Contact Information:
Dickson G. Brown (212-455-2850, dbrown@stblaw.com)
Marcy G. Geller (212-455-3543, mgeller@stblaw.com)
Diane M. Gipstein (212-455-3725, dgipstein@stblaw.com)
Katharine P. Moir (650-251-5035, kmoir@stblaw.com)

SIMPSON THACHER

Integration of Convertible Note Hedge

August 25, 2006

This memorandum was written in connection with the promotion or marketing of the transaction addressed in this memorandum and was not intended or written to be used, and cannot be used, for the purpose of avoiding tax-related penalties under federal, state or local tax law. Each taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

In recent years, companies that issue convertible notes ("Convertible Notes") often seek to hedge against the possibility of excessive dilution from the conversion of the Convertible Notes into the stock of the company. United States Treasury regulations under section 1275 of the Code (the "Regulations") provide that under certain circumstances a qualifying debt instrument ("QDI") – in this case the Convertible Note – and the related hedge may be integrated for federal income tax purposes to create a synthetic debt instrument ("Synthetic Debt Instrument").[1] The resulting Synthetic Debt Instrument typically has no conversion right and is deemed issued at a discount equal to the cost of the hedge, giving rise to original issue discount ("OID") deductions over the term of the Synthetic Debt Instrument. This memorandum discusses the application of the Regulations to the integration of a typical Convertible Note and qualifying hedge, the illustrative terms of which are set forth below.

ILLUSTRATIVE TERMS OF THE INTEGRATION TRANSACTION

For example, assume that an issuer whose common stock is currently trading at $20 per share (the "Issuer") issues $100 million of five-year Convertible Notes to holders (the "Holders"). The Convertible Notes pay interest quarterly at a fixed rate and are convertible at maturity into four million shares of the Issuer's common stock ("Shares"), representing a 25% conversion premium over the current market price.

Upon issuance of the Convertible Notes, the Issuer also pays an investment bank (the "Bank") $30 million for a long-call option ("Long-Call Option"), to purchase Shares at a strike price of $25 per share, in order to prevent dilution upon conversion of the Convertible Note. The Long-Call Option obligates the Bank to deliver the number of Shares due under the Convertible Note to the Issuer if and when the Holders convert (generally, if the price of the Shares rises above the strike price). The anti-dilution and business combination provisions of the Long-Call Option mirror those of the Convertible Note. Likewise, the Long-Call Option has a five-year term, and is only exercisable at such time and to the extent that the Convertible Notes are converted. Thus, upon conversion of a $1,000 principal amount Convertible Note, the Issuer will pay the Bank an exercise price of $1,000

---

1 See Treas. Reg. § 1.1275-6. Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (the "Code") and the Regulations promulgated thereunder.

(the principal amount of the Convertible Note) and the Bank will deliver to the Issuer forty Shares.[2] In certain circumstances, discussed in more detail below, the exact number of Shares due under the Long-Call Option may differ from the number of Shares due under the Convertible Note. However, the likelihood, individually or in the aggregate, of these circumstances occurring is remote. In the event that the Holders do not convert the Convertible Notes at maturity, the Long-Call Option will be cancelled. The Long-Call Option is documented in an ISDA confirmation that is part of the ISDA Master Agreement. In addition, the Long-Call Option is freely transferable.

Simultaneously with the sale of the Long-Call Option, the Bank typically purchases a warrant (the "Warrant") from the Issuer. The strike price of the Warrant is significantly higher than the conversion price of the Convertible Notes so that the Issuer has significantly reduced the dilutive effect of the Convertible Notes while reducing the cost of the hedge by the premium received for the issuance of the Warrant. In the example, assume that the Warrant premium is $10 million and allows the Bank to purchase a number of Shares from the Issuer at strike price of $50.[3] The Warrant has a maturity that is three months later than the maturity date of the Long-Call Option and is exercisable only at maturity (i.e., European style). The Warrant also has different settlement terms than the Long-Call Option, and its anti-dilution provisions and business combination provisions, which are standard ISDA-based provisions, are materially different than the anti-dilution provisions and business combination provisions in the Long-Call Option. The Warrant is documented in a separate and distinct ISDA Confirmation that will be part of the ISDA Master Agreement or a separate call warrant under a warrant agreement. Additionally, the Warrant is freely transferable, and there are no offset rights or cross-collateralization between the Warrant and the Long-Call Option.

All transactions between the Issuer and the Bank are at arms length. In addition, the Issuer will not pledge its rights under the Long-Call Option to secure its obligations under the Warrant, and the Bank will not pledge its rights under the Warrant to secure its obligations under the Long-Call Option.

If the Convertible Note and Long-Call Option are integrated (as discussed below), the resulting Synthetic Debt Instrument will be deemed to have an issue price of $70 million (i.e., the amount the Issuer received from the Holder minus the cost of entering into the Long-Call Option) and a principal amount of $100 million.[4] Accordingly, the Issuer will deduct $30 million of OID amortized

---

2 The illustration in this memorandum provides for physical settlement. If the Convertible Note were to provide for cash or net-share settlement, the amount of cash and shares (if any) due under the Long-Call Option would equal the amount of cash and shares (if any) due under the Convertible Note.

3 Such number of Shares may be the same, more or less than the number of Shares deliverable under the Long-Call Option.

4 See Treas. Reg. § 1.1275-6(f)(4).

on a constant yield-to-maturity basis over the term of the Convertible Notes. The Holders are not required to include any OID in income because the integrated treatment only applies to the parties that integrate the QDI and § 1.1275-6 hedge.

INTEGRATION UNDER SECTION 1.1275-6: LIMITATIONS AND REQUIREMENTS

Under Treas. Reg. § 1.1275-6, a taxpayer who holds or issues a QDI and enters into a qualifying hedge ("a § 1.1275-6 hedge") may integrate the QDI and § 1.1275-6 hedge in order to create a Synthetic Debt Instrument.[5] This hypothetical debt instrument has the same cash flow as the combined cash flows of the QDI and the § 1.1275-6 hedge,[6] and is subject to the Code provisions that apply to debt instruments more generally.[7] For its term, the integrated transaction is treated as a single transaction, subject to the rules of Treas. Reg. § 1.1275-6, rather than the rules to which each component of the transaction would otherwise be subject on a separate basis.[8] Such treatment allows for more accurate determinations of character and timing of income, deductions, and gains or losses than would be accomplished by separate treatment of the components.[9]

Definitions and Limitations

Before electing to integrate a transaction, an Issuer must first ensure that the debt instrument and hedge in question qualify under Treas. Reg. § 1.1275-6 as a QDI and § 1.1275-6 hedge. A QDI is any debt instrument other than (i) a tax-exempt obligation under section 1275(a)(3), (ii) a debt instrument to which section 1272(a)(6) applies, or (iii) a debt instrument subject to Treas. Reg §§ 1.483-4 or 1.1275-4(c).[10] A § 1.1275-6 hedge may be any number of enumerated financial instruments, including

---

5 Treas. Reg. § 1.1275-6(a) and (b).

6 Treas. Reg. § 1.1275-6(b)(4).

7 For example, the Synthetic Debt Instrument (and not the separate QDI and hedge) may be subject to the provisions of sections 163(e) (applicable high yield debt instruments), 263(g) (disallowance of interest accrued to carry straddles), 279 (disallowance of interest with respect to subordinated convertible debt instruments incurred to acquire assets or stock of another corporation) and 1092 (straddles).

8 Treas. Reg. § 1.1275-6(f)(1).

9 Treas. Reg. § 1.1275-6(a).

10 Section 1272(a)(6) applies to certain interests in or mortgages held by a REMIC, and certain other debt instruments with payments subject to acceleration. §§ 1.483-4 and 1.1275-5(c) apply to certain contingent payment debt instruments issued for non-publicly traded property. Treas. Reg. § 1.1275-6(b)(1).

an option, with no exception for a position with respect to an Issuer's own stock.[11] However, a financial instrument will only qualify as a § 1.1275-6 hedge if the resulting Synthetic Debt Instrument has the same term as the remaining term of the QDI. The term of a Synthetic Debt Instrument begins on the issue date of the Synthetic Debt Instrument and ends on the maturity date of the QDI.[12] In addition, a financial instrument will only qualify as a § 1.1275-6 hedge if either the combined cash flow of the financial instrument and the QDI permits the calculation of a yield to maturity under the principles of section 1272[13] (the provision governing the calculation of OID) or the right to such cash flow qualifies as a variable rate instrument that pays interest at a qualified floating rate (the "Cash Flow Requirement").[14] As discussed in further detail below, special circumstances, such as (i) conversion by the Holder prior to maturity, (ii) a mismatch in payments made on the Long-Call Option and on the Convertible Note, and (iii) events and provisions in the Convertible Note and Long-Call Option that would result in contingent payments, could prevent a calculation of this yield to maturity.

Additional Requirements for Integration

If all of the above requirements are met, an Issuer may elect to integrate a Long-Call Option and Convertible Note into a Synthetic Debt Instrument so long as:

1. Proper identification of the § 1.1275-6 hedge is made.[15]

2. The Issuer and Bank are not related parties, as defined under sections 267(b) or 707(b)(1).[16]

---

11 Treas. Reg. § 1.1275-6(b)(2).

12 Treas. Reg. § 1.1275-6(f)(3).

13 The yield to maturity under section 1272 is "the discount rate that, when used in computing the preset value of all principal and interest payments to be made under the debt instrument, produces an amount equal to the issue price of the debt instrument." Treas. Reg. § 1.1272-1(b)(1)(i).

14 Treas. Reg. § 1.1275-6(b)(2). The regulations also indicate that integration may be allowed even if the combined cash flows of the QDI and the § 1.1275-6 hedge are only "substantially equivalent" to the cash flows of a fixed or variable rate debt instrument. Treas. Reg. § 1.1275-6(a).

15 The Issuer must enter and retain as part of its books and records: (i) the date on which the issuer issued the QDI and the date on which it entered into the § 1.1275-6 hedge; (ii) descriptions of the QDI and the hedge; and (iii) a summary of the cash flows and accruals on the resulting Synthetic Debt Instrument. Treas. Reg. § 1.1275-6(e).

3. The Issuer (and not an affiliate) enters into both the Long-Call Option and the Convertible Note.[17]

4. If the Issuer is a foreign person engaged in a United States trade or business, all items of income and expense associated with the Long-Call Option and Convertible Note would have been effectively connected with the U.S. trade or business if not integrated.[18]

5. Neither the Long-Call Option nor Convertible Note was, with respect to the Issuer, part of another integrated transaction which has been legged out within the thirty-day period preceding the issuance of the Synthetic Debt Instrument.[19]

6. The Issuer issues the Convertible Note on or before the date it makes payments on the Long-Call Option, or alternatively, the Issuer issued the Convertible Note "substantially contemporaneously" with its first payment on the Long-Call Option.[20]

7. Neither the Long-Call Option nor Convertible Note was, with respect to the issuer, part of a straddle prior to the issue date of the Synthetic Debt Instrument.[21]

APPLICATION OF SECTION 1.1275-6 REQUIREMENTS AND LIMITATIONS

The Convertible Note and Long-Call Option may be Integrated

The illustrative hedging transaction described in Section I above meets the basic criteria of Treas. Reg. § 1.1275-6. The Convertible Note is a QDI, as it does not fall within one of the excepted debt categories. Likewise, the Long-Call Option is a § 1.1275-6 hedge given that it qualifies as a financial instrument, and, when combined with the Convertible Note, produces a Synthetic Debt Instrument with the same five-year term as the remaining term of the Convertible Note. Furthermore, it fulfills the Cash Flow Requirement, since the terms of the Long-Call Option provide that in all cases the number of Shares deliverable under the Long-Call Option will correspond to the number of Shares

[16] This requirement applies unless the party providing the Long-Call Option uses a mark-to-market method of accounting for all § 1.1275-6 hedge and all similar or related transactions. Treas. Reg. § 1.1275-6 (c)(1)(ii).

[17] Treas. Reg. § 1.1275-6(c)(iii).

[18] Treas. Reg. § 1.1275-6(c)(iv).

[19] Treas. Reg. § 1.1275-6(c)(v).

[20] Treas. Reg. § 1.1275-6(c)(vi).

[21] Treas. Reg. § 1.1275-6(c)(vii).

due under the Convertible Note, which will result in a Synthetic Debt Instrument that is a fixed rate debt instrument with a $70 million issue price that pays $100 million at maturity. Payments on the Synthetic Debt Instrument will, therefore, enable a yield to maturity calculation. Assuming that the Issuer is also able to meet the additional requirements enumerated above, it may elect to integrate the Convertible Note and Long-Call Option.

Scenarios that could Prevent Satisfaction of Cash-Flow Requirement

Although the terms of the hedging transaction discussed above allow for integration, there may be provisions in a convertible debt instrument that could interfere with the ability to calculate a yield to maturity for the integrated debt instrument. As noted above, some such provisions include: (i) conversion by the Holder prior to maturity, (ii) a mismatch in payments made on the Long-Call Option and on the Convertible Note due to anti-dilution and business combination provisions of the Convertible Note and/or Long-Call Option, and (iii) events and provisions in the Convertible Note and Long-Call Option that would result in contingent payments due to fundamental changes. However, these possibilities will not cause the Long-Call Option to fail to meet the Cash Flow Requirement if the parties involved are able to conclude that the likelihood that any of these possibilities will occur is remote.[22] Alternatively, even if the payments are not remote, if the amount and timing of all possible payments under the Synthetic Debt Instrument are known, then so long as one payment schedule is significantly more likely than not to occur, then the yield to maturity under section 1272 can be based on that payment schedule.[23] Furthermore, differences may be able to be ignored to the extent that the combined cash flows of the Convertible Note and Long-Call Option are "substantially equivalent" to the cash flows on a fixed rate debt instrument.[24] Likewise, the Regulations provide that options to convert a debt instrument into the stock of an Issuer may be ignored.[25] Such options would therefore not be treated as causing a contingent payment.

Non-Integration of Warrant

Because the Warrant has different economic terms than the Convertible Note, including different exercise periods, maturity dates, anti-dilution adjustments and settlement terms, the Issuer would

---

[22] Treas. Reg. §§ 1.1272-1(c)(1), 1.1271-2(h)(2) and 1.1275-4(a)(5). Whether an event is remote is determined at the time of the issuance of the Convertible Note.

[23] Treas. Reg. § 1.1272-1(c)(1) and (2).

[24] Treas. Reg. § 1.1275-6(a). See also supra note 14.

[25] Treas. Reg. §1.1272-1(e). Thus, while the Convertible Note in this illustration may be converted by Holders prior to maturity, and early conversion would result in a different yield, the early conversion feature does not, by itself, foreclose integration.

not be able to elect to integrate the Warrant[26]; such terms prevent the Warrant, if it were integrated into the Synthetic Debt Instrument, from meeting the Cash Flow Requirement. Even if the terms of the Warrant were different than those described above, the Issuer need not integrate the Warrant, because the Regulations merely allow, but do not require, taxpayers to integrate instruments if the qualifications for integration are met.[27] Additionally the Long-Call Option and Warrant should not be treated as a single instrument that may be integrated with the Convertible Note. The Warrant discussed in the example above is freely transferable and there is no economic compulsion to retain both the Long-Call Option and the Warrant. Per Revenue Ruling 2003-97, 2003-2 C.B. 380, two instruments will be treated separately if (i) the instruments are separately transferable[28] and (ii) the holder of the two instruments is not economically compelled to retain both instruments and not separate them. The Long-Call Option and Warrant should therefore be treated separately.

ANTI-ABUSE PROVISIONS

Denying Integration of the Long-Call Option

The general OID anti-abuse regulations permit the Internal Revenue Service ("IRS") to deny integration treatment in certain circumstances, even if a transaction meets the Regulation's technical requirements. Under these regulations, the IRS must show both that: (i) the result of the integration is unreasonable in light of the purposes of the OID rules and the related Code sections, namely to correlate the tax treatment of a transaction to its economic substance, and (ii) a principal purpose of the Issuer entering into the transaction was to achieve an unreasonable tax result. In the example discussed above, the effect of integrating the Long-Call Option with the Convertible Note is an OID debt instrument with the terms of the Synthetic Debt Instrument, which is not unreasonable in light of the OID rules. Moreover, the primary reason that the Issuer purchased the Long-Call Option was to hedge its obligation to deliver Shares under the Convertible Note and to prevent dilution of its Shares, rather than to achieve a tax result.[29] Thus, the general OID anti-abuse regulations should not be a basis for the IRS to deny integration treatment.

---

[26] If the Warrant could be integrated, the amount of OID accrued on the instrument would be reduced by the price of the Warrant because the cost of the options sold and bought would be netted for purposes of determining the issue price of the Synthetic Debt Instrument. Treas. Reg. § 1.1275-6(f)(4).

[27] T.D. 8674. Also, by choosing not to integrate the Warrant, the Issuer would fail to meet the identification requirements under Treas. Reg. § 1.1275-6(e).

[28] See Rev. Rul. 88-31, 1988-1 C.B. 302.

[29] Treas. Reg. § 1.1275-2(g).

Forcing Integration of the Warrant

In addition to the general anti-abuse provision described above, the Regulations anti-abuse provisions in Treas. Reg. § 1.1275-6 allow the IRS to treat a QDI and a financial instrument as an integrated transaction if the combined cash flows on the QDI and financial instrument are substantially the same as the requisite cash flows for the financial instrument to be a § 1.1275-6 hedge. The IRS may only force integration if the transaction involves a contingent debt instrument or a variable debt instrument with objective rates.[30] However, the Convertible Note discussed in this memorandum is not a contingent payment instrument or variable debt instrument with an objective rate.

Even if a transaction does not involve such instruments, the IRS has asserted that it may nonetheless attempt to force integration under the general OID anti-abuse regulations in Treas. Reg. § 1.1275-2(g), if, for example, the Issuer's principal purpose is to create an artificial loss.[31] The Warrant described in this memorandum, however, should not be subject to such treatment, given the business purpose of the transaction, the different economic terms of the Warrant and the Convertible Note and the fact that the instruments are separately transferable. Moreover, the fact that the Regulations explicitly limit the IRS's authority to force integration to a specific set of circumstances implies that the general anti-abuse regulations carry less weight when these circumstances do not exist.

* * *

This memorandum is based upon the Code, the regulations, administrative rulings, judicial decisions and other applicable authorities as of the date hereof. The statutory provisions, regulations and interpretations on which this memorandum is based are subject to change, and such changes can apply retroactively.

This memorandum is for general informational purposes only and does not address the terms of any specific transaction or any specific documentation. Accordingly, it may not be relied upon by any person. Persons should make their own independent judgments and consult with their own tax advisors. Notwithstanding anything in this memorandum to the contrary, you and any other person may disclose to any and all persons, without limitation of any kind, the tax treatment and tax structure of the transactions contemplated by this memorandum. Please contact any of us concerning the matters discussed in this memorandum or the terms of a specific transaction.

---

30 Treas. Reg. § 1.1275-6(c)(2).

31 See Rev. Rul. 2002-12, 2000-1 C.B. 744 (Situation 3) (the IRS forced integration, even though the technical requirements of the Regulations were not met).