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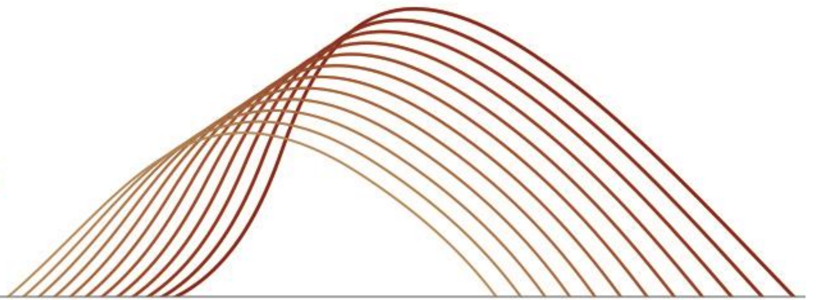

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Debt Buy-backs In a COVID-19 World

By Andrés Mena, Richard Radnay, Michael Rosella, Ira Kustin & Jim Smulkowski

The current loan market conditions present a challenge and an opportunity for debt investors, borrowers, and private equity sponsors alike.

Market data shows loans generally trading at levels significantly below par. The average bid price for single B term loans was at 78 (as of March 23, 2020), down a full 20 points from 30 days ago.[1] Year-to-date returns for single B term loans are at -26.30%.[2]

While the ability of a borrower (or its owners) to purchase its own debt is restricted (and sometimes prohibited) by the underlying credit agreements, those agreements often provide for debt buy-back mechanics. Those mechanics allow a borrower to "buy-back", at market prices rather than at par, loans held by its lenders under certain circumstances, and subject to specific restrictions (including caps as to amounts of loans that may be held by the borrower and its affiliates and as to voting rights for those loans). With similar restrictions, credit agreements also can provide for the ability for entities affiliated with a private equity owner of the borrower to buy those loans in open market transactions (typically referred to as "sponsor buy-backs").

The mechanics to execute these borrower and sponsor buy-backs, and the effects those purchases have on the financings, vary from deal to deal. But at their core, they allow a borrower or a private equity sponsor to capture the value resulting from the below-par trading price of loans. A borrower sees that value crystalize immediately because its obligations as a debtor of the loans are discharged at the par value of the purchased loan. A private equity sponsor gets to double-down on its investment because of the incremental exposure to the upside (and downside) of the loans.

Powerful Incentives for Lenders to Like Debt Buy-backs

Volatile markets create challenges of liquidity, valuation and credit risk. Debt investors may need and benefit from more sources of liquidity during these times. Debt buy-backs may align incentives to provide that liquidity.

Many of these lenders in the market are Business Development Companies ("BDCs"). Certain BDCs provide small- and medium-size companies with additional access to capital.

BDCs voluntarily elect to be treated as such under the Investment Company Act of 1940 ("1940 Act") and are thus subject to certain provisions of the 1940 Act. Among other things, the 1940 Act imposes a requirement that a BDC must maintain asset coverage (the ratio of assets to borrowings, whether through indebtedness or preferred stock) of 200%. However, recent statutory revisions allow a BDC to take certain actions to reduce its statutory asset coverage ratio from 200% to 150%. Failing to meet

the applicable asset coverage requirements may result in a BDC not being able to declare dividends and pay distributions to its common equity holders.

Further, BDCs can also raise debt financings of their own, secured with portfolios of loans made by the BDC. Known as "Net-Asset-Value facilities" or "NAV facilities," these financings use borrowing base calculations and financial covenants depending, among other things, on the value of the underlying portfolios.

In many cases BDCs may agree to other asset coverage limitations in connection with their borrowings, whether through preferred stock issuances, NAV facilities, or other forms of indebtedness. Agreements governing these transactions may impose limitations that go beyond the requirements of the 1940 Act.

The downward pressure on loan prices may put stress on a BDC's ability to meet its statutory and contractual asset coverage limitations. Debt buy-backs may provide a welcomed source of liquidity for these BDCs.

Borrowers and Sponsors May Want to Use Debt Buy-Backs to Address Their Capital Structure Needs

Borrowers with sufficient cash will be in the unusual situation of being able to deleverage their balance sheet by benefiting from the additional value resulting from purchasing (i.e., prepaying) their debt at a discount.

Sponsors owning distressed companies and considering injecting capital into them are likely to consider alternative structures. For example, confronted with the need of curing a financial covenant breach by a portfolio company, a sponsor could pursue structuring a capital infusion that benefits from debt buy-backs. These capital infusions could be structured as common equity, preferred stock, or as debt for borrowed money, so as to provide the sponsor with the appropriate returns for the risks taken. As discussed above, lenders may be interested in discussing creative alternatives that go beyond the prebaked contractual terms.

In addition, debt may even be purchased in a company that has performed strongly—the debt can be purchased at a discount, held and then possibly resold at a higher price. In the current environment, it does not matter whether the underlying businesses have performed well, as loans are likely to trade at a discount, providing yield from interest payments in the interim until the debt is paid off or resold.

Structuring Considerations Based on Fund Governance Issues

Sponsors of private equity funds or similar private investment vehicles wanting to engage in these types of transactions will need to ensure that such a buy-back would be permitted by the fund's governing documents, including any side letters agreed to with investors. Such a transaction would need to be consistent with any investment restrictions in place with respect to the types of investments in which the fund can invest and any limits on the size of individual investments. Fund sponsors should also work with counsel if necessary to ensure compliance with any regulatory requirements. For example, if these transactions would constitute a principal transaction under the Investment Advisers Act of 1940, appropriate consent would need to be sought from investors. And if such a buy-back presents the potential for conflicts of interest for the sponsor and/or its affiliates (for example, other vehicles advised by the sponsor) the relevant fund documents should include disclosure of such conflicts.

Tax Implications

The purchase by a borrower of its debt at a discount has the potential to create cancellation of debt income for the borrower based on the excess of the amount of the debt over the amount paid for it by the borrower. Depending on the borrower's structure and tax attributes, such as net operating losses, and whether the borrower is considered solvent for tax purposes, there may be opportunities to avoid or minimize any such income. The debt cancellation rules can also apply when a related party purchases debt at a discount (e.g., a sponsor forms a vehicle to purchase the debt of a portfolio company). Such related party purchases can also create an Original Issue Discount ("OID") on the debt instrument. An OID can be beneficial to borrowers because it results in interest expense for tax purposes, but can be detrimental to holders of debt instruments because it creates current interest income for tax purposes.

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

Chicago

Richard S. Radnay
1.312.499.6047
richardradnay@paulhastings.com

Ziemowit T. Smulkowski
1.312.499.6056
ziemowitsmulkowski@paulhastings.com

New York

Ira Kustin
1.212.318.6094
irakustin@paulhastings.com

Andrés C. Mena
1.212.318.6740
andresmena@paulhastings.com

Michael R. Rosella
1.212.318.6800
mikerosella@paulhastings.com

[1] *See* Credit Suisse Leverage Loan Index March 24, 2020.

[2] *See* Credit Suisse Leverage Loan Index March 24, 2020.

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