Dealing With The Financial Crisis:
Opportunities And Pitfalls

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Financial Market Overview

State of The Financial Markets

- Uncertainty and Volatility
- Federal Government Bailouts and “Stimulus” Packages
- Extinction of the Wall Street Investment Bank
  - Bear Steams sold to JP Morgan
  - Lehman Brothers bankrupt
  - Merrill Lynch purchased by Bank of America Corporation
  - Goldman Sachs and Morgan Stanley converted into Bank Holding Companies (more regulation)
- Consolidation in the Financial Sector
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State of The Financial Markets (cont’d)

- Struggling Industries and Sectors (Consumer-Dependent Hardest Hit - Banking, Diversified Financials, Gaming, Lodging & Leisure, Advertising-Dependent Media, Real Estate)
- Commercial Banks Struggling and Some Failing
  - Bad loans
  - Balance Sheet Problems
  - Liquidity has Dried Up
  - Tightened Lending
  - Consolidation

Decline of Loan Volumes

- 2008 U.S. Lending falls 55% to $763.98 billion from 2007
  - IG loan issuance plunges 50% to $318.8 billion
  - Leveraged lending falls 57% year-over-year to $294.5 billion

Gasping for air? U.S. Lending falls to $105 billion in 1Q09

- 1Q09 U.S. Lending falls 42% y-o-y to $105 billion
  - IG loan issuance – $51.8 billion – down 18%
  - Leveraged lending – $27 billion – down 58%
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Decline of M&A Transactions

- In U.S., announced M&A transaction volume:
  - Down 37.2% in 2008 vs. 2007
  - Worldwide down 29.6% for same period
  - Lowest U.S. volume since 2005
- In U.S., completed M&A transaction volume:
  - Down 47.3% in 2008 vs. 2007
  - Worldwide down 33% for same period
- Cross border transactions worldwide down 38.5% in 2008 vs. 2007

Secondary Market Loan Prices

Issues and Strategies for Loan/Bond Capital Market Issuances
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The Good News

- Deals are getting done (despite the headlines)
- Healthy banks want to make loans
- Borrowers can still get loans (options may diminish depending on strength of borrower credit)
- Fundamental considerations for bank lenders are back to the “fundamentals” (Credit Quality, Price & Promises)
- Investment Grade bond market leading the overall capital markets back (record 1Q 2009 issuance)

Investment Grade Bond Issuance

![Cumulative Investment Grade Issuance Graph]

Source: U.S. Bancorp Investments, Inc.

The Bad News

- Fewer lenders as consolidation in the financial sector continues
- Lenders’ “Fear of Commitment”
- Changing financial partners
- Lender side challenges negatively impact borrowers
- High-yield bond market only partially open for select issuers
- Consumer-dependent and cyclical industries hardest hit
- Banks still distracted – dealing with internal issues
Lender Side Challenges

Arranging Loans
- Underwritten loan market has virtually disappeared
- “Best efforts” loan market is limited in size resulting in pricing and structure being a “discovery process”
- Fewer players overall due to consolidation
- Focus on capital preservation
- Increased regulation = risk profile reduction
- Restrictive and time-consuming internal credit approval process (nobody wants to be a hero)
- Sector specific pressure affecting overall liquidity
- Economic cycle impact – sharp cash flow reductions

Borrower Side Impacts

What Do Lender Challenges Mean for Borrowers?
- Shorter maturities
- More and tighter covenants – leverage, fixed charge coverage ratio, EBITDA
- Higher pricing – LIBOR floors, increased arranger and upfront fees, higher margin pricing
- Collateral and other structural issues
- Reduced credit availability
- Need to offer ancillary business opportunities
- Importance of bank relationships and diversifying such relationships

Strategies for Obtaining Financing

- Attracting financing in current markets
  - Good credit / low leverage
  - Well organized project and team
  - Good reputation – minimize risk
  - Offer ancillary business opportunities (especially if seeking syndicated financing)
  - Work your banks
- “A Bird in the Hand is Worth Two in the Bush”
  - If have a commitment from a financially sound institution on commercially reasonable terms, do not delay
  - Do not wait for better terms
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Strategies for Obtaining Financing

- Understand financial strength/weakness of respective participating banks
- Evaluate all market options: loan, bond, private placement, etc.
- Preserve Options
- Partner with banks representing:
  - Reliable credit providers
  - Product-agnostic advice
  - Multiple market solutions
- Self-Awareness

Debt and Equity Alternatives

Debt Restructuring

- Limited Refinancing Ability
- Common Characteristics
  - Balloon payment at maturity
  - Low interest rate
  - Covenant lite
  - Trading below par
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Corporate Bond Prices

Debt Repurchase

• Benefits of Debt Repurchase
  – May not have better use of cash
  – Deleveraging of balance sheet
  – Market perception
  – Retire debt at discount to par
  – Deferral of cancellation-of-indebtedness income

Debt Repurchase

• Types of Repurchases
  – Open market purchases
  – Privately negotiated purchases
  – Tender offers
  – Redemption
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Exchange Offers

- Benefits
  - Extend maturity
  - Reduce principal amount
  - Speed

- Types of Exchange Offers
  - Public exchange
  - Private exchange
  - 3(a)(9) exchange

Equity Alternatives

- PIPE
- Registered Direct Offering
- Reverse Stock Split
- Stock Option Repricing

Debtor-In-Possession Lending
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DIP Lending: This Is Not Your Father’s Bankruptcy

• Where Did It Go?
• What Happens Now?
• Is It Coming Back?
• Top 3 issues for Lenders v. Vendors in Bankruptcy
• Case Studies

DIP Lending – Where Did It Go?

• 2008 Credit Crisis
  – GE largely stops DIP loans*
  – 2008 DIP loans were 35% below 2002**
  – 2008 DIP loans were 46% below 2005**
  – DIP Rates climb
    • 2007 LIBOR plus 2.5% to 5%**
    • 2008 LIBOR plus 5%-7%**
    • Late 2008 to early 2009 LIBOR plus 11% to 12%*


DIP Lending – What Happens Now?

• Companies are waiting to file
• Filings find companies in total crisis = “Everything Must Go” or GOB sales
• Defensive DIPs
• Bridge loans to a quick sale
• Chapter 11 Reorganization is now Chapter 363 (bankruptcy sale)
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DIP Lending – Is It Coming Back?

Anecdotal Evidence that Lenders are thinking about DIP loans again
Case Study: Smurfit-Stone Container Corp.
- Filed January 26, 2009, D. Del.
- $750 million loan from new lenders

Top 3 issues for Lenders v. Vendors in Bankruptcy

- Preferences and Liens on Avoidance Actions
- Section 506(c) waivers
- Reclamation and 503(b)(9) Claims and super-priority claims

Case Studies

Steve & Barry’s
- Filed July 9, 2008, S.D.N.Y. (asset sale; Chapter 22)

Mrs. Fields Cookies
- Filed August 24, 2008, D. Del. (Pre-negotiated plan)

Circuit City
- Filed November 10, 2008, E.D. Va. (GOB)

Lyondell Chemical
- Filed January 6, 2009, S.D.N.Y. (distressed filing; ????)

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Top Ten Action Items for Borrowers with Debt in the Current Environment

10. Review financial covenants in loan and financing documents and test them against projections
9. Form a legal and financial team to review financial health of business and develop debt restructuring strategies and proposals if necessary
8. If problems expected, initiate spending controls or freezes until internal financial review completed
7. Actively review and manage budgets
6. Consider affects of action/inaction on key relationships, credit ratings and public disclosure
5. Proactively reach out to creditors to keep them informed, negotiate amendments to prevent defaults or consider restructuring options
4. Solicit relationships with other sources of financing
3. Expect more strenuous terms – pricing, maturities, covenants – and plan accordingly
2. You’re a creditor too – customers, vendors, landlords
1. Make financing a strategic function, not a reactive one

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With economic activity down and frozen credit markets clogging the financing spigot, debt exchanges can be a powerful restructuring tool for issuers facing uncertain cash flows. If structured properly, a debt exchange can provide an opportunity for both issuers and noteholders to benefit. Noteholders gain improved recoveries at premiums unavailable in the broader market. Issuers may be able to avoid difficult and expensive discussions with unmotivated lenders and extend maturities, while preserving opportunity for increased returns to shareholders. However, complex issues that need to be addressed quickly in order to get bondholders to participate often arise during the exchange offer process. Therefore, companies considering debt exchanges need to understand both market and legal dynamics to benefit fully.

Harrah's Entertainment Inc., the world’s largest casino company by revenue, recently announced its second such transaction, an offer to swap $5 billion in bonds for $2.8 billion in new notes to reduce debt and extend maturities to buy time for Harrah's traditional gamblers to increase the “house advantage.” This follows a successful offering completed in December in which $2.2 billion of unsecured notes due 2010 through 2016 were exchanged for $1.4 billion second lien notes due 2015 through 2018. Although only 37% of the $6.6 billion outstanding tendered, the reduction in shorter-term maturities gave Harrah's some much-needed breathing room. Additionally, the first exchange offer resulted in a reduction in principal balances of $1.1 billion, improvement in leverage ratios and extension of the weighted average maturity by about two years. Additionally, the company’s credit rating improved from CCC to B-, although it was subsequently downgraded two notches to CC due to continued pressure on refinancing coupled with downward spiraling economics.

The Harrah’s participating noteholders received cash for earlier maturities at a small premium to market and new secured, second-lien notes for much healthier premiums of 70% to 354%, resulting in weighted average pricing at 64% of par. The transaction was viewed as positive from all sides. Noteholders got much-needed liquidity on an instrument that might have otherwise plummeted in value, equity holders increased their opportunity to recover previously unachievable returns by deleveraging cash flows, and the banks benefited from increased coverage reducing the likelihood of a near-term covenant breach. Assuming none were betting on failure, a positive result all around.

The second Harrah's offering, announced March 4, was a tender offer for $5 billion of senior and senior subordinated notes due 2010-2011 in exchange for 10% second-priority senior secured notes due 2018. The bonds were trading at 25% to 34% of par and are being tendered at prices rumored to be materially higher.

Completion of an exchange offer does not, however, always lead to the intended result. Fleetwood Enterprises Inc., a builder of manufactured housing and recreational vehicles, consummated an exchange offer in December. About 80% of Fleetwood's convertible subordinated debentures were exchanged for common stock and new senior secured notes. In March 2008, Fleetwood's continuing liquidity problems forced it to file for bankruptcy and seek to undo the exchange offer to avoid breaking covenants on secured credit facilities. If not for the exchange offer, the debenture holders would have had the right to immediately force Fleetwood to repurchase their bonds. Because the exchange passed the 50.1% threshold required for covenant stripping, the old covenants no longer protect the remaining holders of the debt and likely had some coercive influence on the high participation rate. Fleetwood now needs to restructure in order to avoid falling below the revised liquidity requirements of its secured loan facilities, which would cause a cross default under the new bonds.

In an ironic twist, Leon Black lost out to his previous client and fellow investor Carl Icahn in a debt exchange involving Realogy Corp., the Parsippany, N.J.-based owner of Coldwell Banker and Century 21 brands. Realogy was sued by Icahn’s High River LP because it was argued that its senior toggle
notes were being unfairly pushed behind new noteholders in the exchange. The Delaware Court of Chancery granted summary judgment to the holders of Realogy’s senior toggle notes and ruled that the proposed exchange would have violated the terms of the senior secured credit facility, which forced Realogy to pull the exchange. Vice Chancellor Stephen Lamb of the Delaware Court of Chancery decided not to prejudice the senior lenders by ruling that an interpretation of “Permitted Refinancing Indebtedness” excluded the new second-lien term loan offered in the exchange, despite the accordion feature of its credit agreement. The subordinated debt declined in value substantially after the cancellation of the exchange.

Bondholders will often form ad hoc committees after an issuer launches an exchange offer or announces its intention to do so. They may also seek to have an issuer pay the expenses of the committee, including the fees of any professional advisers engaged by the committee. The formation of a bondholder committee may increase the likelihood of success of an exchange offer, as the committee provides a vehicle for an issuer to negotiate with a large block of bondholders, rather than having to negotiate with a number of individual holders. A committee that holds a majority of outstanding bonds typically has the ability to waive defaults and rescind accelerations. However, without sufficient bondholder participation, the presence of a bondholder committee may reduce the probability of a successful exchange offer, as was the case with Station Casinos Inc.

In December, Station Casinos withdrew its debt exchange offer after an ad hoc committee consisting of more than two-thirds of bondholders notified Station that the new bonds being offered were deficient. As a result, Station recently announced that it intends to file for bankruptcy. Time will tell whether Station’s bondholders made the right decision by rejecting the terms of the exchange offer.

Negotiations between GMAC LLC and a bondholder committee in December resulted in GMAC sweetening the terms of its exchange offer for $38 billion of its debt; however, its efforts to qualify as a bank holding company were nearly derailed after Pimco withdrew from the bondholder committee and did not tender its bonds. GMAC successfully obtained bank holding company status and $5 billion in Troubled Asset Relief Program funds, causing Pimco’s interest to soar.

In connection with the exchange offer negotiation process, bondholders often request from an issuer certain material nonpublic information, such as detailed information about the issuer’s financial situation. Prior to disclosing such information, issuers will require that bondholders enter into confidentiality and standstill agreements. In addition to preventing disclosure, these agreements generally prevent bondholders from selling their bonds or pursuing enforcement rights under the governing debt documents during the term of the agreement. If an issuer proceeds to negotiate without having in place a restriction on sales by a bondholder, it runs the risk that the bondholder sells its securities during the negotiation process, leaving the issuer in a position of having to start the negotiation process over with new holders, a luxury potentially unavailable in today’s environment. Bondholders typically insist on short durations for these types of agreements (30 to 60 days is fairly standard) and may require that the issuer publicly disclose any material nonpublic information at the expiration of the term, which allows bondholders to resume trading in the issuer’s securities without violating insider trading laws.

A properly structured debt exchange can be a useful tool to delever a balance sheet and provide much-needed cash flow relief for an issuer, while at the same time creating liquidity and price stability for holders. Both debtors and creditors need to work with their financial and legal advisers to handle the complex issues that arise during the process in order to successfully consummate a debt exchange.

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January 8, 2009

Exchange Offer Alternatives for Issuers of Debt Securities

The current credit crisis and worldwide recession, coupled with a substantially frozen market for new high yield debt issuances, has led to a significant number of current and prospective defaults by issuers of high yield debt. A number of companies have failed to pay interest on their debt, while others have defaulted on principal payments at maturity. This trend is expected to continue in 2009 and possibly beyond.

As the credit crisis continues, companies need to anticipate issues they may face as cash flow declines and debt comes due, particularly if refinancing options are not available. Issuers of debt securities have recently been turning to exchange offers both as a substitute for refinancings and in order to restructure their balance sheets and obtain some relief from debt service requirements.[1] This memorandum discusses certain aspects of exchange offers that may be useful to issuers contemplating a debt restructuring.

Fundamentals

In an exchange offer, a company makes an offer to holders of its outstanding securities to exchange the existing debt for newly issued debt securities or a package of debt and equity securities designed to accomplish the company’s financial goals. An issuer considering an exchange offer must carefully analyze its other contractual obligations, particularly senior credit facilities and senior indenture covenants, which may prohibit or restrict the issuer’s ability to consummate the offer. The exchange offer is typically tailored to meet the financial goals of the issuer while also attempting to attract bondholder interest. The offered debt may include lower face amounts and extended maturities compared to the old debt. The new debt may also be more senior in the capital structure or include a collateral package. In some instances, interest requirements on the newly offered debt may be higher than on the old debt to incentivize holders to exchange their bonds; however, if an issuer needs cash flow relief, interest requirements may be lower, in which case issuers will likely need to give new debt holders a higher priority in the capital structure through a new collateral package or otherwise.

From a securities law perspective, an exchange offer is an offering of new securities and must be registered with the Securities and Exchange Commission (the “SEC”) unless an exemption from registration is available. In addition, an exchange offer is subject to the anti-fraud provisions of the Securities Act of 1933 and Rule 10b-5 under the Securities Exchange Act of 1934. A non-convertible debt exchange offer is also subject to only the most basic tender offer rules in Regulation 14E—for example it must be held open for 20 business days—while tenders for convertible securities may be subject to the full panoply of tender offer rules applicable to equity securities.
Exchange offers often include consent solicitations requiring the consent of holders of a majority—or in some cases two-thirds—of the principal amount of the old bonds to remove most or all of the financial and operating covenants and related events of default from the old debt indentures, thus leaving non-tendering bondholders with bonds that do not have significant covenant protections, as well as a potentially illiquid security. However, under the Trust Indenture Act of 1939, fundamental economic terms of bonds cannot be amended without the consent of each holder. Therefore, because it is almost always impractical to obtain the consent of every bondholder, an issuer can only change the economic terms of its debt by offering its bondholders a new security. This gives rise to the problem of holdouts since an existing debt holder can always preserve its economic terms—although not necessarily its covenant protections—simply by declining to make the exchange.

Types of Exchange Offers

An exchange offer can be structured in one of three basic ways: as a registered exchange offer, a Section 3(a)(9) exchange offer or a private exchange.

**Registered Exchange Offer.** In a registered exchange offer, a company will prepare and file with the SEC a registration statement on Form S-4 covering the new securities being offered. The registration process requires substantial public disclosure and can be expensive and time consuming because the registration statement is subject to SEC review. Registered exchange offers may be beneficial in situations where bonds are widely distributed or are not held by holders eligible to purchase new debt in a private placement (generally qualified institutional buyers or "QIBs"). In addition, new bonds in a registered exchange offer are freely transferable, which provides bondholders with greater liquidity than with privately placed bonds. Exchange offers combined with prepackaged plans of reorganization are typically undertaken as registered exchange offers.

**Section 3(a)(9) Exchange Offer.** A Section 3(a)(9) exchange offer is made pursuant to Section 3(a)(9) of the Securities Act of 1933 ("Securities Act"), which provides for an exemption from registration for any security exchanged by an issuer with its existing securities holders if the following conditions are met: (i) no payment is made by the issuer for solicitations made in connection with the offer; (ii) the old bonds and the new bonds and any equity offered in the exchange are all offered by the same issuer (there are limited interpretive exceptions for substantially identical issuers and other specific fact situations); and (iii) bondholders are not required to contribute cash or other property, other than the old bonds in exchange for the new bonds. However, cash or other consideration can be offered by the issuer with the new bonds.

New securities issued in a Section 3(a)(9) exchange offer will be restricted securities for resale purposes only if the old securities were restricted. The prohibition on payments for solicitation prevents an issuer from hiring an investment banker where the banker's fees are based on the success of the offer. Such prohibitions can impede communications with bondholders and make it more difficult to persuade them to tender their securities which is always a difficult process. A Section 3(a)(9) exchange offer avoids SEC registration and review, thus allowing faster completion of an offer than in a registered exchange. Such an offer can also be made to individuals and unsophisticated investors. However, a Section 3(a)(9) exchange is considered a public offering, which can lead to integration issues if an issuer is conducting a simultaneous private placement in connection with the exchange.

**Private Exchange Offer.** New securities may also be offered in a private placement
exempt from registration under Section 4(2) of the Securities Act. In a private exchange offer, offers are typically limited to QIBs and offshore investors under Regulation S (or in some cases accredited investors). The securities issued in a private exchange offer will be restricted securities. However, as with a Section 3 (a)(9) exchange offer, private exchange offers are generally less costly and can occur more quickly than registered exchange offers. Issuers may also pay bankers to solicit holders of outstanding bonds in a private exchange offer. However, any bonds not held by QIBs or offshore investors are generally not eligible to be tendered and will therefore remain outstanding following completion of the exchange offer.

**Exchange Offer Strategies**

Bondholders with a significant stake in the outcome of an exchange offer often form *ad hoc* committees to evaluate the terms of an exchange offer and to negotiate better terms with an issuer. Exchange offers also sometimes attract distress buyers that purchase large blocks of bonds to provide leverage to renegotiate the terms of the offer and obtain more value for the outstanding bonds. Issuers often must struggle through intense and lengthy negotiations in order to complete a proposed exchange offer. Members of an *ad hoc* committee may become insiders, which restricts their ability to trade in the issuer’s securities.

Given bondholders’ general reluctance to agree to principal and interest reductions (which may be even further impaired in a post-exchange bankruptcy proceeding), issuers need to create strong incentives for bondholders to participate in an exchange offer. Accordingly, as noted above, issuers will often combine an exit consent solicitation with the exchange offer. In situations where a payment default and subsequent bankruptcy is a real possibility, an issuer can combine an exchange offer with a prepackaged plan of reorganization under Chapter 11 of the Bankruptcy Code, and solicit debt exchanges and plan acceptances simultaneously. If the higher threshold for exchange offer acceptance is not met, the Company can implement the exchange in bankruptcy to all holders with the vote of two-thirds in amount and a majority in number of old bondholders.

***

Exchange offers can be useful tools in restructuring overburdened capital structures. However, they can be difficult to execute and may involve lengthy negotiations with various constituencies and the risk of litigation. Issuers that carefully plan with their advisors how to address the complex financial and legal issues and creditor dynamics involved in an exchange offer may be able to successfully restructure their balance sheets, improve their financial health and avoid an insolvency proceeding.

[1] There are other restructuring options not addressed in this memorandum that may also be available to issuers with sufficient cash resources, such as optional redemptions, cash tender offers and privately negotiated purchases.

[2] A private exchange offer can also be conducted under Regulation D to accredited investors. However, recent offers have generally been conducted under Section 4(2) and limited to QIBs and Regulation S purchasers.

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