Navigating Debt Repurchases – Issues and Answers

Given the state of the debt markets, we are increasingly asked by clients whether they can repurchase their debt or the debt of their affiliates in the open market or in privately negotiated transactions. While in many cases the answer is yes, there are a variety of legal issues and potential pitfalls that need to be considered in advance of such a transaction. The purpose of this Client Alert is to outline the primary legal issues associated with repurchases of bonds and syndicated bank debt by companies and their affiliates.

While the issues will differ from case-to-case depending on the specific facts and circumstances, there are certain issues that are common to all debt repurchases. In the discussion that follows, we will first address the issues that are common to both bond and loan repurchases. We will then separately discuss the issues that typically arise in bond repurchase programs and we will then turn to the issues unique to repurchases of syndicated bank debt.¹

Our goal is to provide some general answers that may be useful in planning a debt repurchase program. However, you should consult counsel about the facts specific to your circumstances before commencing, and during the course of, any debt repurchase program.

What Do I Need to Worry About in Any Debt Repurchase?

Tax Consequences

A repurchase by a company of its debt at a discount will generally result in taxable income to the company in the form of cancellation of indebtedness income. The amount of this taxable income is generally the difference between the principal amount of the debt repurchased (or its accreted value, if applicable) and the repurchase price. The same result occurs where a person “related” to the company repurchases the debt at a discount. Very generally, a corporation is “related” to a greater than 50 percent stockholder. However, the rules governing “relatedness” are complex and include stock ownership attribution rules, as well as rules governing entities under common control. As a result, generalizations in this area are difficult.

In the case of a related party purchase, the purchased debt is generally treated as having been acquired by the company for the price paid by the related party and reissued to the related party for the same amount. The deemed reissuance of the debt at a discount results in the “new” debt being issued with original issue discount, or “OID.”

¹ Clients contemplating repurchasing their debt or their affiliate’s debt should carefully consider the issues before launching a debt repurchase program.

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Assuming that the new debt is repaid in full at maturity, the company will generally recoup the debt cancellation income over time through additional interest deductions (and the holder will recognize taxable income in a corresponding amount). Special rules apply if the holder of the debt (or its beneficial owners in the case of a partnership) is not subject to US tax on interest paid or accrued on any debt deemed to have been reissued with OID or if the new debt constitutes an applicable high yield debt obligation, or “AHYDO.” For example, if the new debt is deemed to be an AHYDO then the company will not be allowed to deduct the non-cash interest, including any OID, until paid in cash (as opposed to deducting the interest as it accrues), and a portion of the interest deduction may be permanently disallowed. Moreover, once a bond or loan is acquired at a discount by a related person and deemed reissued as new debt with OID, it will no longer be fungible with the other bonds or loans that remain outstanding and, therefore, it cannot be traded as freely as the “old” debt.

**Regulation FD**

If the issuer of the debt is an SEC-reporting company, it should consider its obligations under Regulation FD in connection with any privately negotiated repurchase of debt. Regulation FD prohibits disclosure of material non-public information about SEC-reporting companies to certain types of people unless a confidentiality agreement is in effect. In some circumstances, the fact that a company is seeking to repurchase its outstanding bonds or loans may itself be a material fact that triggers obligations under Regulation FD. Not all debt repurchases will result in disclosure of material non-public information, but some may, and SEC-reporting companies should always consider Regulation FD before embarking on a debt repurchase program. In order to ensure compliance with Regulation FD, companies may elect to disclose their debt repurchase plans publicly before commencing repurchases. As described in greater detail below, this can be done through disclosure of an intent to buy bonds or loans in the “Liquidity” section of the MD&A in a regular periodic report or by special press release.

**Equitable Subordination**

Affiliates considering purchasing the bonds or syndicated bank debt of related companies should consider whether they are putting themselves at risk of being equitably subordinated to other creditors in the event that the related company becomes insolvent. Equitable subordination is a principle under bankruptcy law that allows a court to subordinate a claim (in this case, the bonds or loans acquired by the related person) to other allowed claims and/or to release liens securing the claims of the related person. In evaluating the appropriateness of equitable subordination of the related person’s claims, most courts focus on whether the related person used its influence over, or control of, the borrower to obtain an inequitable benefit or advantage at the expense of the borrower’s arm’s length creditors. A related person is susceptible to failing that test on a variety of theories, including fraud, illegality, breach of fiduciary duties, undercapitalization and use of the related company as a mere instrumentality or alter ego.

**Issues Particular to Repurchases of Bonds**

**Does My Bond Repurchase Implicate the Tender Offer Rules?**

Companies or affiliates planning a bond repurchase program should take care
to design the program such that it does not constitute a tender offer. If a bond repurchase program is conducted so as to constitute a tender offer, it will be subject to certain requirements of the SEC rules including being required to be kept open for 20 business days and will be subject to certain other requirements. An issuer or affiliate that initiates a bond repurchase program that is later held to have been a non-compliant tender offer could face a variety of sanctions, including money damages, injunctive relief and enforcement actions by the SEC.

In general, a debt tender offer is a publicly made offer to bondholders to tender their bonds for sale at a specified price subject to specified conditions over a fixed period of time. However, the SEC has never adopted a definition for the term “tender offer” and that term instead has been defined by case law, from which certain central definitional principles have emerged. The first set of principles was developed in _Wellman v. Dickinson_, in which the court listed eight factors that are characteristics of a tender offer. The eight factors, as they would apply to a tender offer for bonds by an issuer or its affiliate, are:

- Were the offers to purchase or the solicitation of offers to sell disseminated in a widespread manner?
- Did the price offered represent a premium in excess of the current market price of the securities being sought?
- Did the offers fail to provide for a meaningful opportunity to negotiate the price and terms?
- Did the solicitation involve a substantial percentage of the bonds?
- Was the offer contingent on a minimum principal amount of bonds being tendered (and/or a maximum principal amount of bonds being purchased)?
- Was the offer open for only a limited period of time?
- Were the recipients of the offer under pressure to respond to the offer?
- Were public announcements of the acquisition program followed by a rapid accumulation of large amounts of the company’s bonds?

The eight factors test was distinguished in _Hanson Trust PLC v. SMC Corporation_, in which the court held that five privately negotiated purchases and one open-market purchase of a corporation’s common stock totaling 25 percent of the outstanding common stock of such corporation did not constitute a tender offer. The court stated that many of the conditions leading to the enactment of the tender offer rules do not exist in the case of privately negotiated transactions—the number and percentage of stockholders are fewer, the private transaction involves less publicity, and the sellers are typically sophisticated and less likely to be pressured, confused or uninformed. The court then went on to reason that the private transactions in question did not constitute a tender offer for the following reasons:

- The purchaser was in contact with only six of 22,800 stockholders.
- The selling stockholders were all highly sophisticated.
- There was no pressure to sell by conduct that the tender offer rules were designed to prevent.
- There was no active or widespread advance publicity or public solicitation.
- No significant premium was paid (the price paid was less than 1.5 percent over the market price).
- No minimum number of shares or percentage of common stock was required for the purchases.
- There was no time limit during which the purchaser made the subject purchases.

Both the _Wellman_ and _Hanson_ courts were addressing purchases of equity securities. To our knowledge, no court has ever directly addressed the
question of what constitutes a tender offer in the context of debt securities. Given the nature of debt securities and the sophisticated nature of most bondholders, we believe that more flexibility should be granted to issuers seeking to repurchase their debt securities than for equity securities, where the purpose or result of the latter type of offer may be to change the control of the issuer.

Based on these principles enunciated in Wellman and Hanson, we believe that purchases of bonds solely through ordinary open-market transactions at the market and over an extended period of time do not implicate the tender offer rules. However, in other circumstances, including where the repurchase program will include active solicitations or negotiations to purchase bonds, we recommend that companies and their affiliates consider the following factors in designing and implementing their bond repurchase programs:

1. **Timing.** The repurchase program should be made over a meaningful period of time. The longer the period, the better. There should be no set time-period or deadline.

2. **Number of Solicited Sellers.** Solicitations should be made to a limited number of potential sellers. The fewer number of holders contacted, the greater the probability that the offers to purchase will not be considered a tender offer.

3. **Variable Prices and Terms.** Negotiated purchases from multiple sellers should be at different prices and on different terms. The greater the variation in price and terms, the greater the probability that the offers will not be considered a tender offer.

4. **Nature of Sellers.** Privately negotiated purchases of securities from sophisticated institutional investors generally should not be deemed to constitute a tender offer, even if a significant percentage of the outstanding bonds is acquired.

5. **Character of Offer to Purchase.** The purchaser should refrain from applying pressure to potential sellers to sell their bonds, such as “take it or leave it” offers, offers conditioned on other purchases or offers open for very short periods before being rescinded.

Of course, all of the facts and circumstances will be relevant in determining what constitutes a tender offer and should be discussed with counsel.

### Additional Disclosure Issues

Repurchasers of debt securities need to consider whether they are in possession of any material non-public information about the issuer prior to commencing any purchases of debt securities. Rule 10b-5 has been held to impose disclosure obligations on purchasers of securities who possess material non-public information. These obligations are in addition to those required by Regulation FD.

No rule or case of which we are aware directly addresses pre-commencement disclosure obligations under Rule 10b-5 regarding a bond repurchase program. Instead, the question must be analyzed in terms of basic disclosure principles. Support for this view can be found in the SEC’s release adopting Rule 10b-18 under the Exchange Act, which provides a safe harbor from the anti-manipulation provisions of the federal securities laws for issuer repurchases of equity securities. There, the SEC declined to adopt specific disclosure requirements, noting that “other relevant provisions of the federal securities laws and existing policies and procedures of the various self-regulatory organizations impose disclosure responsibilities that appear to be sufficient to ensure that investors and the marketplace in general receive adequate information concerning the issuer purchases.” This principle should apply equally to repurchases of debt securities by issuers and their affiliates.
Prior to making any purchases of an issuer’s debt securities, the issuer (or the purchasing affiliate) must analyze whether it has material non-public information, such as unreleased earnings or financial results or an unannounced merger. For example, an issuer that is about to announce a merger that would trigger a change of control put right under a bond indenture probably should not be in the market purchasing those bonds at prices below par until the merger has been publicly announced. Entities considering purchasing the debt securities of an affiliate face similar issues with respect to material, non-public information they possess (or would be deemed to possess) about the issuer. As a result both issuers and their affiliates should work with counsel to make appropriate materiality judgments regarding undisclosed facts and upcoming events.

In addition, in every bond repurchase program, the question arises whether the fact that the issuer is preparing a bond repurchase program is itself material, non-public information that should be disclosed in advance of commencement of the program. Absent unusual circumstances, the fact that an affiliate of the issuer is preparing a bond repurchase program is less likely in and of itself to be material, non-public information if the bonds will remain outstanding after being purchased. Similarly, if the total “float” of a particular series of bonds will not be materially reduced through issuer repurchases and retirements, we believe that press-release disclosure prior to commencement will rarely be required unless the impact of the repurchase program on the issuer’s financial condition or results will be material to the bondholders and is being selectively disclosed in the process of making repurchases. In some cases, however, a repurchase program’s impact on float or the trading market for the subject bonds may be independently material and in those cases additional disclosure may be indicated.

With respect to the impact of the issuer repurchase program on financial condition or operating results, it will be important to consider whether the potential reduction in the issuer’s cash, coupled with the decline in the amount of outstanding debt, would permit a bondholder to argue credibly that it would not have sold at the agreed price if it had known that the financial position of the issuer would be so improved by the repurchase program. The materiality of the tax liability triggered by repurchasing the debt at a discount should also be considered.

If the effect of the issuer repurchase program is not material either to the issuer’s financial condition or to the trading market for its bonds, as a general matter no prior disclosure of either the commencement, pendency or conclusion of the repurchase program is required. Similarly, we do not believe advance disclosure is required in circumstances where the issuer’s intention to effect material repurchases is not telegraphed to potential sellers in the repurchase program. However, each case is unique and each inquiry is highly fact-specific. There will be some cases where a press release or updated disclosure in the issuer’s periodic reports will be called for. Additionally, the result of an issuer bond repurchase program will be revealed in future periodic reports as the principal amount of the bonds retired will no longer appear on the issuer’s updated balance sheet.

In the event that an issuer intends to implement a debt repurchase program that, due to its scope or other characteristics, should be disclosed prior to commencement, there are at least two ways to make the required disclosure. The most dramatic way is to issue a press release announcing the launch of the debt repurchase program and file a Form 8-K with the SEC as an Item 7.01 or 8.01 disclosure item. Set forth in the following text is an example of a pre-commencement press release and/or 8-K.
"We are aware that our outstanding debt securities and debt under our credit facility are currently trading at substantial discounts to their respective face amounts. In order to reduce future cash interest payments, as well as future amounts due at maturity or upon redemption, we may, from time to time, purchase such debt for cash, in exchange for common stock, or for a combination of cash and common stock, in each case in open market purchases and/or privately negotiated transactions. We will evaluate any such transactions in light of then-existing market conditions, taking into account our current liquidity and prospects for future access to capital. The amounts involved in any such transactions, individually or in the aggregate, may be material." 

A less dramatic method of pre-commencement disclosure is to include a similar statement of intention in a regular periodic report. For example, in the Liquidity and Capital Resources section of the MD&A included in the regular periodic reports on Forms 10-K and 10-Q, it may be possible to insert disclosure along the following lines (tailored, of course, to line up with the issuer's actual situation):

"We may from time to time seek to retire or purchase our outstanding debt through cash purchases and/or exchanges for equity securities, in open market purchases, privately negotiated transactions or otherwise. Such repurchases or exchanges, if any, will depend on prevailing market conditions, our liquidity requirements, contractual restrictions and other factors. The amounts involved may be material."

Of course, this option is only available for those who plan ahead. We recommend that all of our clients with outstanding debt securities consider this or similar disclosure in their periodic reports. In this market environment, MD&A disclosure that a debt repurchase program is being considered will not surprise anyone and it may materially improve the issuer's options when the moment of truth arrives.

What Contractual Restrictions Apply?
The issuer must also consider whether implementation of a bond repurchase program is consistent with the issuer's contractual obligations. The indenture governing the bonds being repurchased is unlikely to prohibit repurchases of the bonds issued under that indenture. However, if the issuer has any outstanding bank debt, the credit agreement may well prohibit repurchasing other debt, even pari passu, unsecured debt, absent pre-negotiated baskets usable for this purpose. Moreover, repurchases of subordinated debt are likely to constitute "Restricted Payments" under bond indentures governing senior debt securities. All of these covenants must be carefully examined before the repurchase program is commenced. Other contractual or regulatory requirements may similarly hamper the issuer's ability to implement a repurchase program and should be considered and discussed with counsel.

Can Bond Repurchase Programs Help Me to Win a Consent Solicitation?
Issuers and affiliates should not pursue a debt repurchase program with the purpose of gaining voting control over bonds in anticipation of an upcoming consent solicitation. Virtually all indentures provide that bonds held by the issuer or its affiliates will be treated as not outstanding for purposes of determining whether requisite consents have been obtained. As a result, a buy-back program by an issuer or affiliate will not typically affect the outcome of a consent solicitation to the issuer's advantage. In fact, by reducing the
number of bonds deemed outstanding for purposes of a consent, a bond repurchase could have the undesired side-effect of concentrating ownership in the hands of fewer bondholders, providing them with extra leverage in a consent solicitation.

What Else do I Need to Worry About if I am an Affiliate of the Issuer?
In addition to the issues previously described, affiliates of bond issuers face other hurdles when buying or selling those bonds. If the bonds are “144A-for-life” or recently issued and have not yet been exchanged in a registered A/B exchange offer, the affiliated purchaser may need to be able to certify that it is a Qualified Institutional Buyer, or “QIB,” in order to purchase the notes. Additionally, absent an effective resale registration statement or an exemption from the registration requirements of the Securities Act (such as Rule 144A, which permits sales to QIBs), affiliates may be limited in their ability to resell the bonds they have acquired. Newly amended Rule 144 provides some relief on this front, but still requires selling affiliates to file a Form 144 with the SEC prior to any sale, limits the amount of bonds affiliates can sell during any three-month period to 10 percent of the total issue, and in some circumstances imposes up to a year-long holding period on affiliates.

Issues Particular to Repurchases of Syndicated Bank Debt
Unlike bond repurchase programs, which have enjoyed a history of success and market acceptance, the ability of a borrower (or its affiliate) to purchase its own syndicated bank debt is a relatively recent phenomenon in the syndicated loan market. Many existing credit agreements simply do not contemplate the possibility of the borrower acquiring its own loans (in essence becoming its own lender), and the technology for doing so is not as well tested in the syndicated loan market. However, in many cases the borrower (or its affiliate) may be able to acquire its loans, if the documentation permits. Given current market conditions, many borrowers are looking very hard at their ability to buy their own loans and the consequences of doing so.

Absent unusual circumstances, loans, including syndicated loans, are not securities under current law. As a result, many of the requirements applicable to bond repurchases—including the tender offer rules and Rule 10b-5’s call for full disclosure to bond sellers—are not implicated by repurchases of syndicated bank debt by borrowers or their affiliates. Instead, the key focus in repurchases of syndicated bank debt is the credit agreement and other documents governing the debt. Although credit agreements vary significantly, common issues arising in connection with repurchases of syndicated bank debt include:

- **Assignment Restrictions.** Certain credit agreements expressly prohibit the assignment of loans to the borrower or its affiliates and, therefore, effectively prohibit repurchases by borrowers and their affiliated parties.

- **Required Consents.** Most credit agreements require the administrative agent’s consent to assign loans to entities other than existing lenders or their affiliates. As a result, even with credit agreements that do not expressly prohibit the assignment of loans to the borrower, the administrative agent’s consent may be required for at least the first repurchase of loans by the borrower or an affiliate.

- **Pro Rata Sharing Provisions.** Many credit agreements require that all repayment of loans be made to all lenders on a pro rata basis.
Depending on the language of the relevant pro rata sharing provisions, borrower repurchases of bank debt could be viewed as violative of this provision on the theory that the payment of the purchase price and the subsequent retirement of the debt by the borrower represent a non-pro rata repayment of principal to the selling lender. As a consequence, the selling lender could be exposed to claims from other lenders that it is required to share the proceeds of the sale. Such pro rata sharing provisions are unlikely to cause similar issues for affiliate repurchases of bank debt, particularly if the loans purchased by the affiliate remain outstanding, but every deal is different and there is no substitute for checking the language of the credit agreement carefully.

- **Other Contractual Restrictions.** Certain capital structures may implicate other contractual restrictions on a borrower’s ability to repurchase its bank debt. For example, in a structure involving first- and second-lien loans, the first-lien credit agreement is likely to place restrictions on the borrower’s ability to prepay or repurchase its second-lien loans.

- **Material Non-Public Information.** Although the SEC’s rules requiring disclosure of material non-public information generally do not apply to purchases of bank debt, borrowers and their affiliates may wish to consider whether they possess information that would make a repurchase unsportsmanlike or otherwise inappropriate. Additionally, as discussed above, SEC-reporting companies need to consider whether information communicated in negotiations relating to the repurchase of syndicated bank debt may necessitate prior public disclosure under Regulation FD.

- **Impact on Excess Cash Flow Sweep.** Most credit agreements require the borrower to prepay loans with all, or a portion of, excess cash flow. In such cases, the amount of excess cash flow required to be so applied is often reduced by the amount of any previous debt repayments. As a result, borrowers should consider whether repurchases will be treated the same as a prepayment for purposes of the excess cash flow calculation. Obviously, it would be unfortunate to discover at year end that a substantial excess cash flow repayment is required using money that has already been spent.

- **Voting Restrictions.** Unlike most bond indentures, many credit agreements do not prevent affiliates of the borrower that own the borrower’s bank debt from participating in lender votes, including with respect to amendments or waivers of the credit agreement (assuming they are allowed to own loans at all). Again, the specific language at issue should be reviewed carefully if voting the loans is an important objective.

While the decision to repurchase your syndicated bank debt may raise some or all of these issues, the relevant provisions of each credit agreement and related considerations may differ widely. We encourage you to consult counsel before repurchasing loans to avoid unpleasant surprises.

In summary, we recommend that you carefully consider the issues before launching a debt repurchase program. Whether you are considering repurchasing your own bonds or loans or those of an affiliate, there are a number of important issues to consider and advance planning will help to avoid unexpected consequences.

**Endnotes**

1. This Client Alert does not address repurchases of convertible debt securities. Additional rules apply to repurchases of convertible bonds since they are treated as equity securities under the federal securities laws. We would be happy to discuss those issues with you directly.

3 See 11 U.S.C. 510(c).

4 See, e.g., Benjamin v. Diamond (In re Mobile Steel Co.), 563 F.2d 692 (5th Cir. 1977) and In re Clark Pipe & Supply Co., 893 F.2d 693 (5th Cir. 1990).

5 Section 14(e) of the Securities Exchange Act of 1934 and Rule 14e-1 promulgated thereunder are the primary laws governing debt tender offers. Section 14(d) of the Exchange Act only applies to tender offers for equity securities, including debt securities convertible into equity.


7 This last factor was first enunciated in S-G Securities, Inc. v. Fugwa Inv. Co., 466 F. Supp. 1114 (D. Mass. 1978).

8 Hanson Trust PLC v. SMC Corporation, 774 F. 2d 47 (2d Cir. NY 1985).

9 All of the subject purchases were made on the same day that the purchaser terminated a conventional tender offer. The court held that the subject purchases did not constitute part of the conventional tender offer because the purchaser: (i) clearly terminated the conventional tender offer; (ii) did not decide to engage in private purchases before terminating the conventional tender offer; and (iii) reserved the right to purchase securities after the termination of the conventional tender offer in the original offer to purchase it filed with the SEC.

10 A hiatus should be taken between bond repurchases on the open market and the launch of a conventional tender offer to avoid integrating the debt repurchase program and the subsequent tender offer as well as to avoid potential claims that the open-market repurchases were part of a “creeping” tender offer.


12 It has sometimes been suggested that because an issuer owes no fiduciary duty to its debt holders, it may repurchase its debt securities without being required to follow the general rule that disclosure of material information must be made prior to commencement of trading. We do not support this view, in part because Rule 10b-5 under the Exchange Act, the cornerstone prohibition on insider trading, draws no distinction between debt and equity securities. On the other hand, the determination of what information is material may be significantly affected by whether the security at issue is debt or equity. In general, given the greater volatility of common equity prices, many types of information that would be material to equity trading might not be required to be disclosed prior to trading in the same issuer’s debt. The materiality standards set forth in SAB 99 and the applicable case law will apply to debt as well as equity.

13 A special sub-class of the pre-commencement disclosure issues may arise depending on what the issuer’s plans may be with respect to the balance of the bonds that remain outstanding. This Client Alert assumes that a bond repurchase program—the opportunistic acquisition of bonds at favorable prices—is the only objective being pursued. However, some companies may consider implementing an open market bond repurchase program as a first stage in an integrated plan to retire the entire issue—for example, by launching a tender offer (presumably at a higher price) for the bonds not purchased on the open market or in privately negotiated transactions. Similarly, a company may contemplate repurchasing bonds more cheaply immediately prior to exercising optional redemption rights at a fixed but higher price. In either case, disclosure questions about the issuer’s plans will need to be addressed.

14 The percentage reduction in the float of any given bond issue that is material will need to be considered in light of all prevailing facts and circumstances. An issuer who purchases bonds “at the market” in small amounts over time may never be telegraphing its intention to substantially reduce the overall float to any individual seller and therefore avoid triggering any Regulation FD obligation. In general, a bondholder who sells in a repurchase program will not be concerned about the size of the float after the sale and will therefore not have a claim under Rule 10b-5 that it would not have sold at the agreed price had it known of the pending float reduction.

15 A consent obtained in connection with a tender offer, or an “exit consent,” is distinguished on the grounds that it is given by the tendering holder as a condition to the tender, and is not a consent given by the issuer (or its affiliate) as the holder of the bonds. Therefore, exit consents generally are effective to achieve a desired consent.
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