Debt Buyback Considerations in Light of Covid-19

March 30, 2020

In light of recent market volatility resulting from the outbreak of coronavirus disease 2019 ("Covid-19"), responsive measures to address the pandemic, recent shocks in commodity markets and other related events, companies may be evaluating opportunities to repurchase their outstanding debt at significantly reduced prices. This memorandum provides a general overview of debt buybacks and certain considerations that companies should take into account when analyzing potential debt buyback opportunities.

POTENTIAL RESTRICTIONS ON DEBT BUYBACKS

As a threshold matter, a company contemplating a debt buyback should analyze whether the buyback is both advisable (e.g., from a liquidity perspective) and permissible (e.g., from a contractual compliance perspective). Review of company credit agreements, indentures and other relevant debt documents should be undertaken to ensure restrictive covenants (such as limitations on restricted payments or junior debt prepayments and, if applicable, passive holding company covenants) do not prohibit the contemplated debt buyback, particularly if the debt contemplated to be purchased is junior lien, unsecured or subordinated debt. In the case of loan buybacks, the governing credit agreement should be reviewed to determine if there are provisions that expressly permit the buyback. In the absence of such express permission, there may be technical provisions in the governing credit agreement that would operate to prohibit the buyback (e.g., assignment provisions that prohibit assignments to the borrower or its affiliates or ratable sharing provisions that require loan payments received from the borrower or its affiliates to be shared ratably among all lenders). Provisions relating to loan buybacks commonly appear in credit agreements with term loan B structures, but rarely appear in credit agreements with term loan A structures.

LOAN BUYBACKS

Types of Loan Buybacks

Provisions in credit agreements relating to loan buybacks will vary depending upon the entity that is purchasing the loans. In general, there are three categories of potential purchasers of loans:

- Borrower Buybacks: buybacks by the borrower and its restricted subsidiaries.
- Debt Fund Affiliate Buybacks: buybacks by affiliates of the borrower that are "bona fide debt funds" (i.e., entities that are primarily engaged in the extension of credit in the ordinary course of business and with respect to which neither the borrower nor any affiliate of the borrower exercises control over investment decisions) ("Debt Fund Affiliates").
- Non-Debt Fund Affiliate Buybacks: buybacks by affiliates of the borrower that are not Debt Fund Affiliates ("Non-Debt Fund Affiliates").

If the governing credit agreement has a "Holdings" entity that guarantees the obligations of the borrower, review of the credit agreement should be undertaken to determine if a buyback by that entity would be treated as a "borrower buyback" or as a "non-debt fund affiliate buyback". The same review should be undertaken in respect of buybacks contemplated to be made by unrestricted subsidiaries of the borrower.

Mechanics of Loan Buybacks

There are three primary mechanisms for effecting loan buybacks:

- Open Market Purchases: process in which loans are purchased as they become available in the secondary market on a non-pro rata basis; likely to involve smaller increments of loans and to be less costly than purchasing via a Dutch Auction.
- Open Market Purchase Programs Via Intermediary: process in which a third-party purchasing agent (typically a market maker in the loans, such as the administrative agent under the relevant credit agreement) is directed to purchase loans subject to pre-agreed pricing parameters for a set period of time, similar to a Rule 10b5-1 share repurchase plan. Once such a program is established, loans purchased by the purchasing agent pursuant to the program will be required to be repurchased from it by the borrower or other relevant purchaser. Depending on the particular circumstances, it may be the case that utilizing such a program (versus open market purchases without the use of an intermediary) could achieve more optimal pricing, as the identity of the ultimate purchaser of the loans is not generally disclosed to the loan market.
- Dutch Auction Purchases: process in which an offer to purchase a certain amount of loans within certain pricing parameters is submitted ratably to all lenders; after interested lenders submit their bids, the auction agent (typically the administrative agent under the relevant credit agreement) determines the applicable price (which typically will be the lowest price for which the purchaser can purchase the amount of loans subject to the offer) and the purchaser then purchases loans from each interested lender at such set price or, depending on the structure of the particular auction, such lender's bid price, if lower.

Considerations for Loan Buybacks

Companies contemplating loan buybacks should take into account certain considerations when analyzing potential loan buyback opportunities. The considerations typically vary depending upon the entity that is purchasing the loans.

Borrower Buybacks

- Cancellation of Principal: once purchased by the borrower or its restricted subsidiaries, the relevant loans will be extinguished and no longer remain outstanding; as such, the borrower or such subsidiary will not have any rights as a lender under the credit agreement.
- Impact on Scheduled Amortization: the governing credit agreement should be reviewed to determine if there are provisions that address the impact of the buyback on scheduled amortization (i.e., whether future scheduled amortization installments and the remaining bullet payment at maturity are to be reduced in forward order of maturity, reverse order of maturity or on a pro rata basis); many credit agreements will expressly address this issue and typically provide for pro rata reduction of scheduled amortization installments and the payment due at maturity. In the event that the credit agreement is silent on the issue, advice of counsel should be taken to determine the appropriate approach.
- Not a Voluntary Prepayment: the borrower buyback likely does not constitute a voluntary prepayment (and many credit agreements will state that expressly), unless the governing credit agreement expressly provides otherwise. This generally means that reduction of scheduled amortization installments in direct order of maturity is unlikely to be achievable with a loan buyback.
- Types of Loans: the governing credit agreement should be reviewed for restrictions on the types of loans that may be purchased by the borrower; most credit agreements limit borrower buybacks to term loans only.
- Impact on Leverage Ratios: the borrower buyback will have a direct effect on the borrower's leverage ratios through a reduction in the numerator equal to the full principal amount of the extinguished debt. In credit agreements that permit unlimited cash netting in the calculation of leverage ratios (i.e., the amount of debt included in the numerator is reduced by the amount of unrestricted cash of the borrower and its restricted subsidiaries), a benefit will still be achieved but would be more muted, as the net reduction to the numerator will be limited to the excess of the principal amount of the debt extinguished over the amount of cash expended in the buyback.
- Impact on Excess Cash Flow and Incremental Facility Capacity: the borrower buyback will have a direct effect through a deduction in the calculation of excess cash flow and, in many credit agreements, an increase in the

maximum permitted amount of incremental facilities. In each case, review of the governing credit agreement should be undertaken to determine whether the borrower would receive credit for the full principal amount of the debt extinguished or only the amount of cash expended in the buyback.

- Source of Funds: the governing credit agreement often will include a prohibition of the use of the borrower's revolver to fund loan buybacks; to the extent other long-term indebtedness is used to finance a loan buyback, the credit agreement may provide that the loan buyback will not be deducted in the determination of excess cash flow or will not increase the maximum permitted amount of incremental facilities.

Affiliate Buybacks

- No Cancellation of Principal and No Impact on Scheduled Amortization: loans purchased by an affiliate of the borrower will remain outstanding and will not affect scheduled amortization installments or the bullet payment at maturity, unless and until the loans are contributed to the borrower; once contributed to the borrower, the relevant loans will be extinguished and scheduled amortization installments and/or the bullet payment at maturity will be adjusted (see "Impact on Scheduled Amortization" under "Borrower Buybacks" above).

- Types of Loans: the governing credit agreement should be reviewed for restrictions on the types of loans that may be purchased by affiliates; the restrictions in many credit agreements vary depending upon the type of affiliate that is purchasing the loans:

  - Debt Fund Affiliates: buybacks are often permitted with respect to term loans or revolving loans and are typically not subject to a cap on the aggregate amount of loans that may be held by such affiliates (but see "Voting Rights" below).

  - Non-Debt Fund Affiliates: buybacks are typically limited to term loans only and are typically subject to a cap on the aggregate amount of term loans that may be held by such affiliates (commonly in the range of 25% to 35% of the aggregate outstanding amount of all term loans).

- Voting Rights: the governing credit agreement should be reviewed for restrictions on the voting rights of loans purchased by affiliates; the restrictions in many credit agreements vary depending upon the type of affiliate that is purchasing the loans:

  - Debt Fund Affiliates: voting limitations are generally less restrictive, but most credit agreements provide that Debt Fund Affiliates may not constitute more than 49.9% of the lenders for purposes of voting; as such, the majority of the consenting lenders in a required lender vote cannot be Debt Fund Affiliates.

  - Non-Debt Fund Affiliates: voting limitations are generally more restrictive and most credit agreements provide that loans held by Non-Debt Fund Affiliates either do not count at all for purposes of lender votes or are deemed to have been voted ratably with the votes of other lenders. Restrictions often apply in the bankruptcy context as well, and many credit agreements require the Non-Debt Fund Affiliate to grant a power of attorney to the administrative agent authorizing the administrative agent to vote on behalf of the Non-Debt Fund Affiliate in connection with bankruptcy proceedings. A common exception to the foregoing limitations exists for matters that would disproportionately and adversely affect the relevant Non-Debt Fund Affiliate, in which case the vote of such affiliate would be required. In addition to limitations on voting rights, a Non-Debt Fund Affiliate is typically not permitted to participate in lender-only meetings or receive certain lender-only communications.

- Impact on Leverage Ratios: the affiliate buyback will not have a direct effect on the borrower's leverage ratios, unless and until the loans are contributed to the borrower; once contributed to the borrower, the ensuing extinguishment of the loans will have a direct effect on such leverage ratios (see "Impact on Leverage Ratios" under "Borrower Buybacks" above).

- Impact on Excess Cash Flow and Incremental Facility Capacity: the affiliate buyback will not have a direct effect on the calculation of excess cash flow or the maximum permitted amount of incremental facilities under the governing credit agreement, unless and until the loans are contributed to the borrower; once contributed to the borrower, the ensuing extinguishment of the loans will, in many credit agreements, have a direct effect on the maximum permitted amount of incremental facilities but likely will not have any effect on the calculation of excess cash flow as the borrower did not expend any cash in connection with the buyback (see "Impact on Excess Cash Flow and Incremental Facility Capacity" under "Borrower Buybacks" above).

- Impact on Available Amount Basket: the affiliate buyback will not have a direct effect on any "Available Amount" basket contained in the governing credit agreement, unless and until the loans are contributed to the borrower; the contribution to the borrower will typically increase such an "Available Amount" basket, providing the borrower with a greater capacity to make investments, restricted payments or junior debt prepayments.

- Additional Equity Fund Considerations: while an in-depth discussion of such issues is beyond the scope of this memorandum, an equity fund contemplating the purchase of loans of a portfolio company should take into account applicable fund-level considerations, including, among other things, the permissibility of the loan buyback under the fund's constituent documents, possible conflicts of interest or fiduciary duty issues associated with the buyback and the potential impact on co-investors and other equity owners (including management) if the loans are ultimately intended to be contributed to the borrower.

Disclosure Considerations

Although bank loans are not securities for purposes of the Federal securities laws, companies should nonetheless be careful to take into account disclosure considerations to ensure compliance with relevant internal policies and external requirements. Most credit agreements today do not require the purchaser of loans (including the borrower) to make a "no-MNPI" representation that neither it nor any of its affiliates is in possession of material non-public information that has not been disclosed to other lenders. However, for its own protection, the purchasing agent in an intermediated open market purchase program may require the purchaser to make a no-MNPI representation. Further, if the borrower (or its parent) is an SEC reporting company, it should consider whether the plan to purchase outstanding loans may, in and of itself, be material information that subjects the borrower to Regulation FD. Disclosure considerations may also arise in respect of general anti-fraud principles, particularly when the purchaser is indirectly purchasing the loans through an intermediary (as in an intermediated open market purchase program) and the identity of the purchaser has not been made known to the selling lender by the intermediary.

BOND BUYBACKS

Mechanics of Bond Buybacks

- Cash Tender Offers: In a cash tender offer, an issuer offers to purchase all or a portion of one or more series of its bonds either at a fixed price, a variable price based on a spread to benchmark securities or a range of prices within which it solicits Dutch auction bids as to the price at which individual holders are willing to sell. Cash tender offers for non-convertible debt securities are primarily governed by Regulation 14E under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), whose chief requirements are that a tender offer (other than an abbreviated tender offer, discussed below) remain open for at least 20 business days (and at least 10 business days following a change in the amount of, or consideration for, the securities that are the subject of the tender offer). Cash tender offers for convertible debt securities also are subject to Regulation 14D under the Exchange Act.

  Issuers conducting a tender offer also may choose to simultaneously solicit consents to amend the indenture governing the bonds. These amendments usually eliminate covenants that may otherwise restrict the issuer if any bonds remain outstanding following the tender offer, and the consent is delivered substantially simultaneously with the delivery of the tendered bond (hence the commonly used term "exit consent").

- Abbreviated Tender Offers: A January 2015 SEC no-action letter reduced the minimum number of days that certain issuer self-tender offers for non-convertible debt securities must remain open (including following a change in the amount of, or consideration for, the securities that are the subject of the tender offer) to five business days. Tender offers must satisfy numerous criteria in order to qualify for this abbreviated timeline, including that they cover "any or all" of a class or series of non-convertible debt, be made for cash or other qualified debt securities, provide for certain withdrawal rights and not contain any solicitations for exit consents.

- Open Market and One-off Private Purchases: An issuer looking for greater flexibility in pricing or timing may repurchase its bonds on the open market using a broker-dealer, or in privately negotiated transactions. Any such repurchase program that is not conducted in compliance with the traditional requirements of Regulation 14E or the no-action letter described above must be structured to ensure that it is not inadvertently deemed to be a tender offer (often referred to as a "creeping tender offer"). Under SEC guidance, a tender offer is defined by certain key features, including active and widespread solicitation, a purchase price at a premium to the market price and/or pressure on the offerees to sell.

Considerations for Bond Buybacks

In addition to deciding whether to structure a bond buyback as a tender offer, an abbreviated tender offer or otherwise, issuers should evaluate the following considerations when analyzing potential bond buyback opportunities.

Antifraud Considerations

Cash tender offers are subject to the antifraud provisions of Section 14(e) of the Exchange Act, which provide that it is "unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer."

U.S. courts have consistently held that the antifraud provisions of Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder do not give rise to liability for "nondisclosure" (or withholding information) by a person transacting in securities – even if that person possesses material non-public information – absent a "duty to speak." Because the relationship between an issuer and holders of its debt securities is contractual, courts have consistently held that the issuer does not have a fiduciary duty to those holders and, therefore, does not have the duty to speak that would give rise to liability for non-disclosure.[1] Despite the settled law in this area, an issuer nevertheless will wish to consider whether it should repurchase its debt securities while in possession of material non-public information that would reasonably be expected to influence the trading price of those debt securities. Even if an aggrieved debt holder is unlikely to be able successfully to make a fraud claim under Rule 10b-5 in these circumstances, the cost of defending such a claim could be significant, a plaintiff may seek relief under state anti-fraud or other laws and the issuer may suffer reputational damage that could affect its future ability to access the credit markets and other potential adverse consequences.

To reduce these potential risks, an issuer generally has two options:

(1) ensure that it is not in possession of any material non-public information while engaging in the repurchases; or

(2) make repurchases pursuant to a written trading plan in accordance with Rule 10b5-1(c) (a "10b5-1 Plan").[2]

Black-Out Periods

Issuers' internal insider trading policies usually impose "black-out periods" during which insiders are prohibited from purchasing or selling issuer securities due to the increased likelihood that the insiders possess material non-public information with respect to upcoming results. These periods typically occur around the close of each fiscal quarter,

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[1] It is important to distinguish "non-disclosure" from affirmative misstatements. While an issuer may not have fiduciary duties to the holders of its debt securities, if it elects to speak, it must speak truthfully to avoid potential Rule 10b-5 liability.

[2] To qualify as a 10b5-1 Plan, a trading plan must:
- be adopted at a time when the issuer is not aware of any material non-public information;
- either specify the date, price and volume of securities to be purchased, include a written formula, algorithm or computer program to determine such parameters, or otherwise restrict the issuer's influence over the 10b5-1 Plan after adoption; and
- be entered into in good faith and not as part of a plan or scheme to evade liability under the securities laws.

An issuer currently considering the adoption of a 10b5-1 Plan to facilitate bond repurchases in light of Covid-19 should ensure that it does not possess material non-public information at the time of the 10b5-1 Plan's adoption, including with respect to the effect of the pandemic on the issuer's business or prospects. The SEC's Division of Corporation Finance underscored this point in guidance issued on March 25, 2020, which reminded issuers and their insiders to refrain from trading in an issuer's securities if they are in possession of material non-public information regarding the effects of Covid-19 on the issuer.

meaning that issuers with fiscal years ending December 31 currently may be in or nearing their black-out periods as they approach the end of the first fiscal quarter.

Issuers may be contemplating repurchases during their black-out periods. In connection with any determination to do so, an issuer in this situation should consider the anti-fraud considerations described above.

Effect on Voting

Following a repurchase, bonds are typically canceled unless there are tax or accounting benefits to holding them on the issuer's (or its affiliates') balance sheet. Further, most indentures provide that bonds held by the issuer or its affiliates are not "outstanding" for purposes of voting calculations.

Disclosure Considerations

An issuer must consider the overall materiality of the bond repurchase when deciding whether and to what extent advance disclosure would be appropriate. Factors to consider include the reduction in the trading volume of the bonds and whether the effect of the repurchase on the issuer's cash on hand and debt profile materially alter its financial condition and prospects. If required, disclosure can be made in current and period reports filed with the SEC—issuers typically refer to these plans in broad terms, indicating an intention to "from time to time" repurchase bonds using one or more methods as appropriate in light of then-prevailing market conditions and financial needs.

TAX CONSIDERATIONS

Companies considering debt buybacks should assess the tax consequences of a buyback. Although debt buybacks can raise a variety of tax issues, this discussion highlights two considerations that are frequently significant in connection with a buyback: cancellation of indebtedness income and interest deductibility. We also note certain statutory changes relevant to debt buybacks that have been implemented in response to Covid-19.

Cancellation of Indebtedness Income

In general, when a lender agrees to forgive any portion of a debt, the obligor will realize cancellation of indebtedness income ("CODI") to the extent of the debt forgiveness. Accordingly, if an obligor repurchases outstanding debt at a price less than its adjusted issue price, the repurchase will be treated as a partial forgiveness of the debt, and the obligor will generally have CODI in an amount equal to the excess of the debt's adjusted issue price over the repurchase price. An obligor will likewise have CODI if certain related parties acquire the obligor's debt at a discount. In limited circumstances, such as where the obligor has filed for bankruptcy or is otherwise insolvent, the obligor may reduce its tax attributes (such as NOLs) by the amount of any CODI in lieu of recognizing CODI in the current period.

Critically, the impact of the CODI rules is that a debt buyback may generate an upfront cash tax liability to the obligor even though the obligor will not have received any cash (and, indeed, will have paid cash) in the transaction.

In connection with a buyback by an affiliate of the obligor, if the debt remains outstanding after the repurchase, the obligor will be treated for tax purposes as having issued new debt to the related party with an issue price equal to the buyback price. Companies should consider the tax implications of having debt remain outstanding following a buyback, including the possibility of the "new" debt being issued with original issue discount and whether interest payments will become subject to withholding tax.

Interest Deductibility

Buybacks may reduce the amount of interest that is payable (and potentially deductible) by the obligor; the loss of the deduction may, in turn, increase the amount of cash taxes payable by the obligor. In estimating the potential tax cost of the foregone deduction, companies should consider whether the obligor's ability to deduct interest payments is currently, or in the future will be, subject to limitation.

Moreover, if repurchased debt remains outstanding following a debt buyback, interest deductions attributable to the debt may become subject to limitation. For instance, the tax benefit of deductions attributable to related party debt may effectively be disallowed as a result of the U.S. base erosion and anti-abuse tax, depending on the company's size and existing tax planning.

Statutory Changes

Congress has implemented statutory changes in response to Covid-19 that may affect the tax considerations relevant to debt buybacks. In particular, these changes loosen restrictions on the ability of companies to deduct interest payments and to use NOLs.

CONCLUDING THOUGHTS

Covid-19 increases the relevance of debt buybacks and companies contemplating debt buybacks should be careful to review the relevant debt documents, securities laws and tax regulations and to consider the implications of such buybacks, many of which may vary depending upon the entity that is purchasing the underlying debt.

Please feel free to contact us if we can provide further information on these matters.

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