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private equity developments

spring 2009

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Making Lemonade from Lemons: Issuer Bond Repurchases

By Michael R. Littenberg and James Nicoll

FINANCING FOR NEW private equity-backed acquisitions has all but dried up as a result of the ongoing credit crisis. However, for those companies already in the portfolio, market events have, in many cases, created an opportunity to reduce leverage by repurchasing outstanding bonds at a deep discount.

Open-market purchases are the simplest way for an issuer to repurchase its debt securities. They often can be completed quickly and require minimal or no documentation, resulting in modest transaction costs.

However, before engaging in open-market bond repurchases, an issuer must be sensitive to a number of potential legal landmines.

Avoiding Insider Trading Claims

The anti-fraud rules under the federal securities laws prohibit an issuer from repurchasing its securities while in possession of material non-public information. Under case law, information is considered material if there is a substantial likelihood that a reasonable investor would consider the information to be important in deciding whether to sell its securities. Whether particular information is material is determined by the particular facts and circumstances; there is no bright line test. Examples of information that may be considered material include the following: (1) historical financial information for the most recently completed financial period; (2) projected financial results or changes in business outlook; (3) acquisitions, dispositions and other significant transactions; (4) new material contracts or other business relationships; and (5) restructuring or refinancing plans.

To mitigate insider trading risk, an issuer often will repurchase bonds only during a prescribed window period, beginning after the issuer releases earnings and ending before it has visibility as to the next quarter's earnings. If, during the window period, the issuer comes into possession of material non-public information, it must cease further open-market repurchases of its bonds.

An issuer also must evaluate whether the decision to repurchase its debt securities is itself material information that needs to be disclosed to investors prior to commencing repurchases. In most cases, a plan to repurchase debt in open-market transactions is unlikely to constitute material non-public information. However, because there is no bright line materiality standard and the analysis is fact-specific, some issuers first opt to issue a press release, file a Form 8-K or make disclosure in a Form 10-Q or Form 10-K indicating their intent to engage in open-market bond purchases.

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Complying with Regulation FD

If an issuer concludes that the intent to engage in open-market repurchases is, in and of itself, material non-public information, it also must be sensitive to compliance with Regulation FD. Regulation FD generally prohibits selective disclosure of material non-public information to investors, analysts and other market professionals unless the recipient agrees to keep the information confidential. Absent a written or verbal agreement by a recipient to keep information confidential, Regulation FD requires broad-based disclosure of the information before it can be shared with the recipient.

Navigating the Tender Offer Rules

A bond tender offer is required to comply with the Exchange Act's tender offer rules. The tender offer rules generally require that a bond tender remain open for at least 20 business days and 10 business days following a change in the offering price or the percentage of securities being sought. In addition, in the equity context, the SEC has indicated that an offer must remain open for at least 5 business days following any other material change in the terms of the offer. Convertible debt securities are subject to additional requirements, which are not discussed in this article, since those securities are treated as equity securities under the tender offer rules.

The federal securities laws do not define what constitutes a "tender offer." Therefore, there is no bright line division between open-market purchases and a tender offer. The issuer must instead apply an eight-factor test derived from case law, which looks at whether:

- there is active and widespread solicitation of security holders;
- the solicitation is made for a substantial percentage of the issuer's securities;
- the offer to purchase is made at a premium over the market price;
- the terms of the offer are firm rather than negotiable;
- the offer is contingent on the tender of a fixed amount of securities or subject to a fixed maximum amount to be purchased;
- the offer is open only for a limited period of time;
- the offeree is subject to pressure to sell its securities; and
- public announcement of a purchase program precedes or accompanies rapid accumulation of large amounts of securities.

No single factor is dispositive in determining whether a repurchase transaction constitutes a tender offer, and the conclusion always depends on the facts and circumstances. However, most open-market repurchase transactions are unlikely to implicate the tender offer rules, even if a fairly significant percentage of bonds is acquired, since repurchases tend to occur over time, involve a small number of sellers, are at prevailing market prices and for available quantities, and are not coercive. Nevertheless, given the lack of clarity in this area, it is prudent for an issuer to consult with counsel regarding the parameters of its repurchase program before commencing purchases.

Complying with Debt Covenants

Open-market bond repurchases must navigate restrictive covenants contained in the issuer's other debt instruments, including credit facilities and indentures of more senior series of bonds.

For example, a bond repurchase may constitute an "investment" or "restricted payment" under a credit agreement. Similarly, where the issuer has issued bonds at different levels in the capital structure—such as senior notes and senior subordinated notes—the senior notes indenture may limit the amount of subordinated notes that may be repurchased without violating the restricted payments covenant. The restricted payments covenant may require the issuer to either rely on the covenant's net income buildup or utilize a catch-all basket to repurchase subordinated notes.

Although an issuer can seek a waiver of a covenant, this often is expensive and time-consuming. In addition, if the issuer has bank debt or privately placed notes that are widely held, a waiver might not be practical.

Taking Tax into Account

Open-market purchases of debt usually result in cancellation of indebtedness ("COD") income, which arises when an issuer purchases debt in exchange for consideration that is less than the adjusted issue price of the debt. The amount of taxable income generated is equal to the difference between the amount paid to repurchase the debt and its face amount (in the case of debt issued without original issue discount ("OID")) or its adjusted issue price (i.e., its issue price plus any accrued OID, in the case of debt issued with OID).

The issuer also will have COD income to the extent that bonds are purchased by a person related to the issuer. The determination of who is related to the issuer for this purpose is highly technical. In many cases, the person that desires to purchase the issuer's debt is the fund that sponsored the acquisition of the issuer (or any entity created by that fund). The sponsoring fund (or the entity created by it) will generally be "related" for purposes of the COD rules. Under the tax code, related-party purchases are treated as if they were a repurchase by the issuer coupled with the issuance of new debt at the purchase price paid by the related person. This "deemed reissuance" of the debt generally results in the "new" debt being treated as issued with OID. Accordingly, following the deemed reissuance, the issuer is generally entitled to OID deductions, but the related person must include accrued OID in its income for tax purposes.

During February 2009, however, new legislation was adopted as part of Congress's fiscal stimulus plan that allows borrowers to defer taxes on COD income for five years following the date of repurchase for debt cancelled in 2009, and for four years for debt repurchased in 2010. Following the end of the deferral period, the COD income must be included ratably in income over the subsequent five years.

Being Mindful of Affiliate Issues

As discussed above, a sponsor may wish to make open-market purchases through an up- the-chain affiliate of the issuer. If so, in addition to the considerations discussedearlier, the sponsor will need to navigate potential conflicts of

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interest if issuer debt is purchased through a different fund than that which holds the equity investment. The sponsor will need to be sensitive to divergent interests between debt and equity holders, resolving any conflicts of interest in accordance with each fund's limited partnership agreement. Up-the-chain debt ownership also may raise additional fiduciary duty considerations at the portfolio company level, such as when the portfolio company has publicly traded minority equity or is in the zone of insolvency.

The affiliated purchaser also must be sensitive to the possibility of attempts to equitably subordinate its claims. In bankruptcy, a court may subordinate an affiliate's claims to those of other debtholders or invalidate any liens securing notes held by the affiliate if the court concludes that the affiliate used its relationship with the debtor to obtain an unfair advantage or benefit that resulted in a cognizable harm to other creditors.

Finally, if the affiliate intends to resell bonds prior to maturity, it needs to be sensitive to restrictions on its ability to do so. It may not engage in resales while in possession of material non-public information. In addition, absent registration for resale of the bonds under the Securities Act, the affiliate also may be subject to a holding period of as long as one year and resales will be subject to volume limitations under Rule 144, which limit the affiliate to resales in any three-month period equal to not more than 10% of the total series.

Considering Alternatives to Open-Market Repurchases

Notwithstanding their ease of completion, open-market repurchases may not enable the issuer to repurchase the desired amount of bonds or to accomplish its other financing goals. The issuer may instead opt to conduct a cash tender offer or an exchange offer.

A cash tender offer may be effected as part of a refinancing in parallel with a new issuance or on a stand-alone basis as a deleveraging transaction. As discussed above, a debt tender must be held open for a minimum time period. The tender offer can be either at a fixed price or a price based on a formula, such as a spread over treasuries. In connection with a debt tender, an issuer prepares and distributes an offer to purchase; however, unlike in the equity context, the offer to purchase is not required to be filed with the SEC.

Alternatively, as part of a refinancing transaction, the issuer may seek to exchange existing bonds for new securities, such as debt with a later maturity date or equity securities.

Exchange offers raise a number of additional considerations not presented by cash tender offers. First, because an exchange offer involves a new issuance of securities, it may need to be analyzed under, among other things, the debt incurrence and lien restrictions contained in the issuer's existing debt instruments to the extent that the covenants in those instruments will remain in place following the exchange offer.

An exchange offer also is subject to the requirements of the Securities Act, since it involves the offer and sale of a new security. The securities to be issued must either be registered with the SEC on a Form S-4 or issued pursuant to an exemption from registration. Issuers often shy away from registered exchange offers, which can be expensive and typically require significant lead time to launch.

There are two applicable Securities Act exemptions. Section 3(a)(9) provides an exemption from registration for an issuer making an exchange offer exclusively to its existing securityholders where no compensation is paid for the purpose of soliciting holders to exchange their securities.

In many cases, an issuer will need the assistance of a paid solicitation agent to complete an exchange offer, either because of the number of bondholders or the complexity of the restructuring transaction. Although a Section 3(a)(9) exchange offer does not prohibit all advisory fees, the limitation on paying compensation for soliciting bondholders often makes the Section 3(a)(9) exemption impractical.

Alternatively, an exchange offer may be able to be structured as a private exchange—i.e., a transaction not involving a public offering—since, following their issuance, high yield bonds continue to be held overwhelmingly by qualified institutional buyers. The disclosure in a private exchange offer is similar to what would be included in a Form S-4, although the timetable is shortened because no SEC filing is required. The issuer also is not subject to the restrictions of Section 3(a)(9).

Both tender offers and exchange offers often are structured to include a consent solicitation. Indentures typically allow most covenants to be stripped out by a vote of a majority in interest of the bondholders. In connection with tendering bonds, the holder agrees, for an extra consent payment, to vote those bonds to remove the covenants relating to the tendered series. This incentivizes holders to tender and often facilitates other pieces of a broader refinancing transaction. ■

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Distressed M&A

Lots of Distress and Not Much M&A, But Some Interesting Opportunities for Creative Private Equity Dealmakers

By Robert Goldstein, Robert Mrofka and Larry Friscia

AS ANYONE FROM Main Street to Wall Street might observe, something seems very different about this economic downturn and the resulting fallout not only for distressed businesses but for the private investment community as well. The almost absolute freeze in the credit markets and the unwillingness of even those traditional "lenders of last resort" to make available acquisition financing—on any terms, much less terms that investors find remotely attractive for generating suitable returns—represents this recession's defining characteristic for private equity investors and has made deal-making in the current economic environment exceedingly difficult.

Without a viable financing market, traditional private equity firms looking to deploy capital have had to become more creative in sourcing, executing on and financing investment opportunities. One of the emerging trends we have seen and explore below is private equity firms providing debt financing directly to their own portfolio companies or acquiring that debt in the secondary market, all in an effort to hedge against losses on their equity investment, as part of a loan to own (or re-own) strategy or a combination of the two. In short, private equity firms looking to salvage existing investments or put additional capital to work have had to depart from their traditional comfort zones and implement these types of alternative investment strategies to stay active in the current environment.

Discussion

In the M&A arena, during economic downticks, there is typically some transition from typical M&A deals to distressed M&A transactions, in which a distressed company disposes of all or part of its business in an orderly manner by way of a sale under Section 363 of the Bankruptcy Code or under a plan of reorganization. A sale conducted under the Bankruptcy Code affords protections to buyers that are not otherwise available outside of bankruptcy and, typically, attracts attention from several prospective strategic or financial buyers seeking acquisitions at a discount. Accordingly, a well-marketed distressed company would have a reasonable prospect of accomplishing a sale in Chapter 11.

There is usually some systemic lag between the beginning of an economic downturn and the first wave of bankruptcy filings. It is also fair to say that not all distressed M&A sales are going to be successful. However, the expectation of successful distressed deals that has been a byproduct of the significant increase in Chapter 11 filings has been called into serious question by a recent flurry of failed sales processes where a frozen credit market has stifled distressed M&A transactions. Whether this is primarily a function of a shrinkage in the pool of prospective financial and strategic bidders with the financial wherewithal to close a distressed deal, given the lack of financing, or a general retrenchment in deal-making in a highly uncertain market for other reasons is largely beyond the scope of this article. Nevertheless, it seems clear to us that the ground rules for distressed M&A have shifted dramatically.

Cases and Businesses Foundering

Most companies that plan to sell themselves in Chapter 11, like their counterparts in a non-bankruptcy setting, start with an auction process. The difference between being in and out of court is that the distressed auction process is subject to court-ordered bidding procedures. In some cases, debtors select a stalking horse bidder and afford them certain negotiated bid protections. Even with a committed stalking horse bidder, however, bankruptcy sales processes can abort, for example, after a failure to obtain a qualified bidder or when a stalking horse bidder's closing conditions cannot be satisfied.

In some recent bankruptcy settings, attempts to sell the debtor's assets have been abandoned altogether and the assets liquidated under either a liquidating plan or by a Chapter 7 trustee after the case is converted. The confluence of a tight credit market, depressed real estate values and lagging consumer confidence have hit the retail sector particularly hard, producing a significant number of companies seeking Chapter 11 protection. Recent casualties in the retail sector include household names such as Circuit City, Sharper Image, KB Toys, and Linens 'n Things—companies which, in past down economic cycles, would have generated—and, in fact, did generate—substantial interest from the private investment community but which, in this economic environment, failed to sell as going concerns and have been relegated to liquidation and dissolution.

The saga of Circuit City, once the nation's No. 2 consumer electronics retailer, illustrates well the current state of distressed M&A. On Nov. 10, 2008, Circuit City Stores Inc. filed for Chapter 11 bankruptcy protection, disclosing that it had, as of Aug. 31, 2008, $3.4 billion in assets and $2.32 billion in liabilities. The company entered into Chapter 11 with the stated goal of selling itself as a going concern. In pursuit of this objective, it successfully petitioned the bankruptcy court to approve its proposed expedited auction process, and obtained Jan. 16, 2009, as the bid deadline.

Three bidders participated in the process. However, it was noted that "[t]ight credit had limited retailers' ability to reorganize," and that "[n]o major retailers that have filed for creditor protection since January 2008 have remained in operation." On Jan. 16, Circuit City notified the court that the auction to sell itself as a going concern failed to produce any bids, and indicated its intent to accept bids from going-out-of-business liquidators to dispose of its inventory in an orderly wind-down liquidation. Since then, the company has ceased operations and engaged in widespread liquidation sales of its inventory, leases and office equipment.

Retail is, of course, not the only sector to be hit hard by the economic crisis and the absence of a healthy financing market. Blue Water Automotive Systems Inc. ("Blue Water") is another cautionary tale of an auction process gone awry. BWAS was a substantial supplier of plastic components and assemblies to industrial concerns, particularly those in the automotive sector, including Ford, GM and Chrysler. On

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Feb. 12, 2008, the company filed for Chapter 11 bankruptcy protection in Michigan with the intention of conducting an auction process for the sale of its assets. Consistent with this objective, it obtained a stalking horse bidder, NYX Inc., a parts makers in the automotive sector, which offered to purchase it for $28 million. An auction was scheduled for July 27, 2008. The sale process got off to a bad start when NYX withdrew from the bidding before the scheduled auction took place. Another bidder, automotive parts maker Flex-N-Gate LLC, offered $22.4 million, but that bid was rejected by Blue Water because Blue Water's largest secured creditors objected to the price. On July 15, 2008, less than two weeks before the auction was scheduled to take place, Ford Motor Co., Blue Water's largest customer and the primary sponsor of the auction and sale plan, withdrew its support. Left with no viable alternatives, Blue Water obtained confirmation of a liquidating plan of reorganization to sell off the company piecemeal.

What Role Can Private Equity Play?

While private equity firms have been no less impacted upon by the credit crisis than have any other financial or strategic acquirers, we are seeing private equity firms, particularly those with flexible investment strategies, implement less orthodox financing and acquisition plans in an effort to increase returns on their existing distressed private equity investments and/or to simply deploy capital and "get back in the game." Among others, Sun Capital Partners Inc. ("Sun"), Irving Place Capital Management LP ("Irving Place") and Oaktree Capital Management LP ("Oak Tree"), prominent hedge funds and private equity funds, have each recently implemented clever, but slightly different, investment strategies that have become popular ways for private equity firms to exert significant influence over the future of distressed companies and to deploy capital in a difficult environment.

Fluid Routing Solutions (Sun)

Fluid Routing Solutions Inc. ("FRS"), a designer and manufacturer of fuel management systems, fluid handling systems and hose extrusion products, was a portfolio company of Sun that, on Feb. 6, 2009, filed for protection under Chapter 11 of the Bankruptcy Code, having fallen victim to the downturn in the global economy, a steep decline in sales in the automotive industry and its own excessive cost structure. In addition to owning a controlling interest in the equity of FRS, Sun had, prior to the filing, also made a $10 million senior subordinated loan to FRS (subordinated to FRS's approximately $4.23 million in senior secured debt).

As it likely became clear to Sun that FRS could not, in the current environment, meet its continuing obligations and presumably as part of Sun's strategy to seek some return on its prior debt and equity investments, Sun, at the same time as the Chapter 11 filings, agreed not only to provide FRS with debtor-in-possession funding during the pendency of its proceedings but also to serve as a stalking horse bidder for the company's hose extrusion operations, fuel hose assembly and power steering services business in a Section 363 asset sale transaction. Sun agreed to pay $11 million for these assets through a credit bid of their DIP obligations (and cash if the purchase price exceeded the DIP loan), subject to any higher or better offers that might come along in a bankruptcy-court sanctioned auction for the assets. Ultimately, the auction produced no other qualified bids and the transaction promptly closed despite a number of objections to the sale process lodged by FRS creditors.

In so doing, Sun afforded itself the opportunity to own the only part of the FRS business that FRS has claimed in court filings to be viable, streamlined due to the stripping of substantially all liabilities and unprofitable contracts as part of the 363 sale process for what is likely an attractive price. Alternatively, it may well be that Sun did not desire ultimately to own this business again—even the slimmed-down version—but stepped in as stalking horse to generate interest in the business at a premium to Sun's bid sufficient to not only pay off any of its DIP loans, but to potentially achieve some level of return on its pre-petition secured debt and, albeit unlikely, its equity position. In either case, through its participation as a DIP lender and stalking horse bidder—not traditional roles for private equity players, although one in which Sun does have experience—Sun has created multiple avenues to recover on its original investment with presumably limited risk as a super-senior secured DIP lender.

Chesapeake Corporation (Irving Place, Oaktree)

Unlike the relationship between Sun and FRS, the acquiring private equity funds in the Chapter 11 case of Chesapeake Corporation, a packaging company, did not own any of the equity of Chesapeake prior to the commencement of the Chapter 11 case in December 2008. Irving Place and Oaktree, however, had acquired some portion of Chesapeake's notes and were members of an ad hoc committee of note holders that had engaged in workout discussions with the company pre-bankruptcy. The two funds joined forces to propose a stalking horse bid for an asset sale to be completed as a sale under Section 363 of the Bankruptcy Code. On Jan. 20, 2009, the bankruptcy court, over the objection of the creditors committee, approved the bidding procedures, which included a $16 million breakup fee, minimum overbid requirements and other protective provisions. On March 17, 2009, after receiving no competing bids, Chesapeake declared the funds to be the successful bidder and, on March 23, 2009, the court approved the sale. The committee complained of the restrictive time frame, claiming that the terms of the DIP (which was filed under seal) mandated an expedited process designed to ensure the success of the stalking horse bid. The funds' pre-petition investment in Chesapeake's distressed securities, which, in turn, yielded their seats on the ad hoc committee, undoubtedly had some significant influence on the auction process result.

Conclusion

The current economic malaise, the fear that the "bottom" has yet to be found, and the absence of meaningful third party financing alternatives has made traditional private equity leveraged buyout activity scarce. The general consensus, however, is that there are compelling investment opportunities for the careful and creative private equity investor to obtain valuable businesses at severely depressed prices if they are willing to step out of their normal investment program and into the distressed investment world. While the large-cap victims of the economy may not be good candidates for credit-bidding and other novel "loan to own" investment strategies due to the need for third-party financing to operate the business, the strategy it employed in FRS and Chesapeake may be the wave in private equity investing for the foreseeable future. ■

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