Remarketing of unit securities and IRS guidance

The hybrid instruments generically known as unit securities were a favourite of many public companies during the past decade.

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Also known by their trade names such as Feline PRIDES, WITS and ITS, 2006 and 2007, in particular, saw a large number of issuances. The securities were issued by both financial and non-financial institutions based on:

- favourable regulatory capital treatment (in the case of financial institutions, where the securities commonly qualified as Tier 1 capital);
- favourable treatment by ratings agencies; and
- deductions for federal income tax purposes for interest paid on the underlying debt securities.

As we discuss in more detail below, a units deal pairs a debt instrument and a forward over common or preferred stock. The debt is designed to be remarketed to new investors to provide cash to exercise the forward. These remarketings are now occurring and issuers are considering various options for retiring the securities or remarketing the debt component. The present day economic landscape looks quite different when compared with the market conditions during the original issuance of unit securities which could present difficulties for the remarketing of the underlying debt securities, many of which are scheduled to be remarketed in 2011, 2012, and 2013. Issuers have several options available to address remarketings in light of changed market conditions, including:

- modifying the terms of the underlying debt securities or of the remarketings; or
- using such liability management techniques as repurchases, redemptions, exchange offers, and consent solicitations to retire or swap out the securities themselves.

The US federal income tax considerations need to be taken into account with respect to all of these options.In this regard, the Internal Revenue Service (IRS) recently issued a private letter ruling addressing the repurchase of equity units prior to the scheduled remarketing date.

Composition of unit securities

Unit securities are hybrid securities consisting of two securities velcroed together. The first security is a stock purchase contract requiring the holder to purchase a variable number of shares of common or preferred stock of the issuer on a specified date. The second security is a debt instrument that is pledged as collateral by the holder to secure its obligations under the forward stock purchase contract. The underlying debt securities are typically subordinated to the issuer's senior and subordinated indebtedness and are usually redeemable at the issuer's option, but only after a fixed non-call period. Unit securities may differ based on these characteristics:

- maturity;
- the interest provisions (for example fixed or floating);

- the specific terms of the stock purchase contract (for example common stock or preferred stock);
- the inclusion of replacement capital covenants (which are covenants whereby the issuer agrees for the benefit of holders of senior debt securities that the issuer will not redeem, repay, or purchase subordinated debt securities or more junior debt securities unless the proceeds used for such redemption, repayment, or purchase originate from the issuance of equity or equity-like securities);
- the definition of tax and/or regulatory events (which may trigger a redemption or cause adjustments to the remarketing provisions); and
- any permitted flexibility in the remarketing process.

Remarketing procedures

At the time of remarketing, a remarketing agent assists the issuer in the sale or remarketing of the underlying debt securities, for which the remarketing agent is entitled to a fee for services provided in the remarketing. The remarketing agent agrees to use commercially reasonable efforts to sell the underlying debt securities at a price that ensures net proceeds sufficient to settle the stock purchase contract. Upon a remarketing of the underlying debt securities, the interest rate on the debt securities is reset to the rate (the reset rate) necessary to obtain the required net proceeds. Deals done in the 2006-2008 timeframe typically provided for a series of four or five remarketings with the interest rate subject to a cap except in the final remarketing (this was required for tax purposes to show the remarketing was substantially certain to succeed). An unsuccessful initial remarketing will result in attempted subsequent remarketings, which will usually be conducted quarterly. The timing of the remarketing process may be accelerated under certain circumstances, for example for financial institutions, in the event that certain capital ratios (such as total risk-based capital, Tier 1 risk-based capital, and leverage capital) decrease below certain threshold levels.

If the remarketing agent is unable to successfully remarket the underlying debt securities by the end of a certain number of remarketing periods (typically four or five), then (i) the interest rate will not be reset and the underlying debt securities will continue to accrue interest, and (ii) the underlying debt securities will be delivered to the issuer as payment under the stock purchase contract (through the collateral agent).

The stock purchase contract and debt instrument in a unit deal were only velcroed together. The holder is entitled to separate the two and substitute Treasury securities for the debt component. If the unit remained separated at the time the forward contract was settled, the separate debt instrument's interest rate would be reset through the remarketing.

Recent remarketings

Recent examples of remarketings completed by financial institutions include:

- on December 15 2010, Citigroup completed a remarketing of $1.8 billion in principal amount of its 4.58% junior subordinated deferrable interest debentures, representing the third of four series of debt securities required to be remarketed under the terms of Citigroup's Upper DECS Equity Units;
- on February 1 2011, U.S. Bancorp completed a remarketing of $6.7 million in principal amount of its 3.4% remarketed junior subordinated notes due 2016 (in connection with its Normal ITS); and
- on February 11 2011, State Street completed a remarketing of $500 million in principal amount of its 9.56% junior subordinated debentures due 2018 (in connection with its Normal APEX).

Recent examples of remarketings completed by non-financial institutions include: (i) on May 15 2010, Stanley Black & Decker completed a remarketing of $8.6 million in principal amount of its floating rate convertible senior notes due May 17 2012 (in connection with its floating rate equity units); (ii) on November 15 2010, Avery Dennison completed a remarketing of $109 million in principal amount of its 5.35% senior notes due 2020 (in connection with its HiMEDS Units); and (iii) on March 4 2011, Reinsurance Group of America completed the remarketing of its preferred securities triggered by the redemption of warrants (in connection with its Trust PIERS Units).

IRS guidance

On July 24 2003, the IRS issued Revenue Ruling 2003-97, 2003-2 C.B. 380 (July 24 2003), which addressed the US federal income tax characterisation of an equity unit as described above. In the Revenue Ruling, the IRS held that an instrument, such as the equity units, should not be treated as a single instrument for US federal income tax purposes, but should be treated as consisting of two separate components (for example a debt instrument and a forward contract). The IRS based its conclusion in the Revenue Ruling on several critical factors including (i) that it is substantially certain that a remarketing of the underlying debt securities will succeed, and (ii) that the remarketing dates and the maturity date are such that the notes will remain outstanding after the remarketing for a period that is significant both absolutely and relative to the total term of the notes. If, contrary to the Revenue Ruling's conclusions, the unit was one instrument for federal income tax purposes then it might be equity for federal income tax purposes or might run afoul of section 163(l) which prohibits interest deductions for debt payable in issuer equity.

During the first quarter of 2011, the IRS issued Private Letter Ruling (PLR) 201105030, addressing the repurchase by a corporate taxpayer of its outstanding equity units (Units). The Units, which the taxpayer had issued earlier in accordance with the requirements of Revenue Ruling 2003-

97 and which were consistent with the equity units described above, consisted of an undivided beneficial interest in certain notes issued by the taxpayer and a forward contract to purchase the taxpayer's stock. The taxpayer paid, on a quarterly basis to unit holders, interest on the notes and a fee pursuant to the forward contract. The notes were pledged to secure a Unit holder's obligations to perform under the stock purchase contract. After a certain number of years following the issue date and pursuant to the terms of the units, the taxpayer was required to attempt to remarket the notes to generate proceeds in an amount sufficient to satisfy the unit holder's obligation under the stock purchase contract. After the remarketing and settlement of the stock purchase contract, the notes were intended to remain outstanding for another few years.

After the issue date of the units, however, the taxpayer's financial position had deteriorated, its credit rating had been downgraded significantly and it had experienced a steep drop in its stock price. Considering these circumstances, the taxpayer made an exchange offer to each unit holder before the remarketing date pursuant to which:

- The taxpayer would repurchase the notes in exchange for a number of shares of its common stock plus an amount in cash; and
- Each unit holder would pay an amount in cash to the taxpayer for settlement of the stock purchase contract. The fair market value of the common stock plus the amount of cash offered by the taxpayer equaled the adjusted issue price of the notes plus accrued but unpaid interest.

The IRS ruled that:

- The taxpayer's gain resulting from the cash settlement of the stock purchase contract is not recognised pursuant to section 1032(a);
- Because the taxpayer paid each unit holder an amount equal to the notes' adjusted issue price plus accrued but unpaid interest, the taxpayer was neither entitled to deduct interest expense (except for accrued but unpaid interest) nor to recognise cancellation of indebtedness income;
- No amount paid by the taxpayer pursuant to the exchange offer was deductible, except for the amount paid for the accrued but unpaid interest;
- The exchange offer did not prevent the units from complying with the requirements of Revenue Ruling 2003-97; and
- The foregoing rulings were not affected by the fact that the payments pursuant to the exchange offer were netted.

The taxpayer did have to make a number of representations to obtain these rulings, including that, on the original issue date, it satisfied the requirements of Revenue Ruling 2003-97; that it had not treated the fee payments under the stock purchase contracts as deductible items; that, as of the original issue date of the units, it did not intend to tender for the notes, or otherwise seek to repurchase the notes with the result that the notes would not be outstanding for at least two years after exercise of the stock purchase contract; that it believed that a remarketing would have a negative impact on its credit rating which could substantially jeopardise its operations; and that, as of the original issue date of the units, the taxpayer did not reasonably foresee that its financial position and credit rating would deteriorate as it did. Issuers that have equity units outstanding with upcoming remarketing dates should keep the facts and circumstances of PLR 201105030 in mind when mapping out their options. Unfortunately, for federal income tax purposes, private letter rulings cannot be relied on by other taxpayers and cannot be cited as precedent.