FRIED FRANK

To Our Clients and Friends

Memorandum

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Navigating Discounted Debt Repurchases

As markets react to the Coronavirus Disease 2019 (COVID-19) pandemic, the trading prices of loans and notes have declined. In light of these developments, borrowers and their affiliates, including private equity sponsors, are considering whether to buy back outstanding debt at a discount. In analyzing the potential benefits and drawbacks of pursuing debt repurchases, borrowers and private equity sponsors should consider the following:

Outstanding Debt Documents

The provisions in debt documents that govern buybacks turn upon who is repurchasing the debt. There are three potential categories of debt purchasers: the issuer/borrower itself (or its subsidiaries); sponsor affiliates of the issuer/borrower who control the issuer by way of equity ownership and are not independent bona fide debt funds ("private equity sponsors"); and for some borrowers, sponsor affiliates who are bona fide debt funds that act independently of the private equity sponsor ("affiliated institutional lenders").

Indentures do not typically restrict an issuer's ability to repurchase the notes issued thereunder, but instead contain covenants restricting the repurchase or prepayment of other junior indebtedness. Furthermore, repurchased notes held by the issuer or an affiliate are not typically considered "outstanding" for purposes of voting, and do not count towards achieving requisite consent for an amendment.

Credit agreements typically contain express provisions permitting term loan repurchases. Credit agreements also typically restrict a borrower's ability to repurchase junior debt, which may consist of second lien or subordinated debt. In addition, U.S. credit agreements typically allow open market repurchases, while European credit agreements also allow for open market repurchases, but often only after a solicitation or open order process has been run. Because the repurchased loans must often be canceled once repurchased, there is typically no cap on the amount that the borrower or its subsidiaries can repurchase. Credit agreements often specify additional requirements, such as prohibiting the use of revolving loans or (in a European context) specifying certain prescribed sources to fund the repurchase, and no existing event of default.

On the other hand, if a private equity sponsor repurchases a borrower's term loan debt, such repurchase in a U.S. credit agreement is generally capped at a specified percentage of outstanding term loans (usually 25-30%). In both European and U.S. credit agreements, the private equity sponsor is generally not able to vote the repurchased loans, although there are some exceptions for matters disproportionately affecting it, and it is often not permitted to participate in lender-only meetings.

Affiliated Institutional Lenders are generally free to purchase and hold term loans under credit agreements, and may vote their loans to approve amendments or consents under the applicable credit agreement—however, in U.S. credit agreements where the affiliated institutional lender holds a majority of the outstanding indebtedness, its vote may be limited, as holders of loans approving any amendment or consent are often capped at 49.9%.

Credit agreements may contain additional contractual requirements, and the specific provisions of the applicable credit agreement should be reviewed prior to commencing any term loan buybacks. Financial covenant impact should be checked to ensure that any debt buyback will have the expected consequences.

Material Non-Public Information

Prior to commencing any repurchase of debt securities, a bond issuer or public company borrower should determine whether it has material non-public information ("MNPI"), such as unreleased financial results or an unannounced pending transaction. In addition, private equity sponsors considering a purchase of debt securities of a portfolio company face similar issues with respect to the MNPI they possess about the issuer. Expansive debt repurchases may be considered MNPI unto themselves; accordingly, bond issuers, public company borrowers and private equity sponsors should review their own insider trading policies, including those regarding trading windows.

If an issuer intends to repurchase debt in a manner that requires disclosure, there are several ways to make the required disclosure. Most obviously, an issuer can issue a press release announcing the debt repurchase and, in the case of a company that publicly reports to the Securities and Exchange Commission (the "SEC"), furnish or file a Form 8-K with the SEC. Otherwise, more generic disclosure could be included in a broad statement of intention in a regular periodic report.

While some U.S. credit agreements expressly provide that the purchaser of term loans is not required to make any representation regarding MNPI, and the securities laws only apply to repurchases of debt securities (i.e., bonds but not term loans), general anti-fraud principles may still apply to loan buybacks, and borrowers and private equity sponsors may choose not to proceed with loan repurchases while in possession of MNPI.

Creeping Tender Offers

When considering a repurchase of bonds, issuers should be wary of inadvertently commencing a tender offer under federal securities laws, as tender offers are subject to documentary and regulatory requirements. While case law supports a view that repurchases of debt securities solely through ordinary open market transactions generally should not implicate the tender offer rules, in situations where the issuer is engaged in active solicitations or negotiations to purchase bonds, issuers or their private equity sponsors should consider the following factors in order to avoid a debt repurchase being characterized as a tender offer:

- Timing: Avoid set time periods or deadlines in connection with negotiations; instead, make repurchases over a reasonable period of time, taking the circumstances into account.
- Number of Solicited Sellers: Limit the number of potential sellers solicited (fewer is better).
- Variable Prices and Terms: Purchase from multiple sellers, and negotiate prices on an individual basis and on different terms (more variation in price and terms is better).

- Nature of Sellers: Limit purchases to only those from sophisticated institutional investors.
- Character of Offer to Purchase: Avoid making "take it or leave it" offers, offers conditioned on other purchases, offers open for very short periods before being rescinded or other offers that potentially apply pressure on sellers to sell their bonds.

Private Equity Sponsor Concerns

Private equity sponsors should carefully consider their own internal fund documents and any applicable stockholder or other agreements in order to make sure there are no restrictions or limitations on the purchase of debt of their portfolio companies. They should also consider any required public disclosure related to such purchases, and assess the potential conflicts of interest that may arise due to affiliated or related funds of such private equity sponsor.

Where applicable, under the corporate opportunity doctrine, directors, officers and equity owners may not usurp corporate opportunities from the company for their own benefit. Repurchasing discounted debt may be viewed as a corporate opportunity that should not be usurped by the company's private equity sponsor. The board of a company should, as a general matter, be informed of any potential debt repurchases. Private equity sponsors may ask the company to formally consider the buyback, and formally decline to proceed. The decision to formally decline the debt repurchase opportunity is best made by directors of the portfolio company who are independent of the private equity sponsor.

A private equity sponsor's purchases of a portfolio company's debt can give rise to issues regarding corporate governance, particularly if the company is distressed. If the interests of equityholders and debtholders are at odds regarding a distressed company's potential course of action, private equity sponsor directors may be unable to participate in decision-making if the private equity sponsor is a creditor of the portfolio company.

In addition, private equity sponsors face potential risks of equitable subordination in the event of bankruptcy of the portfolio company, where a bankruptcy court can exercise equitable jurisdiction to subordinate the claims of the private equity sponsor to those of third-party creditors. However, as equitable subordination claims in the United States require the purchaser to have engaged in inequitable conduct that injured the other creditors, this risk can be mitigated by keeping any transaction in portfolio company debt at arm's length, not trading on MNPI and ensuring that the purchase is not usurpation of a corporate opportunity. Equitable subordination can also be a concern in other jurisdictions, so it will need to be considered where necessary in the relevant jurisdiction of the borrower/issuer.

Private equity sponsors that purchase bonds should also understand the limitations on resale that they may encounter as affiliates of the company. Most notably, during any three-month period, no more than 10% of the principal amount of a particular tranche of securities may be resold by an affiliate and a Form 144 will be required if the amount sold in any three-month period exceeds 5,000 shares or other units or has an aggregate sale price in excess of $50,000.

Certain Tax Considerations

Debt repurchases can have significant tax implications for both issuers and purchasers.

In the United States, debt repurchased by the issuer at a discount will generally cause the issuer to recognize cancellation of indebtedness income ("CODI") that is taxable as ordinary income for federal income tax purposes. The amount of CODI is generally equal to the difference between (i) the principal amount of the debt (or the adjusted issue price of the debt, in the case of debt originally issued at a discount) and (ii) the repurchase price. If the issuer is a corporation (or is treated as a corporation for federal income tax purposes), the CODI generally will result in a current cash tax liability unless the corporation has net operating losses ("NOLs") or certain other tax attributes to wholly or partially offset the CODI. If the issuer is a partnership (or is treated as a partnership for federal income tax purposes), the CODI generally will flow through as taxable income to the partners.[1]

If debt is purchased by a person that is "related" to the issuer (which, for these purposes, generally means greater than 50% common ownership as determined after the application of complex constructive ownership rules, which can sometimes lead to surprising results), including a "related" private equity fund or sponsor, the debt is treated as retired and then reissued as "new" debt, with an issue price equal to the related person's purchase price. The issuer will generally be required to recognize CODI to the same extent as if it had repurchased the debt itself. The "new" debt between the issuer and the related debtholder will have original issue discount ("OID") that is generally equal to the difference between its principal amount and the related debtholder's purchase price. Where these rules apply, and the repurchase generates a material amount of CODI, the OID on the "new" debt generally will also be material. Debt that is repurchased within one year of its stated maturity date is not treated as retired and reissued under these rules, provided that the debt is actually retired by the issuer on or before its stated maturity date.

It should be noted that, while the issuer will deduct the OID, and the related debtholder will include the OID in income as interest income, over the remaining term of the debt, the deductibility of interest and OID may be subject to limitations, and in some cases may be deferred or disallowed.[2] As a result of these limitations, the CODI that the issuer would be required to recognize at the time of the debt purchase may exceed the OID deductions that would become available to the issuer over the remaining term of the debt.

Non-U.S. investors may be subject to a 30% federal withholding tax on payments of interest and OID, because the portfolio interest exemption may not be available. In addition, because the repurchased debt is treated as "new" debt that has been issued with OID, it may not be fungible for federal income tax purposes with the other outstanding debt of the same class (with which it was previously fungible) and, as a result, the repurchased debt may need a separate CUSIP. This could affect the marketability or liquidity of the purchased debt, as well as the other outstanding debt of the same class and the pricing of incremental issuances of debt.

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1 In certain circumstances, an issuer may exclude CODI from its gross income, although these circumstances are unlikely to be relevant in the context of debt repurchases by a portfolio company or private equity fund or sponsor. For example, an issuer that is insolvent or in bankruptcy may exclude CODI from its gross income, subject to a write-down of the issuer's tax attributes (such as NOLs, tax credits, capital losses, and asset basis). In the case of an issuer that is a partnership (or is treated as a partnership for federal income tax purposes), the insolvency and bankruptcy exclusions apply only where the partner is insolvent or bankrupt. Another exclusion applies to CODI from a discharge of qualified real property business indebtedness of an issuer (other than a C corporation), subject to certain limitations and requirements (including a requirement to reduce the basis of depreciable real property by the amount of the CODI).

2 These provisions include U.S. Federal Income Tax Code Section 163(j), which limits deductions for business interest expense to a fixed percentage of a borrower's adjusted taxable income, Section 163(e)(3), which defers deductions for OID on debt held by a related foreign person until paid and Section 163(e)(5), which disallows deductions for OID on certain high yield debt that is issued at a discount.

In certain circumstances, it may be possible to manage or avoid the company-level and debtholder-level issues described above by strategically structuring the debt repurchase transaction. For example, if the debt is purchased by a person that is not "related" to the issuer (as discussed above), the debt will generally not be treated as retired and reissued, and the issuer will generally not be required to recognize CODI for federal income tax purposes. However, the debtholder will generally be subject to the "market discount" rules that can convert all or a portion of the debtholder's gain on the debt into ordinary income upon a future sale, repayment or other disposition of the debt. Debt that is purchased by a person that is not related to the issuer at the time of the purchase may, in certain circumstances, become subject to the related party rules discussed above if the debtholder subsequently becomes related to the issuer.

The Coronavirus Aid, Relief, and Economic Security Act, which was signed into law on March 27, 2020, contains certain provisions that are expected to benefit issuers that repurchase their own debt or whose debt is purchased by related persons. The legislation permits issuers that have NOLs to fully offset taxable income, including CODI, in taxable years beginning before January 1, 2021 to the extent of their NOLs, and to elect to carry back any unused NOLs generated in 2018, 2019 or 2020 to the prior five taxable years. In addition, the legislation expands the deductibility of business interest (and OID) for the 2019 taxable year (for corporations, but not partnerships) and the 2020 taxable year (for all entities), by increasing the cap on deductible business interest from 30% of "adjusted taxable income" ("ATI," which is similar to EBITDA) to 50% of ATI, and by allowing a company to elect to use its 2019 ATI to compute its 2020 business interest deduction, benefiting companies with reduced ATI in 2020.

There will be similar tax considerations to be borne in mind in other relevant jurisdictions of any particular borrower/issuer.

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Authors:

Lee T. Barnum

Neil Caddy

Kathryn Cecil

Ryan L. Conley

Joseph E. Fox

Jons F. Lehmann

Meredith L. Mackey

Hana Nah

J. Christian Nahr

Alexander J. Panisch

Carole J. Rosenberg

Ezra Schneck

Eli Weiss

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents. If you have any questions about the contents of this memorandum, please call your regular Fried Frank contact or an attorney listed below:

Contacts:

London

Neil Caddy	+44.20.7972.9675	neil.caddy@friedfrank.com
Kathryn Cecil	+44.20.7972.9624	kathryn.cecil@friedfrank.com
Jons F. Lehmann	+44.20.7972.9149	Jons.lehmann@friedfrank.com
Ashar Qureshi	+44.20.7972.9173	ashar.qureshi@friedfrank.com
John Satory	+44.20.7972.9210	john.satory@friedfrank.com

New York

Andrew B. Barkan	+1.212.859.8468	andrew.barkan@friedfrank.com
Lee T. Barnum	+1.212.859.8883	lee.barnum@friedfrank.com
Daniel J. Bursky	+1.212.859.8428	daniel.bursky@friedfrank.com
Joshua T. Coleman	+1.212.859.8633	joshua.coleman@friedfrank.com
Mark S. Hayek	+1.212.859.8890	mark.hayek@friedfrank.com
Meredith L. Mackey	+1.212.859.8974	meredith.mackey@friedfrank.com
Joshua D. Roth (Co-Head)	+1.212.859.8035	joshua.roth@friedfrank.com
Ezra Schneck	+1.212.859.8764	ezra.schneck@friedfrank.com
Joshua Wechsler	+1.212.859.8689	joshua.wechsler@friedfrank.com
Gail Weinstein (Co-Head)	+1.212.859.8031	gail.weinstein@friedfrank.com
Steven M. Witzel (Co-Head)	+1.212.859.8592	steven.witzel@friedfrank.com
Jennifer A. Yashar (Co-Head)	+1.212.859.8410	jennifer.yashar@friedfrank.com

Washington, DC

Stuart A. Barr	+1.202.639.7486	stuart.barr@friedfrank.com