# MEMORANDUM ON THE IMPACT OF THE UNITED STATES SECURITIES LAWS ON THE RESTRUCTURING OF NON-U.S. DEBT

The Honorable Allan L. Gropper
United States Bankruptcy Court for the Southern District of New York

May 2003

*The views expressed in this memorandum are the personal views of the author and do not reflect the position of the Court.*

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In recent years, companies located outside of the United States have issued large amounts of public debt, often in the form of bonds. These securities are usually issued under exemptions from the U.S. securities laws which are generally believed not to impose unreasonable restrictions on the ability of foreign issuers to raise capital. On the other hand, if it becomes necessary to restructure the same debt, the restrictions of the U.S. securities laws often impose burdens that may, in some cases, make a restructuring impossible. The U.S. securities laws may also make it impossible to restructure non-U.S. debt even in a foreign insolvency proceeding, forcing debtors to consider a filing in the United States that would otherwise be unnecessary.

This memorandum will analyze the impact of the U.S. securities laws on offshore restructurings where there are holders of debt in the United States and propose certain amendments that would facilitate such restructurings. It will also analyze a provision of the Trust Indenture Act that impedes the use of "collective action clauses" even where the market may desire to include such a clause in the bond Indenture.

## 1. The Effect of the U.S. Securities Laws on Offshore Restructurings.

Debt issued by non-U.S. entities that is not registered under the U.S. securities laws is usually issued under one or more of the following exemptions from registration: (i) in an offshore transaction in accordance with Rule 903 of Regulation S under the Securities Act of 1933, as amended (the "Securities Act"); (ii) if issued to "accredited investors," as a private placement under Regulation D under the Securities Act, 17 C.F.R. § 501 et seq. or (iii) in the form of debt issued abroad in an offering to "qualified institutional buyers" ("QIBs") under Rule 144A under the Securities Act, 17 C.F.R. § 144A. In a transaction under Rule 144A, much foreign debt may in fact be quickly resold to U.S. QIBs, who are believed to have the expertise to protect themselves without the need for registration of the securities.

Whatever the method of initial issuance, over time the debt may change hands. Under Rule 144 of the Securities Act, restricted securities may be resold freely after a two-year holding period. Some offshore debt may ultimately "come to rest" in the hands of U.S. purchasers who are not QIBs or would not meet the definition of accredited investor in a private placement. Most public debt issued by non-U.S. entities is also held either in nominee names or in unregistered form, and the issuer does not know the identity of most of the holders.

Assuming that a restructuring of the debt becomes essential, an issuer will often seek to exchange the original debt for a substitute instrument with a smaller principal amount, longer tenor, or different terms. The substitute instrument may be offered by an affiliate or successor to the original issuer. In such a situation, the foreign issuer will confront problems under the U.S. securities laws that did not exist when the debt was originally issued and that impede and may in some cases preclude the restructuring. The problems lies in the narrowness of the following exemptions:

**(i) Exchange Offers**

The U.S. securities laws have an exemption that is obviously designed to facilitate restructurings,

§ 3(a)(9) of the Securities Act, 15 U.S.C. § 77c(9), that exempts "any security exchanged by the issuer with its existing security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange." This exemption is only available, however, when the initial issuer and the issuer of the new securities are the same entity, and it therefore would not apply where the new security is issued by an affiliate of or successor to the original issuer (for example, after some foreign insolvency cases). More important is the requirement that no commission or other remuneration be paid "for soliciting such exchange," which most significantly defines the limits of a § 3(a)(9) exchange offer, and often precludes its use.

The "no payment for solicitation" restriction does not preclude solicitation itself, but instead prohibits payment or compensation for soliciting activities. The contact permitted by § 3(a)(9) with security holders and investment bankers or financial advisors, though, is unclear. Officers, directors or other employees, may engage in solicitation activities provided they are not specially compensated therefor. Similarly, information agents are permitted to perform certain ministerial tasks (notifying security holders of details of an exchange offer, confirming mailing addresses of security holders, communicating with the security holders by telephone to ascertain whether the holders understand the proposed exchange offer). *See* PaineWebber Retail Property Investments, Inc., SEC No-Action Letter (July 9, 1993). *But see* Stokeley-Van Camp, Inc., SEC No-Action Letter (March 31, 1983) (financial advisor may not convey management's opinion or recommendation concerning the exchange transaction). Issuance of a fairness opinion concerning the transaction and telephoning security holders to inquire whether they have received the materials or have questions is impermissible.[1] Meeting with the security holders may be permissible in some situations.[2] In Calton Incorporated,[3] financial advisors had even more extensive contact with bondholders, but did not make substantive comments of their own relating to the exchange, instead leaving that solely to the company.[4] There the issuer's counsel stressed the difference between "effecting" an exchange and "promoting" an exchange, and the solicitation was found not to be barred by § 3(a)(9).

While there may be some general guideposts to § 3(a)(9), the application of the section has been unpredictable, and it has been difficult to demarcate the line between "effecting" and "promoting" an exchange. At a minimum, the SEC's application of § 3(a)(9) has created uncertainty in the marketplace and, as one commentator has stated, is part of a larger problem of the poor promulgation of the resale rules, which has increased complexity and costs to society.[5] As a result, the market has

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[1] *See* Dean Witter & Co., Inc., SEC No-Action Letter (November 21, 1974).

[2] See Seaman Furniture Company, Inc., SEC No-Action Letter (September 29, 1989) (No-action position issued where an investment advisor and the company met with institutional holders to advise such holders that the company was formulating a proposal to restructure the debt. The no-action letter request stated that the investment advisor did not "make a recommendation to the banks or the legal or financial advisors to the Committee with respect to the restructuring or the Exchange Offer."). See also International Controls Corp, SEC No-Action Letter (August 6, 1990), where an issuer sought and received a no-action letter in which its paid financial advisor proposed to meet with the financial and legal advisors to a bondholders committee after commencement of exchange offers, "not to make a recommendation to security holders, but merely to facilitate an understanding by the legal and financial advisors to the Committee ...".

[3] SEC No-Action Letter (September 30, 1991).

[4] The advisor did participate in meetings between the issuer and a number of institutional bondholders and conversed by telephone with other holders.

[5] *See* Rutherford B. Campbell, Jr., *Resales of Securities Under the Securities Act of 1933*,

been unwilling to rely on the § 3(a)(9) exemption, even though it seems to be best suited for use in connection with a workout.[6] As one commentator has noted, where § 3(a)(9) can be used, it offers a quick and relatively inexpensive method for effecting exchange offers.[7] But, in practice, the limited usefulness of the 1933 Act's exemptions means that for a financially distressed company with publicly held securities outstanding, the choices may be a registered exchange or a Chapter 11 reorganization, both of which may be less efficient and cost-effective than a workout.[8] The SEC should issue clearer, simpler guidance than the Seaman, International Controls and Calton no-action letters, broadening the range of what a paid financial advisor can do in restructuring foreign debt without jeopardizing the § 3(a)(9) exemption, perhaps prohibiting only a fee for each bond tendered and not an overall advisory fee for work that may involve meetings with investors to work out an acceptable restructuring plan.

**(ii) Offshore Transaction**

As noted above, many securities are initially issued outside of the United States under the Regulation S exemption for offshore transactions. In restructurings of public debt, it will rarely, if ever,

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52 WASH. & LEE L. REV. 1333, 1350 (1995).

[6] Beyond the notion of uncertain application, § 3(a)(9) is also over-inclusive. This is illustrated in the compensation of financial advisors and investment banking firms for services in an exchange offer, which is generally prohibited from being contingent on the success or failure of the offer. Perhaps this arrangement makes sense where advisors actually contact the security holders (and where the temptation to solicit may be greater if there would be some financial reward), but where the advisor or investment banker does not contact the holder there can be no attempt to solicit the holder and no reason to limit the fee arrangement. See Bryant Edwards, *Restructuring European High Yield Bonds,* 1347 PLI/CORP 753, 780 (2002).

[7] *See* Richard E. Mendales, *We Can Work It Out: The Interaction of Bankruptcy and Securities Regulation in the Workout Context*, 46 RUTGERS L. REV. 1211, 1271 (1994).

[8] *Id.*

be available since some of the holders of the debt to be exchanged are almost certain to be located in the United States.

**(iii) Rule 144A and Private Placements**

Because of concern as to the availability of the exemptions under § 3(a)(9) and Regulation S, most offshore exchanges are designed to comply with the Rule 144A and/or Regulation D governing private placements. Under these sections, however, the offer can only be made to QIBs (under Rule 144A) or accredited investors (under Regulation D), and small individual holders of debt located in the United States cannot be solicited. Since the issuer will not be able to identify holders of the debt, it will have to restrict the availability of the offer and will not be able to solicit all holders. This by definition makes the offer less effective than if it were available to all holders. Moreover, the ironic and unfortunate result of reliance on Rule 144A or Regulation D is to preclude small U.S. holders from being able to participate in the offer, as a result of which they may be offered nothing in the exchange but be unable to pursue their remedies effectively under the original instruments.

**A proposed clarification of § 3(a)(9).**

As noted above, the most simple solution to the problem outlined above would be to amend § 3(a)(9), or the rules thereunder, to clarify the conditions under which foreign out-of-court workouts could take advantage of the exemption. This might require nothing more than a clarification of the Rule's requirement that there be no commission paid for a "solicitation" in connection with the exchange. The original purpose of this limitation is unclear. One commentator views it as a Congressional effort in the 1930's to limit the role of advisors.[9] But this attempt at compromise does not appear to serve a material purpose under present conditions or to represent a sensible method for determining which exchanges to exempt from the securities laws. It would also be useful to permit entities other than the initial issuer to issue the debt in the exchange, so long as the new issuer was a successor to the original issuer or carried on its business in substantial part.

**Section 3(a)(10)**

It would also be useful to consider new rules under § 3(a)(10) of the Securities Act. This section exempts "any security which is issued in exchange for one or more bona fide outstanding securities, claims or property interests, or partly in such exchange and partly for cash, when the terms and conditions of such issuance and exchange are approved, after a hearing upon the fairness of such terms and conditions at which all persons to whom it is proposed to issue securities in such exchange shall have the right to appear, by any court ... or other governmental authority expressly authorized by law to grant such approval..."[10] Section 3(a)(10) represents a legislative determination that the protection to the investor inherent in the registration process can be replaced by a fairness determination

[9] *See* Rutherford B. Campbell, Jr., *Resales of Securities Under the Securities Act of 1933*, 52 WASH. & LEE L. REV. 1333, 1358 (1995), citing Louis Loss, Securities Regulation 573 (2d ed. 1961) (noting that the § 3(a)(9) exemption may represent nothing more than "horse-trade compromise.").

[10] Section 3(a)(10), like § 3(a)(9), also does not apply to securities issued under Title 11, the Bankruptcy Code. The Bankruptcy Code has its own, much broader exemption for securities issued in connection with a Chapter 11 proceeding, and an exemption under the securities laws is not needed. 11 U.S.C. § 1145.

by a “body in question,” often a court.[11] It is theoretically available in connection with securities issued in a foreign bankruptcy case, where the foreign court can hold a “fairness” hearing.

But § 3(a)(10) has been used sparingly because of the uncertainty regarding standards for the fairness inquiry and the availability of other exemptions.[12] Furthermore, the Securities and Exchange Commission (“SEC”) has construed it strictly, and no-action letters have restricted its availability in foreign insolvency cases and proceedings under the Canadian Companies’ Creditors’ Arrangement Act. Notwithstanding the fact that other foreign proceedings have been accorded recognition in the United States under § 304 of the Bankruptcy Code, they have not generally been deemed to provide sufficient notice and an adequate fairness hearing to make reliance on the 3(a)(10) exemption reasonably available even where there is a formal court proceeding abroad.

Although the main thrust of this memorandum is to find ways to facilitate out-of-court

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[11] *See* SEC Release No. 312, 1 FED. SEC. L. REP. ¶. 2183.

[12] *See* Richard E. Mendales, *We Can Work It Out: The Interaction of Bankruptcy and Securities Regulation in the Workout Context*, 46 RUTGERS L. REV. 1211, 1270 (1994). Beyond the problems associated with the unclear “fairness inquiry” lurk equally imposing obstacles. A proponent of a workout plan pursuant to § 3(a)(10) essentially attempts a task similar to confirming a bankruptcy reorganization plan, but does not get procedural advantages a debtor receives under the Bankruptcy Code. A § 3(a)(10) forum may lack jurisdiction over property of the debtor or be unable to confirm an effective plan. *Id.* at 1271-72.

restructurings, if a non-U.S. debtor should file a reorganization proceeding in a foreign court, it should be possible for the foreign proceeding to meet the standards of § 3(a)(10) even if the "fairness hearing" is not identical to the hearing required for confirmation of a plan under the Bankruptcy Code. As § 304 recognizes, the United States readily grants recognition to foreign insolvency proceedings that meet the criteria in that section. If a foreign case satisfies the § 304 criteria, it should be able to meet the requirements under § 3(a)(10). Otherwise, a non-U.S. debtor may be compelled to file a proceeding in the United States in order to avail itself of the securities law exemption in § 1145 of the Bankruptcy Code. Such a proceeding might be expensive and burdensome to the creditors, the debtor and the U.S. court system. It should not be encouraged by virtue of an unnecessarily narrow construction of the § 3(a)(10) exemption.

**2. Collective Action Clauses**

Much attention has been given in recent years to the impact on consensual restructurings of holders of a relatively small amount of debt who refuse to accept a workout that is acceptable to the overwhelming majority of the holders. When a "holdout" refuses to accept a restructuring proposal, the issuer may decide to file under a bankruptcy law that permits a super-majority of creditors in a given class to agree to a proposal and bind the minority. A similar problem arises even where there is no dissident minority; it may be impossible to locate all of the holders to determine even whether they will participate in the restructuring. The pre-packaged plan provisions of § 1126 of the U.S. Bankruptcy Code are frequently utilized for the specific purpose of binding minority bondholders without a full-scale, lengthy bankruptcy case and the consequent disruption of the enterprise. In recent years attention has been given to instituting such "expedited proceedings" in the international area. See Proposed New Expedited International Reorganization Procedures at the website of the International Insolvency Institute, www.iiiglobal.org.

In sovereign debt restructurings, where a bankruptcy filing is not possible, collective action clauses have been considered a possible substitute for prepackaged or full bankruptcy filings. A collective action clause is a provision in a bond indenture that provides that a super-majority of holders may agree to waive certain provisions of the indenture, including agreeing to a restructuring that would require the forgiveness of principal or interest. For example, in an address on April 2, 2002, U.S. Undersecretary of the Treasury John B. Taylor advocated the use of collective action clauses in debt issued under U.S. law, noting that such clauses had long been used in debt issued under English law. See address to Institute for International Economics, at www.treas.gov/press/releases/po2056.htm. In response to proposals made by the International Monetary Fund to establish a sovereign debt restructuring mechanism, the financial institutions that are members of the International Institute of Finance advocated the use of collective action clauses as one reason why such a sovereign debt restructuring mechanism is unnecessary. These institutions stated that collective action clauses "would facilitate effective restructurings where unavoidable while protecting essential creditors' rights." See IIF Press Release, Dec. 6, 2002, at www.iif.com/press/pressrelease.quagga?id=55.

As Mr. Taylor recognized, broad collective action clauses have been utilized for many years in English-law indentures. They permit the Indenture Trustee, acting on its own or more commonly at the instructions of the requisite bondholders, to agree to a reduction of principal or a waiver of interest on the bonds, as well as to agree to the waiver of covenants and other requirements of the Indenture. By contrast, in indentures issued under U.S. law (most commonly, New York law), collective action is restricted. It is routine for collective action to be required for the waiver of certain covenants and perhaps certain defaults, and it is routine to require collective action when bondholders wish to call a meeting (usually only a small percentage is required) or to accelerate (usually less than a majority). But U.S.-law indentures rarely permit the action of a super-majority of holders to waive interest or to reduce principal, both of which may be required in order to effect a successful restructuring out of court.

There are many reasons for the differences in English and American practice—history, the legal environment, the willingness of Indenture Trustees to act without bondholder instructions. But one important reason for the U.S. position is § 316(b) of the Trust Indenture Act of 1939, 15 U.S.C. § 77ppp(b), which prohibits the impairment of each holder's right to principal and interest in connection with an indenture that must be qualified under that Act. This was a provision that was adopted in the wake of the depression and the perception that the interests of small bondholders had been seriously abused by committees controlled by the issuer or by large holders with conflicts of interest.[13] Also of concern was the poor quality of information that flowed to investors and binding all bondholders to a recapitalization that had not received adequate disclosure.[14] Although § 316(b) does not apply to most issues of debt by non-U.S. enterprises, which do not usually require an indenture qualified under the Trust Indenture Act, it is often included in an indenture governed by New York law, if only because it is part of the Model Debenture Indenture promulgated by the American Bar Association. It has thus had

[13] *See* Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232, 251-52 (1987).

[14] *Id*. at 252.

an impact of the viability of collective action clauses generally and has helped to render them less acceptable in the U.S. market.

It has been suggested that in light of current market conditions, the protections of § 316(b) of the Trust Indenture Act are no longer required and that the provision be repealed. See Mark J. Roe, The Voting Prohibition in Bond Workouts, 97 Yale L.J. 232, 279 (1987).[15] Professor Roe views § 316(b) as a symbolic "gesture toward a stylized autonomy in individual bondholder decisionmaking," that incorrectly imposes antiquated policy decision over decisions that should be made in the marketplace by the parties involved.[16] This is especially true as bondholders today tend to be more sophisticated than bondholders of the 1930's and generally hold securities through mutual funds and other collective mechanisms.

It has been argued, by those hostile to collective action clauses, that the market disfavors them and that issuers have to pay higher interest rates if they are included in the Indenture. Mr. Taylor did not think so. In any event, the market will price bonds at the appropriate level. Even if collective action clauses may never be accepted in this country to the extent they are accepted in transactions governed by English law, the question remains whether we should retain an artificial legal restriction on such

[15] It has also been suggested that the SEC has adopted an unnecessarily broad position as to what constitutes a fundamental change to the rights of bondholders that requires protection afforded by registration under the Securities Act and qualification under the Trust Indenture Act. Even in the absence of proposed indenture amendments which would affect the principal amount, interest rate, maturity date, and mandatory redemption rights of the bonds, the deletion or modification of a significant number of restrictive covenants has also been considered a fundamental change. *See* Ford Lacy & David M. Dolan, *Legal Aspects of Public Debt Restructurings: Exchange Offers, Consent Solicitations and Tender Offers,* 4 DEPAUL BUS. L.J. 49, 65-66 (1991).

[16] 97 YALE L.J., at 279

clauses.  These clauses can facilitate a workout that may be much less expensive and time-consuming and much more favorable to the survival prospects of the enterprise than a formal bankruptcy filing.  To the extent that collective action clauses constitute a mechanism that facilitate restructurings, and to the extent prospective purchasers of bonds determine that this is a positive result, they should be able to accept a bond subject to a collective action clause without having to confront the bar of § 316(b) of the Trust Indenture Act.

Allan L. Gropper