Synthetic Debt
Repurchase
Transactions & Other
Transactions
Utilizing Self-
Referencing Exposure.

Introduction

Unprecedented illiquidity and uncertainty continue to pervade the world’s financial markets. This distressed economic environment has dramatically increased many borrowers’ funding costs and widened their credit default swap spreads (i.e. the cost to purchase credit protection on such borrowers’ debt). However, for borrowers with outstanding debt and the wherewithal to do so, distressed market pricing provides the opportunity to buy back debt at relatively inexpensive prices. Furthermore, some borrowers are discovering that they can also benefit from market conditions by entering into synthetic transactions that reference themselves or their outstanding indebtedness. Such self-referencing transactions provide borrowers with exposure to their own outstanding indebtedness through the use of over-the-counter derivatives like total return swaps (“TRS”), credit default swaps (“CDS”), and options (including puts and calls), or through bank-issued or SPV-issued credit-linked notes (“Self-Linked CLN”). Some of the benefits these borrowers may realize include obtaining very favorable rates of return on investment, reducing funding costs and leverage, and improving liquidity for their indebtedness and the CDS written on them in the marketplace.

Borrowers can pursue a number of these goals through open market debt repurchase transactions or public debt tender offers (collectively, “Cash Debt
Repurchases”), however, self-referencing synthetic transactions may provide borrowers with additional options, enhancing their flexibility and, in some cases, reducing transaction or implementation costs. Synthetic transactions may also be blended together with Cash Debt Repurchases, creating hybrid programs to better suit a borrower’s needs.

These types of synthetic transactions give rise to a combination of legal and regulatory issues involving, among other things, disclosure, preferential treatment of creditors, market abuse, stock exchange rules and tender offer requirements. These legal and regulatory issues can be expected to be highly specific to the particular structure employed for a given synthetic transaction and will vary depending on the jurisdiction or jurisdictions that are applicable to that transaction. In order for an arranger or borrower to ascertain the best approach in any particular case, it is necessary that the structure of these synthetic transactions and the legal issues attendant to them be well understood and be given careful consideration.

Accordingly, in the following discussion we provide basic descriptions of several types of self-referencing synthetic transactions and a brief discussion of some of the significant legal issues that may arise in such transactions when US or UK law applies.

Overview of Certain Self-Referencing Synthetic Transaction Structures

This section provides basic descriptions of several types of self-referencing synthetic transactions currently being pursued in the market.

Synthetic Debt Repurchase via a TRS

- A synthetic debt repurchase through a TRS seeks to replicate the economics of a Cash Debt Repurchase, as if the relevant debt securities are retired, by providing the borrower with synthetic exposure to its debt. Accordingly, even though the borrower’s debt remains outstanding, under the TRS, the borrower may have the right to receive payments from its counterparty that match and offset the payments it makes on its outstanding debt, less a financing fee paid to the counterparty (who may acquire the borrower’s debt in the open market in order to hedge its position under the TRS).

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1 See Open-Market Repurchases - Market Abuse Issues and Announcement Obligations, Linklaters, LLP (March 2008); see also Debt Repurchases and Amendments: U.S. Securities Law Considerations, Linklaters, LLP (October 2008).
An example of a synthetic debt repurchase through a TRS might be as follows: The borrower may enter into a TRS (as total return receiver) with an arranger (“Bank”) (as total return payer) with the borrower’s outstanding debt securities as the underlying reference assets. The TRS may be fully or partially funded. The Bank will pay to the borrower the interest payments and any amortization or other principal repayments made on the debt securities. If the TRS has a shorter life than the debt securities so that the debt securities have not been fully repaid by the termination date of the TRS, the TRS may provide that the Bank pay the borrower any increase in the value of the borrower’s debt securities, and that the borrower pay to the Bank any decline in the value of the borrower’s debt securities. The TRS may provide that the borrower provide the Bank with collateral (with which the Bank may hedge its position by purchasing the borrower’s debt securities in the market) and/or pay a financing fee (which might be used to offset the Bank’s funding costs with respect to hedging its position). In the end, the borrower would like to be in a position that is economically very similar to that which it would be in if it had carried out a Cash Debt Repurchase.

Synthetic Convertible Bond Exposure Transactions

Where the borrower has outstanding convertible bonds and wishes to retire them, two synthetic transactions that may be beneficial are as follows:

- **Synthetic Convertible Bond Repurchase and Conversion**
  - In this structure, the borrower achieves the economic equivalent of converting its convertible bonds to shares even though its shares are trading below the threshold required for conversion under the terms of its convertible bonds.
  - For example, assume the borrower has convertible bonds outstanding which are out of the money (e.g. the conversion price is $20, while the shares currently trade at $15). The Bank locates convertible bond holders in the market who wish to sell their holdings and investors who wish to purchase shares in the borrower. The Bank agrees to sell to the borrower the borrower’s convertible bonds at par (e.g. at $20), with the borrower paying the purchase price partially in cash (i.e. a $5 “top-up” reflecting the out-of-the-money amount on the convertible bonds) and partially “in kind” (by issuing the number of shares to the arranger that a conversion of the convertible bonds would have required). The Bank sells the borrower’s shares for $15 to the investors who wished to purchase such shares. Once it has received the convertible bonds from the Bank, the borrower extinguishes the convertible bonds, putting itself in the same economic position as if the convertible bonds had actually been converted. Financing the “top-up” payment was much easier than it would have been.
to finance the full purchase price if paid in cash. Note that in certain circumstances, shares issued by borrowers to arrangers will be deemed “restricted securities” under Rule 144 and may only be sold pursuant to a US registration statement or an exemption from registration under the US Securities Act of 1933.

- **Synthetic Convertible Bond Conversion**
  - Synthetic conversion of convertible bonds may also be achieved through the use of paired options.
  - For example, assume the borrower has outstanding convertible bonds which are out-of-the-money, with a conversion price of $20 and a market price for the shares of $10. The borrower enters into paired option contracts with the Bank to create a “call spread” position with respect to the borrower’s own shares. The “call spread” position is created by the borrower selling a call option for its own shares to the Bank with a strike price of $15 ("Sold Option") and buying a call option for its own shares from the Bank with a strike price of $20 ("Bought Option"). The premium that the Bank must pay for the Sold Option is much higher than the Bought Option premium which the borrower must pay, and the positive difference may be used to reduce the funding costs of the borrower’s outstanding convertible bonds.
  
  - If the share price rises above $15, the Bank may exercise the Sold Option, requiring the borrower to sell its shares at $15. Exercising the Sold Option at any point above $15 and up to $20 is economically equivalent to a partial conversion of the borrower’s outstanding convertible bonds. This is because the shares have been issued and the cash proceeds from the sale thereof can be earmarked to repay the corresponding portion of the borrower’s outstanding convertible bonds at their maturity. If the share price rises further to $20, the convertible bond may actually convert. In that case, the borrower may exercise the Bought Call to receive its shares back from the Bank to deliver to converting bondholders.

**Self-Referencing CDS (Borrower as Credit Protection Seller and Reference Entity) and Self-Linked CLN (Borrower as Purchaser of Credit-Linked Note Linked to Borrower’s Credit)**

Both structures described below can provide a borrower with a very favorable rate of return on its investment in the synthetic transaction or favorably reduce the borrower’s net interest payments on its outstanding indebtedness.
- **Self-Referencing CDS**
  - In this structure, the borrower (as credit protection seller) sells protection on itself, or on certain of its outstanding debt obligations to the Bank (as credit protection buyer), in exchange for the periodic payment of premium during the term of the CDS. The borrower will likely be required to post collateral to secure its obligations under the CDS. The Bank will likely hedge its exposure under the CDS by purchasing the borrower’s bonds in the market or selling credit protection on the borrower to other counterparties under back-to-back CDS².
  - If the borrower does not experience a credit event and the CDS is not otherwise subject to early termination prior to its scheduled termination date, the premium payments will nicely compensate the borrower for undertaking the obligations under the CDS during its term without having to make any payments to the Bank under the CDS (aside from any collateralization obligation). The premium payments received by the borrower under the CDS can subsidize the coupon payable by the borrower on the borrower’s outstanding indebtedness.
  - However, if a credit event occurs during the term of the CDS, aside from the borrower’s obligations under its indebtedness and the CDS (which are roughly duplicative), the Bank would be required to make a credit protection payment under its back-to-back CDS with its third party counterparties. In such case, the Bank will be in a position to apply the collateral amount posted to it by the borrower to satisfy any obligations under the back-to-back CDS.

- **Self-Linked CLN**
  - In this structure, the borrower purchases a credit-linked note ("CLN") issued by the Bank or a special purpose vehicle the repayment of which is linked to the borrower’s credit. Like the example of the self-referencing CDS, the Bank will likely hedge its exposure under the CLN by purchasing the borrower’s bonds in the market or selling credit protection on the borrower to other counterparties under CDS. The coupon on the CLN can subsidize the coupon payable by the borrower on the borrower’s outstanding indebtedness.
  - As long as no credit event occurs in respect of the borrower during the term of the CLN, the principal amount of the CLN would be due in full at maturity. If the borrower’s outstanding indebtedness was co-terminus with the CLN, the payment by the borrower of the indebtedness would be matched approximately by the amount received from repayment on the

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² Cash settlement is much more likely when the CDS and the related bonds are not co-terminus
CLN. If a credit event occurs in respect of the borrower during the term of the CLN, the principal repayment on the CLN will be reduced in an amount that corresponds with the decline in value of the borrower’s bonds that the Bank purchased as a hedge or the amount needed to satisfy its obligations under the CDS.

Legal Issues

A number of legal, accounting and regulatory issues may be implicated in these self-referencing synthetic transactions. This section provides a brief discussion of some of the significant legal issues that can arise in such transactions when US or UK law applies, and some other general legal considerations. Parties seeking to engage in these transactions should consult with their advisors to determine whether any other matters merit consideration.

Legal Issues in the US

– US Tender Offer Considerations

  – Transaction participants need to be mindful of the tender offer rules under the US Securities Exchange Act of 1934 (the “Exchange Act”). The activities of the borrower and the Bank in any self-referencing synthetic transaction should be carefully evaluated to ensure that any actual repurchases of the borrower’s securities do not constitute a “tender offer” subject to US tender offer rules.

  – For example, if the Bank intends to hedge its position by purchasing the borrower’s securities in the market, the Bank should take measures to ensure that the repurchases are conducted on a limited and individually negotiated basis. Offers extended to multiple parties in the US, with fixed prices and deadlines may be recharacterized as a tender offer. Compliance with the US tender offer provisions of Section 14 and Regulation 14E of the Exchange Act generally require, among other things, that the offer remain open for at least 20 business days.

  – The term “tender offer” is not defined in the Exchange Act or any of the rules adopted by the US Securities and Exchange Commission (the “SEC”), but the SEC has developed a list of eight factors for determining whether an open market purchase program or series of negotiated purchases extended to US holders by the use of US jurisdictional means (e.g., the US mail, wire services, the Internet, etc.) is a tender offer subject
to Section 14 of the Exchange Act. These factors must be considered in relation to the specific facts and circumstances of the particular transaction to determine whether the Bank’s purchases of the borrower’s debt in connection with these synthetic transactions constitutes a tender offer.

- If the purchases of the borrower’s debt obligations in the synthetic transactions described above are deemed to constitute a tender offer and the applicable tender offer rules have not been complied with, such purchases may give rise to suits or challenges from investors who have not been able to sell their securities in such open market repurchases, particularly after the price of the borrower’s debt securities has fallen. Conversely, holders who have sold their securities in repurchases at depressed levels, may have a claim for damages if the trading price of the securities later increases and such earlier repurchases were deemed to have constituted an illegal tender offer.

- To minimize the risk that the US tender offer rules will be deemed to apply to debt purchases in connection with these types of synthetic transactions, such purchases should be conducted through a broker-dealer/arranger-manager with liability management capability and knowledge of the ownership profile of the relevant borrower’s outstanding debt.

- **Antifraud provisions under Section 10(b) and Rule 10b-5**

  - Section 10(b) of the Exchange Act and Rule 10b-5 thereunder prohibit material misstatements and omissions in connection with any purchase or sale of a security. These obligations apply whether or not repurchases are effected via a tender offer. These rules also apply to securities based swap transactions like the synthetic transactions described in this memorandum. Information is deemed material for the purposes of Section 10(b) and Rule 10b-5 liability if there is a substantial likelihood that a reasonable investor would have viewed its disclosure as significantly

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3 The following eight factors are generally used to determine if a tender offer exists: (i) whether there is an active and widespread solicitation of public security holders; (ii) whether the solicitation is made for a substantial percentage of the target’s outstanding securities; (iii) whether the offer is made at a premium over the prevailing market price; (iv) whether the terms of the offer are firm rather than negotiable; (v) whether the offer is contingent upon the tender of a fixed minimum number of securities and/or is subject to a ceiling of a fixed maximum number of securities to be repurchased; (vi) whether the offer is open for only a limited time; (vii) whether the offerees are subjected to pressure to sell; and (viii) whether public announcements of a purchase program precede or accompany a rapid accumulation of large amounts of the securities. See *Wellman v Dickinson*, 475 F. Supp. 783 (S.D.N.Y. 1979), *aff'd*, 682 F.2d 355 (2d Cir. 1982), *cert. denied*, 460 U.S. 1069 (1983).
altering the “total mix” of available information, and would consider it important in deciding whether to purchase or sell the securities.

- The facts and circumstances relating to a proposed transaction should be examined against the general standards of Section 10(b) and Rule 10b-5 to determine what, if any, disclosure should be made. For example, a potential issue may arise as to whether the Bank’s purchase of the borrower’s debt to establish its hedge position in respect of these synthetic transactions, in itself, amounts to material information which requires disclosure. Pre-transaction disclosure by both the borrower and the Bank should be evaluated on a case-by-case basis.

- **Other US securities considerations involving convertible debt**
  Synthetic transactions involving convertible bonds may give rise to additional considerations.

- **Beneficial ownership issues**
  Sections 13(d) and 13(g) of the Exchange Act require direct or indirect beneficial owners of more than 5 percent of any class of voting equity securities registered under Section 12 of the Exchange Act to file reports with the SEC disclosing such beneficial ownership. A synthetic transaction contemplating settlement via physical delivery of convertible bonds could implicate Section 13 as could a synthetic transaction intentionally structured to replicate beneficial ownership of convertible bonds in a manner intended to circumvent the corresponding disclosure obligations.\(^4\)

- **Possible application of the Regulation 14D tender offer rules**
  Transactions involving the purchase of convertible debt could also trigger the tender offer rules as discussed above, which could trigger significant disclosure and procedural requirements in the US, if applicable.

- **Form 8-K Disclosure Requirements**
  Borrowers that are SEC registrants will need to consider pre-transaction and post-transaction disclosure obligations. For example, if a synthetic transaction is deemed material to the borrower, or other events triggering a filing requirement occur (e.g. borrower’s issuance of unregistered shares or other securities), a Form 8-K report may need to be filed with the SEC.

\(^4\) See CSX Corporation v. The Children’s Investment Fund Management (UK) LLP, et al., (08 Civ. 2764 (LAK) (SDNY June 11, 2008) (holding cash settled total return swaps structured to avoid beneficial ownership disclosure obligations violated Section 13(d) of the Exchange Act). CSX should not, however, be read to stand for the proposition that all TRS result in beneficial ownership requiring disclosure, but rather stands for the proposition that intentionally structuring transactions to circumvent the disclosure obligations accompanying beneficial ownership is problematic.
Legal Issues in the UK

– **Insider Dealing and Market Abuse**

  – If either party is in possession of price-sensitive information, any transaction should be postponed until after such information has been announced. Otherwise the parties risk breaching the market abuse and insider dealing rules.

  – Section 118(2) of FSMA prohibits dealing in qualifying investments by an insider, on the basis of inside information possessed by him relating to those investments. In these synthetic transactions, the Bank may purchase the borrower’s securities in the market, for example, to hedge its exposure. A potential issue arises as to whether such transactions, in themselves, amount to inside information in relation to the outstanding securities. However, the fact that the borrower or the Bank has knowledge of its own intention should not prevent it from carrying out that intention, by virtue of the safe harbor for persons acting on knowledge of their own intentions, as set out in the Section 1.3.6 of the Code of Market Conduct (“MAR 1”) and Recital 30 of the Market Abuse Directive (“MAD”).

  – Also, when the Bank carries out purchases of the borrower’s securities, it will not be considered to be dealing on the basis of inside information and is exempt from the requirement to make an announcement regarding its purchase of the securities, as MAR 1.3.7 and Recital 18 of MAD provide a safe harbor for market makers pursuing their legitimate business of dealing in financial instruments. MAR 1.3.10 states that the extent to which the Bank’s trading is carried out in order to hedge a risk is a factor to be taken into account in determining whether or not the Bank’s behavior is in pursuit of legitimate business, and is an indication that it is.

– **Insolvency law**

A key concern for Banks which act as counterparties to self-referencing credit derivatives is whether they may be attacked by a liquidator of the borrower. This would be the case, broadly, if the transaction could be characterized as a preference or “transaction at an undervalue,” or otherwise as vulnerable under insolvency law, for example as a breach of the pari passu distribution principle. While, if properly structured, the transactions should be enforceable under the current law, a degree of caution is required. Transactions of this nature are likely to be closely scrutinized on a liquidation or administration and there is a high degree of litigation risk. Furthermore, since a credit event can result in the borrower (protection seller) suffering a considerable loss, there is a risk that a self-referencing credit derivative could accelerate the borrower’s descent into bankruptcy. For a Bank involved in such a transaction, there is therefore a significant reputational risk, even if the enforceability of the transaction is upheld.

Synthetic Debt Repurchase Transactions & Other Transactions Utilizing Self-Referencing Exposure.
A preference under section 239 of the Insolvency Act 1986 is given if a company (e.g. the borrower) does something, or allows something to be done, that puts one of its creditors in a better position than it otherwise would be in, in the event of the company’s insolvency liquidation. Preferences given to persons that are not connected to the company are liable to be set aside if they were entered into in a period of 6 months prior to insolvency and the company was unable to pay its debts at the time or as a result of the preference (although only if the company was influenced by a desire to put the creditor in such a better position). If the company is the seller under a credit derivative and the buyer is one of its creditors at the time of the transaction (for example, as a holder of its debt securities), this test could be satisfied in certain circumstances. In practice, however, it is unlikely to be satisfied because the company is unlikely to have had the necessary desire (i.e. that it was acting with a desire to put the relevant creditor in a better position) where it is motivated to engage in such transactions by the desire to generate an investment return on the perceived undervalue of its own credit risk.

If a self-referencing credit derivative is a “transaction at an undervalue,” and was entered into in the two years prior to insolvency, and at a time when the company was unable to pay its debts (or became unable to pay them as a result of the transaction), it is liable to be set aside under section 238 of the Insolvency Act 1986. A transaction falls within this provision if the consideration received by the company is significantly less than the consideration provided by it, unless it acted in good faith and for business purposes and there were reasonable grounds to believe that the transaction would benefit the company. A self-referencing credit derivative is potentially open to attack on this basis, although in practice a company is unlikely to enter into such a transaction unless there are reasonable grounds for believing that it would benefit the company.

Of more concern is the common law principle that requires a company’s assets to be distributed on a pari passu basis in the event of it winding up or (if the administrator decides to make a distribution) administration. Under this principle, an agreement under which a company becomes obliged to make a payment, or transfer assets, to another person in the event of the company’s insolvency is void. Transactions must therefore avoid such obligations, although, on the current state of the law, a transaction under which the company’s entitlement is to receive a payment or delivery from a counterparty, provided that it is solvent, would be enforceable. As noted above, there is a significant degree of litigation risk because, although the distinction between obligations that arise on insolvency and rights that are conditional on continued solvency is an established one, the possibility of a change of law by the higher courts cannot be ruled out.
Options entered into by a company over its own shares

Various company law restrictions prevent an English company from entering into transactions over its own shares unless certain conditions are satisfied. While a company will normally be able to sell a call option over its own shares, with a view to issuing new shares if the option is exercised, it will need to have the necessary corporate authorities in place to effect such an issue if necessary. The purchase of a call option over its own shares is more problematic as English companies are not permitted to acquire their own shares except in prescribed circumstances. These are unlikely to apply where the acquisition takes place under a derivative transaction. Cash settled transactions are not subject to the same restrictions but they may contravene company law requirements relating to the maintenance of capital, at least where their effect is to protect a shareholder, directly or indirectly, from the risk of a fall in the value of the company’s shares.

Other General Legal Considerations

Self-Regulatory Organization or Exchange Compliance Issues

If the borrower is subject to the rules of a Self-Regulatory Organization or is listed on a stock exchange, it may be subject to additional rules and regulations in respect of its ability to effect, or in the case of the Bank facilitate, debt repurchases or to engage in self-referencing synthetic transactions. For example, in the UK, a borrower which has a primary listing of preference shares or “equity securities” in London and wishes to enter into a bond repurchase arrangement is restricted from purchasing or redeeming its own securities during a prohibited period. A prohibited period is defined as any close period, or any period when there exists any matter which constitutes inside information in relation to the company. In the US, another example might be a borrower listing its shares on the New York Stock Exchange being required to comply with any rules and restrictions on transacting in its shares imposed by the New York Stock Exchange.

Covenants in Credit Facilities/Trust Deeds/Indentures which Restrict Repurchases

Equity securities are defined as equity shares and securities convertible into equity shares.

Financial Services Authority’s Listing Rules 12.2.

Close period is defined in the Financial Services Authority’s Listing Rules as the shorter of (1) the period from the relevant financial period end to and including the time of the preliminary announcement of the Company’s results and (2) the period of 60 days preceding the preliminary announcement of the Company’s yearly or half-yearly results, or 30 days preceding the announcement of its quarterly results.

Please refer to further discussion in Part 3.2.1 above with respect to the borrower’s obligations in relation to inside information under UK law.
A borrower should evaluate its outstanding credit facility documentation to determine whether debt repurchases are prohibited or subject to limitations or restrictions, and whether such provisions would be violated by synthetic debt repurchases.

- **Restrictions in the Borrower’s Charter**

  A borrower should review its constitutive and governing documents as well as any applicable internal corporate governance and related policies to verify whether and when it is permitted to repurchase its debt, and whether any restrictions or limitations apply.

- **Local Law Issues**

  Local law considerations arise in respect of these types of synthetic transactions, including the laws of the jurisdictions in which the borrower, the arranger or in the case of a CLN, the special purpose vehicle, is organized, or any other jurisdictions where any of the foregoing are otherwise subject to regulation by virtue of their respective activities. Local law legal and regulatory issues can be expected to be highly specific to the particular structure used. Recurring themes tend to include local stock exchange disclosure; insider dealing and market manipulation rules; and, in common law jurisdictions at least, issues relating to financial assistance for equity-related synthetic buy-backs, and insolvency preference concerns for self-referencing credit structures. Many jurisdictions also have rules which restrict the holding of securities in inventory by their issuers and which regulate the way in which derivative instruments can be used.

**Practical steps to protect against legal risk**

Where self-referencing credit derivatives are involved, Banks should take care to manage the potential reputational risk involved in such transactions. For example, it may be unwise for an arranger to act as the counterparty for a borrower whose solvency is in question or where a borrower has entered into a disproportionately large number, relative to the value of its net assets or shareholders’ equity, of self-referencing credit derivatives. Standard practice includes both due diligence and the receipt of various representations and warranties from the borrower, and, sometimes, its directors and accountants. Counterparties will also generally wish to verify that the relevant borrower is accounting properly for the transactions it enters into, as improper accounting by the borrower could involve reputational risk for the counterparty. The counterparty may, for example, require the existence of the transaction to be publicly disclosed or to receive assurances that it has been properly disclosed to the company’s accountants or otherwise. To address the potential insider dealing issues, counterparties normally seek representations and warranties from borrowers to the effect that no price sensitive information is held and that
the borrower is complying with all applicable laws on insider dealing and disclosure.

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