)'s prohibition on pre-filing offers if certain steps are taken. In particular, participants must take all reasonable steps within their control to prevent further distribution or publication of the communication until either the first public announcement is made or the registration statement related to the transaction is filed.
- Rule 165 exempts from Section 5(c) certain communications made after announcement. It also exempts those communications from Section 5(b)'s restrictions on communications after a registration statement is filed, subject to various requirements, such as filing of any written communications used.[8]

Rules 165 and 166 combine to offer an effective method of testing the waters prior to launching a registered exchange offer. For example, during the time period prior to the announcement of a registered exchange offer and prior to filing a registration statement on Form S-4, Rule 166 permits issuers and dealer-managers to discuss the terms of a potential exchange offer with existing securityholders. Indeed, even written materials (such as term sheets) could be used in these discussions, subject to the requirement to take reasonable steps to prevent further distribution. By informally interpreting the definition of "exchange offer" in Rule 165 to include issuer exchange offers, the Staff has significantly increased the utility of Rules 165 and 166 in the context of debt restructurings.

Comparing the Two Approaches

The following chart compares certain aspects of CD&I 139.29 on the one hand, and Rules 165 and 166 on the other, in the context of exchange offers:

	Rules 165 and 166	**C&DI 139.29**
Persons covered	Issuers and dealer-managers	Issuers and dealer-managers
Recipients covered	All debtholders	Debtholders that are accredited investors only
Communications covered	Oral and written	Oral and written
Filing requirements	None for pre-announcement communications (per Rule 166); post-announcement written communications must be filed (per Rule 165)	None
Exemption from "offer" under the Securities Act	Yes	Yes

Perhaps the key difference between the two approaches is that C&DI 139.29 (like Rule 166) does not contain a filing requirement for written communications. The Staff has informally noted to us that C&DI 139.29 remains available even if the safe harbors of Rule 165 or 166 become available and vice versa. As a result, an issuer, or a dealer-manager acting on its behalf, may continue to freely communicate with accredited investors even after public announcement of a registered exchange offer (*i.e.*, the point in time when Rule 165 would ordinarily become applicable) without any requirement to file the written materials provided to those investors.

Conclusions

C&DI 139.29, coupled with the Staff's informal interpretation of Rules 165 and 166, offer up helpful new pathways for issuers, and dealer-managers acting on their behalf, to gauge the appetite of debtholders for an exchange offer without foreclosing the possibility of conducting the subsequent exchange offer on a registered basis.[9] This added flexibility will be very helpful to issuers seeking to restructure outstanding convertible bonds.

Endnotes

[1] Issuers are (often justifiably) highly sensitive to the risk of launching an exchange offer that is immediately determined to be unacceptable to debtholders. Not only may a failed exchange offer rack up unnecessary expenses for already cash-strapped issuers, but a failed exchange offer may weaken market perceptions of the issuer and further shake the confidence of its investors, lenders and trade creditors.

[2] For a general discussion of exchange offers, *see* Latham & Watkins' *Client Alert 696, Restructuring High Yield Bonds: Getting Ready for the Next Phase of the Cycle*.

[3] The reason for this lies in Rule 13e-4 under the Exchange Act, which governs "issuer tender offers." An issuer tender offer for these purposes is a tender offer for its own equity securities by an issuer with a class of equity securities registered with the SEC. Convertible debt is considered an equity security in this context. Accordingly, in the case of an exchange offer by an SEC registrant for its own convertible debt, Rule 13e-4 applies. In turn, Rule 13e-4(f)(8) would require such an offer to be made to all holders of the convertible debt — some of whom may not be institutions or otherwise qualify as accredited investors. Because the issuance of new securities in the exchange hence may not be able to benefit from a private placement exemption from registration, the transaction must be registered under the Securities Act unless another exemption applies.

[4] However, the final sentences of C&DI 139.29 warn that where debtholders actually tender their debt securities prior to filing a registration statement, the subsequent registered exchange offer may be inappropriate. The theory underlying that conclusion is that, at that point, the private transaction has actually been completed and, once the transaction is complete, it cannot thereafter be publicly registered.

[5] We note that C&DI 139.29 does not attempt to define the term "tender offer" or relieve issuers from their obligation in issuer self-tenders governed by Rule 13e-4 to file a Form TO upon commencement of the tender offer. Therefore, the ability to lock-up a substantial percentage of a particular series of convertible debt prior to making any public disclosure may well be limited by the tender offer rules found in Rules 13e-4 and 14e-1. For a general discussion of tender offer rules applicable to debt repurchases, *see* Latham & Watkins' *Client Alert 687, Navigating Debt Repurchases — Issues and Answers*.

[6] C&DI 139.29 does not provide a definition of the term "lock-up agreement." These agreements can come in a wide variety of forms, and may well contain contingencies (potentially going so far as requiring, and being conditioned upon, the provision of satisfactory disclosure).

[7] We note in this connection Instruction 4 to Rule 13e-4(c), which makes reference to Rule 165.

[8] *See* Rule 165(a) (requiring pre-filing written communications to be filed with the SEC in accordance with Rule 425 of the Securities Act).

[9] In deciding how to structure any particular transaction, it may be useful to bear in mind that C&DI 139.29 and the informal Staff interpretations we summarize in this *Client Alert* are not official positions of the Staff, or the SEC as a whole. As such, they are subject to some inherent limitations (*e.g.*, they do not have the force of an SEC rule).

If you have any questions about this *Client Alert*, please contact one of the authors listed below or the Latham attorney with whom you normally consult:

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