March 13, 2020

COVID-19: Debt Buyback Considerations

As market reaction to COVID-19 leads to declining trading prices for bank loans and notes, many debt issuers (and, in some cases, their private equity sponsors) are considering repurchasing their outstanding debt to capture discount. This memorandum highlights certain considerations that well-advised debt issuers and private equity sponsors should take into account in analyzing these potential debt buybacks.

Liquidity

As a threshold matter, before a debt issuer voluntarily repurchases outstanding debt, the issuer should undertake a full analysis of the issuer's forecast liquidity. Generally speaking, liquidity is paramount, and debt repurchases by a debt issuer should only be made if there is sufficient liquidity to operate the business, including in a downside scenario. If a debt issuer that is owned by a private equity sponsor is liquidity-constrained, it may be worth considering whether the private equity sponsor could instead purchase outstanding debt.

Provisions in Debt Documents relating to Debt Buybacks

Provisions in debt documents governing debt buybacks vary based on who is purchasing the debt. There are three types of possible debt purchasers that are worth considering: (a) the debt issuer and its subsidiaries (the "Company"), (b) affiliates of the debt issuer that control the debt issuer through their equity ownership and that are not bona fide debt funds ("Affiliated Lenders") and (c) affiliates of the debt issuer that are bona fide debt funds (with such persons generally acting independently of the underlying private equity business that owns the debt issuer) ("Affiliated Institutional Lenders").

Additionally, the provisions applying to each of these purchasers differ in notes indentures and credit agreements. Finally, there also are a number of covenants in debt documents that could potentially be implicated by debt buybacks by the Company.

- Notes Indentures

  Notes indentures generally do not restrict the repurchase of notes issued thereunder by the Company, Affiliated Lenders or Affiliated Institutional Lenders. Notes owned by such persons, however, typically are disregarded and deemed not to be outstanding for voting purposes. Moreover, purchased notes generally are not automatically cancelled (with such notes typically only cancelled when surrendered to the trustee for cancellation).

- Credit Agreements

  Credit agreement provisions relating to loan purchases by Affiliated Institutional Lenders, Affiliated Lenders and the Company generally are more complicated than analogous provisions in notes indentures. For example:

  - *Affiliated Institutional Lenders:* Credit agreements often do not restrict Affiliated Institutional Lenders from acquiring or holding loans. In addition, Affiliated Institutional Lenders often are able to vote their loans for purposes of approving amendments or consents (but often with the prohibition on these loans constituting more than 49.9% of the loans approving any amendment or consent).
  - *Affiliated Lenders:* Affiliated Lenders generally only may purchase term loans (and not revolving loans) of up to a specified percentage of term loans outstanding (often 25-30%) on a non-pro rata basis through Dutch auction procedures or open market purchases. Affiliated Lenders acquiring loans usually are permitted to continue to hold the purchased loans (without any requirement to retire them). Affiliated Lenders, however, generally are not permitted to vote the loans they hold (with certain exceptions for matters disproportionately affecting them), with such loans being disregarded for voting purposes. Moreover, Affiliated Lenders generally are prohibited from attending lender meetings and receiving certain information provided by the administrative agent to lenders.
  - *Company:* The Company generally only is permitted to repurchase term loans (and not revolving loans) on a non-pro rata basis through Dutch auction procedures or open market purchases. There usually is no cap on Company repurchases, as loans repurchased by the Company are typically deemed cancelled upon acquisition thereof. Additionally, some credit agreements also prohibit the use of proceeds of revolver borrowings to acquire debt.

  It is worth noting that credit agreements generally do not restrict purchases of participations in loans by such persons, which could be an alternative path to a debt buyback. Moreover, it also may be possible to realize the economics associated with a debt buyback through using derivatives such as total return swaps, which also may allow a private equity sponsor to obtain leverage in connection with a debt buyback and avoid the issues discussed above.

Finally, there also are a number of covenants in debt documents that could potentially be implicated by debt buybacks by the Company. Covenants that may need to be assessed include: restricted payment or junior debt prepayment covenants and, in the case of any debt exchange or transaction involving the incurrence of new indebtedness, debt and liens covenants.

Securities Laws and Anti-Fraud Principles

Any person considering debt buybacks also will need to consider issues related to debt buybacks that may arise under applicable securities laws and general anti-fraud principles. As a threshold matter, it is important to recognize that notes are securities, and bank loans generally are not considered securities. As such, the securities laws apply to any notes purchases, but likely do not with respect to bank loan purchases (although general anti-fraud principles may apply). As a result, you generally cannot purchase notes while in possession of material non-public information. [1] Many issuers and private equity sponsors adopt similar policies which prohibit the purchase of bank loans while such issuers or sponsors are in possession of material non-public information. Any Company or sponsor insider trading policies (including with respect to trading windows) would need to be considered and followed.

Corporate Governance Matters

Debt buybacks by private equity sponsors also may require consideration of certain corporate governance issues, including with respect to (1) the corporate opportunity doctrine and (2) ongoing corporate governance.

- Corporate Opportunity Doctrine

  The corporate opportunity doctrine prohibits corporate directors and officers and equity owners from usurping corporate opportunities for their own benefit. It is possible that the opportunity to purchase debt at a discount may be viewed as a corporate opportunity that belongs to the Company. This opportunity should not be wrongly usurped by the private equity sponsor. Unless the Company's charter formally waives the application of this doctrine, it may be prudent to have the Company first consider the debt buyback opportunity and formally decline to pursue it. The decision to formally decline to pursue such an opportunity would best be made by directors who are independent of the private equity sponsor (if there are such persons). A lack of sufficient liquidity (or a decision to allocate liquidity to other opportunities) may be a strong basis for a Company to decline to pursue a debt buyback opportunity. In addition, where the potential consequences to the Company raised by some of the tax issues described below can be mitigated by having a private equity sponsor repurchase the debt,

---

[1] Despite the general prohibition on purchases of notes while in possession of material non-public information, certain issuers and private equity sponsors are willing to purchase notes while they may be in possession of material non-public information where the counterparty is sophisticated and enters into a "big boy" letter acknowledging the potential information disparity. A fulsome discussion of "big boy" letters is beyond the scope of this memorandum, but it is worth noting that issuers and private equity sponsors take different views on them, with some issuers and private equity sponsors willing to trade on them and others not.

they also may provide a basis for the Company to decline to pursue a debt buyback in favor of the private equity sponsor.

- Ongoing Corporate Governance

  If a private equity sponsor purchases debt in a portfolio company, the private equity sponsor's ability to exercise governance rights on a go-forward basis with respect to the Company may become limited where the Company's solvency comes into question. In such situations the private equity sponsor may be conflicted as a result of being both a significant creditor of the Company and its equity holder. In such cases, directors that are not independent from the private equity sponsor may be required to recuse themselves from board decisions related to the Company's capital structure or any future restructuring involving the Company. This could result in control of future capital structure and restructuring decisions being ceded to board members who are independent of the private equity sponsor. If such a conflict scenario is a possibility, it may be prudent to appoint independent board members well in advance of the consideration of any potential conflict transaction.

Bankruptcy Issues

Debt buybacks by private equity sponsors also may implicate certain bankruptcy issues, including potential equitable subordination challenges. Equitable subordination is an extraordinary remedy pursuant to which a bankruptcy court may, under principles of equity, subordinate the recovery of certain claims until other claims are first satisfied. For equitable subordination to apply, a court must find that a creditor engaged in inequitable conduct that resulted in injury to other creditors. The mere fact that a private equity sponsor purchased debt in a portfolio company on an arm's length basis would not support a claim to equitably subordinate such debt. Instead, courts require some other form of inequitable conduct, although such inequitable conduct need not necessarily arise in connection with the acquisition of the issuer's debt.

U.S. Federal Income Tax Issues

A lengthy discussion of U.S. federal income tax issues associated with debt buybacks is beyond the scope of this memorandum. It is, however, worth highlighting two issues that may arise in the context of debt buybacks: cancellation of indebtedness income and related party issues.

- "Cancellation of Indebtedness Income" or "CODI"

  In the most basic scenario, when a Company fails to repay a loan for whatever reason the Company may recognize cancellation of indebtedness income ("CODI") to the extent of the loan forgiveness. Depending on the Company's tax attributes and tax position, this CODI may create a cash tax liability or, in a number of ways, reduce the Company's tax attributes such as net operating losses or "NOLs".

If a Company (for these purposes including subsidiaries) or an entity related to the Company under relevant tax rules (e.g., a private equity sponsor that owns the Company) buys back debt in the market at a discount, the repurchase transaction is, in effect, treated as if the Company did not repay the loan to the extent of the discount on the repurchase, which creates CODI for the Company with the same consequences as if the lender forgave the loan. U.S. federal income tax law also recognizes an insolvency exception to CODI that may be available to a Company in certain circumstances.

CODI as a result of loan forgiveness and debt buybacks can be particularly challenging from a tax perspective with respect to entities treated as partnerships for U.S. Federal income tax purposes, so it is important to model any consequences with a partnership borrower.

- Issues with Holding Repurchased Loans

In a case where the loan remains outstanding after a related party purchase, e.g., where the loan is held by the private equity sponsor, the loan is treated as deemed reissued generally with a new issue price equal to the purchase price (in effect, the discount becomes original issue discount on the deemed newly issued loan). This can have an impact on the future interest and original issue discount ("OID") profile for the loan. Moreover, in many cases the interest and OID may be subject to deductibility limitations at the Company-level going forward, which may create an inefficient mismatch from a tax perspective as the Company may never be able to deduct the interest/OID on the reissued loan, but the private equity sponsor may have to pick up the interest/OID income.

Where a related private equity sponsor holds a US portfolio company's loan after a repurchase, the Company and the private equity sponsor should consider whether the interest may be subject to a 30% withholding tax with respect to non-US investors in the fund (including non-US corporate "feeder funds" or "blockers"). The most common exemption from U.S. withholding tax—the portfolio interest exemption—may not be available with respect to interest paid on debt of US companies held by related parties such as a private equity sponsor. These rules, and potential tax leakage they create, should be carefully considered, along with the availability of additional exemptions such as those under tax treaties between the U.S. and certain non-U.S. countries.

As a result of the deemed reissuance that occurs as described above, the repurchased debt may cease being fungible with the other outstanding debt, which could have an impact on liquidity and pricing for future debt sales.

In some cases where a private equity sponsor (and not the Company itself) purchases the debt at a discount, it may be possible to structure the repurchase to avoid the related party rules described above (including through the use of derivative structures) and avoid triggering the Company-level CODI and holder-level consequences, but these structures are very fact specific.

Private Fund Issues

If a private equity sponsor is anticipating the purchase of debt securities, the private equity sponsor may have a host of fund-level considerations that need to be analyzed, including (1) the private equity fund's investment mandate, (2) conflict of interest issues that may arise with respect to the various funds or accounts managed, (3) issues related to fund-level borrowings if leverage is to be utilized and (4) co-investor issues. A discussion of these issues is beyond the scope of the memorandum, but significant workplanning with respect to these issues may be required.

* * *

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Matthew W. Abbott
+1 (212) 373-3402
mabbott@paulweiss.com

Angelo Bonvino
+1 (212) 373-3570
abonvino@paulweiss.com

Kelley A. Cornish
+1-212-373-3493
kcornish@paulweiss.com

Gregory A. Ezring
+1 (212) 373-3458
gezring@paulweiss.com

Matthew Goldstein
+1 (212) 373-3970
mgoldstein@paulweiss.com

Kyle J. Kimpler
+1 (212) 373-3253
kkimpler@paulweiss.com

Austin Witt
+1 (212) 373-3181
awitt@paulweiss.com