

December 18, 2002

A Bond Swap Available Only to Big Players

By FLOYD NORRIS

In the summer of 1998, U S West, a Baby Bell phone company with a solid investment-grade rating, set a record by selling \$1.5 billion in 30-year bonds to eager investors. It was the largest long-term bond issue in corporate history.

To people not swept up in the technology stock mania, the bonds looked like a safe investment with a good yield of 6.9 percent stretching out for 30 years. In the jargon of Wall Street, they were ideal investments for widows and orphans.

Any widows or orphans who bought those bonds now find themselves in an unhappy position. U S West was taken over by Qwest, whose fiber optic dreams have led to crushing debt, dubious accounting and federal investigations. Qwest is unable to offer any assurances about its real financial condition.

Today a federal judge in New York will decide whether Qwest can proceed with an exchange offer in which institutional investors are being asked to exchange each \$1,000 of those bonds for new ones with a face value of \$545. The offer is a coercive one that will leave bondholders who do not accept it in the back of the line for repayment if Qwest goes broke.

For individual investors who own the bonds, the choices are even worse because the offer specifically excludes them. In fact, Qwest professes outrage that the details of its offer have been made public by disaffected bondholders. The offer is open only to qualified institutional investors, like mutual funds and hedge funds.

At a hearing today, Federal District Judge Denny Chin in Manhattan will consider a request by some bondholders for a temporary injunction blocking the exchange offer, which is scheduled to close Friday night. He will also consider a motion from Qwest to dismiss the suit.

If Judge Chin allows the offer to go ahead, institutional investors who own the bonds will find themselves in a position with some resemblance to the classic "prisoners dilemma," in which two suspects in a crime are questioned separately by the police. They would be better off if neither one of them talked, but the worst possible outcome for each prisoner would be to keep quiet while the other one

talked.

For the owners of the \$12.9 billion in bonds in the 11 issues that Qwest wants to at least partly retire through the bond exchange, the offer provides interesting tradeoffs. In most cases, the higher interest rates on the new bonds would provide additional income while the bonds are outstanding, but the owners would get far less money when the bond matures — assuming that Qwest is then able to repay the principal.

The new bonds being offered would represent discounts in face value ranging from 17.5 percent for bonds maturing in 2004 to 47.5 percent for an issue maturing in 2018. Bonds maturing before 2010 would also have maturities extended, but those maturing after that would be repaid sooner, assuming all works out.

In addition, the new bonds would be collateralized to a greater extent, giving them a better chance of being paid if Qwest does enter bankruptcy.

If the offer is oversubscribed, not all bonds will be exchanged for the new bonds being offered. But owners who get some bonds back will have them reclassified to have better security if Qwest goes broke.

If the offering is a success, those holders who do not tender or are not permitted to will wind up in the worst position. They will still have their old bonds, but they will rank lower than they did in the pecking order if Qwest does go under.

So the question will be: to tender or not. If no one tendered, then Qwest would be in the same position as before the offer, and any bondholder would be no worse off. But if a lot of holders tender, those who refuse will be worse off than they were.

For the individual investors who own such bonds, the alternatives are even less appealing. They cannot tender, so their choices are to hold or sell now depressed prices. If they hold, and the exchange offer is a success, then their bonds will probably fall in price.

In the longer term, the question is whether these bonds can be paid off at maturity. If so, then it probably would be better not to tender. As recently as early this year, the bonds traded as if default were very unlikely, but that has changed. The bond mentioned above — the bond that set a record for the size of issuance of a 30-year obligation — now trades for about half of face value.

So will the bonds be paid in full at maturity? Some people who bought the bonds as they fell this year calculated that the answer was yes. One estimate said that the company was worth about what it owed, which might leave little for the shareholders but could provide full payment for the bondholders.

But it is even harder than normal to make such calculations. The company has no audited financial reports available, and while it has disclosed large revisions to past numbers, it has warned that those may

not be the final changes. If the coming news is bad enough, getting the extra security could be crucial to making a substantial recovery for the bondholders. On the other hand, if it is good, that might indicate that there is no need for bondholders to make sacrifices.

In its offering memorandum, Qwest states: "The restated information and other information we intend to include in future S.E.C. filings is not available at this time, and were it available, could be material to your decision whether or not to participate in the exchange offer."

The bondholders suing Qwest argue that management, which decided to make the exchange offer, probably has inside knowledge of how bad the news is going to be. Qwest responds that because the information is not available now, it cannot be penalized for failing to disclose it.

Exchange offers that damage bondholders are not unheard-of on Wall Street. And, as Qwest pointed out in arguments in this case, companies do not normally owe a fiduciary duty to bondholders. But this case is unusual because Qwest's financial situation is so unclear.

Because it has no audited financial statements, it cannot sell a bond offering in the public market, and cannot make the exchange offer to public investors. But it may still need the balance-sheet improvement that would come from a successful exchange.

If it is allowed to go ahead and the exchange offer succeeds, Qwest will get some debt off its balance sheet, a possibility that has encouraged shareholders, who have bid the stock up 28 percent, to \$5, since the offer was announced on Nov. 20.

In that case, however, the biggest losers will be the people that securities laws are meant to protect — the individual investors who thought they were buying a safe bond but instead got stuck with bonds in a company that came up with a strategy that damaged their interests.

Wall Street, on the other hand, will do fine. Qwest has hired no fewer than six investment banks to help manage the exchange offer: [Bank of America](#), [Merrill Lynch](#), [UBS Warburg](#), [Credit Suisse First Boston](#), [Lehman Brothers](#) and [Wachovia Securities](#). All will profit if the offer goes through.

As it happens, two of those banks — [Merrill Lynch](#) and [Lehman Brothers](#) — were among the lead managers who earned fees in 1998 for selling the U S West bonds that proved to be such poor investments for the buyers.