Update

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Credit Market Turmoil and Stimulus Package Bolster U.S. Loan Buybacks

The credit crisis that began in August of 2007 and intensified with Lehman Brothers' September 2008 bankruptcy continues largely unabated in U.S. loan markets in early 2009.[1] Many bank loans, particularly leveraged loans, continue to trade at a significant discount to par in illiquid secondary markets. Borrowers have begun sensing opportunity.

It is estimated that more than 25 U.S. companies have attempted buybacks of their bank loans in the last year or so. Given the challenges posed by the recession and the current premium placed on liquidity preservation, not every borrower has (or will be comfortable deploying) the resources necessary to buy back its loans. For those able to do so, however, the benefits can include the monetization of a significant trading discount to par, as well as a reduction in leverage and interest cost, which may ease ongoing compliance with ratio covenants.

What's more, *The American Recovery and Reinvestment Act of 2009*, the stimulus package signed into law by U.S. President Obama on February 17, 2009, may soften the negative tax consequences of certain loan buybacks[2] by potentially allowing borrowers to elect to defer, until their 2014 – 2018 tax years, the recognition of taxable "cancellation of debt" income arising on buybacks occurring in 2009 or 2010.

GENERAL STRUCTURE AND SOURCE OF FUNDS FOR LOAN BUYBACKS

Bank loan repurchases are generally structured as either an assignment of loans by, or a non-pro rata prepayment of the loans of, exiting lenders. In transactions involving assignments, the entity purchasing the loans (i.e. the assignee) will be the borrower, a subsidiary or another affiliate, such as a private equity sponsor[3]. In transactions involving non-pro rata prepayments, sponsors can often contribute the necessary repurchase funds in the form of additional equity or subordinated debt. Borrowers must obviously bear in

1 By contrast, January and February of 2009 were the most active months for investment-grade corporate-bond issuance by U.S. companies since 1995. (Wall Street Journal, "*This Debt Boom Marked by Caution*", March 3, 2009.) Unfortunately, sentiment had deteriorated at the time of writing, following what appeared to be the beginning of a thawing in U.S. credit markets earlier in 2009. (Wall Street Journal, "*New Fears as Credit Markets Tighten Up*", March 9, 2009.)

2 The stimulus package's deferral of COD income also extends to buybacks of different types of debt, such as public bonds. These are not addressed in this article.

3 Private equity-sponsored borrowers are often viewed as prime candidates for debt buybacks, given that the trading price of their debt is often among the most deeply discounted in secondary markets. Where the sponsor purchases and holds the debt, the transaction can provide equity-like returns taking into account monetized discount and interest.

mind the need to avoid mandatory prepayment provisions that might be triggered by such contributions, or by asset sales the borrower wishes to effect to fund the buyback. In many cases, the existence of such provisions will mean a buyback by a borrower or a subsidiary would need to be funded with cash already in the borrower's or subsidiary's possession. This may instead argue in favor of the sponsor or another affiliate effecting the buyback directly.

PROVISIONS TO CONSIDER IN CREDIT AGREEMENTS

Most U.S. credit agreements[4] do not specifically address loan repurchases but, nevertheless, effectively require lender consent to such transactions. This is because most bank loan repurchases will violate one or more of the relevant credit agreement's pro rata payment, sharing or assignment provisions.

- Pro rata payment and sharing provisions are typically drafted to require repayments of the loans to be made to the lenders on a pro rata basis and to obligate any lender receiving repayments of the loans in excess of its pro rata portion to share the excess with the other lenders. If a buyback were to violate the sharing provision, a lender could be required to share the proceeds it receives with the other lenders (which is obviously not the desired result).

- Assignment provisions often prohibit assignments to the borrower or its affiliates[5], or limit eligible assignees to financial institutions which are in the business of making or holding loans (a standard the borrower and its affiliates are unlikely to meet). In addition, the consent of the administrative agent is often required for assignments.

There may very well be other contractual provisions to consider, such as a first lien credit agreement's restriction on repurchases or prepayments of loans under a second lien credit agreement; financial covenants; and prepayment obligations. If the loans are prepaid by the borrower on a non-pro rata basis, they will no longer be picked up as "debt", thereby providing immediate relief under leverage ratio calculations and other financial covenants. Reduced leverage resulting from the buyback may, in turn, affect the pricing of the loans or the borrower's capacity to make capital expenditures. Excess cash flow prepayment provisions will need to be analyzed to ensure that amounts used to repurchase the loans are excluded from excess cash flow – i.e., that the borrower is not obligated to prepay its remaining loans with cash already used to effect a buyback. If the loans are purchased by an affiliate and (as described below) subordinated, it will be necessary to address the treatment of the outstanding affiliate loans under the different provisions of the credit agreement. For instance, amortization and mandatory prepayment provisions will need to be reviewed to determine how amounts otherwise payable to the affiliate lenders should be treated. In addition, the loans held by the affiliate lenders may need be carved out of leverage ratio covenants. Each credit agreement is different and must be carefully reviewed.

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4 This may change in the future. At the time of writing, the Loan Syndication and Trading Association (LSTA) was said to be considering the creation of model loan repurchase provisions for incorporation into U.S. credit agreements.

5 Occasionally, "Affiliate" definitions will pick up persons taking direction from, or acting in concert with, the borrower or its affiliates. This would tend to chill "creative" solutions to affiliate assignment prohibitions, such as where two unaffiliated sponsors each agree to repurchase the debt of the other's portfolio company.

MAJORITY VERSUS UNANIMOUS LENDER CONSENT

Because most U.S. bank loan repurchases will violate the relevant credit agreement's pro rata payment, sharing, assignment or other contractual provisions, such a transaction will necessarily involve an amendment to the credit agreement[6]. The question then becomes whether all lenders, or only those holding a requisite majority (typically, more than 50%, although occasionally, more than 66²/3%) of the outstanding principal amount of the loans, must consent to the amendment. Since unanimous lender consent is generally extremely difficult to obtain (except potentially in the context of club deals), borrowers often seek to structure buybacks so as to require only requisite majority lender consent. Pro-rata payment and sharing provisions are often, although not always, unanimous lender consent provisions and would generally be violated by a direct repurchase of loans by the borrower. In such instances, repurchases are effected by affiliate assignments since these generally[7] do not violate a credit agreement's pro rata payment or sharing provisions (particularly if the loans are not immediately extinguished) and amendments to assignment provisions to allow such repurchases usually only require requisite majority lender consent.[8]

WHAT HAPPENS TO THE REPURCHASED LOANS? WHICH ENTITY EFFECTS THEIR REPURCHASE?

Repurchased loans are generally either extinguished or deeply subordinated. The question of what happens to the repurchased loans, as well the choice of which of entity (i.e. the borrower, a subsidiary, the sponsor or another affiliate) will repurchase them, is a function of a number of factors. These include the effect under financial covenants, tax considerations, the borrower's desire to avoid the need for unanimous (rather than requisite majority) lender consent, and the quid pro quos demanded by lenders in exchange for their consent.

WHAT ARE THE LENDERS' QUID PRO QUOS? WHAT'S IN IT FOR THEM?

Lenders often seek quid pro quos for consenting to buyback-related amendments. These can include removal of the repurchasing entity's right to vote the repurchased loans, consent fees, and (as described above) subordination of the repurchased loans (to the extent not extinguished). Lenders may require that the repurchased loans be amended to pay interest in kind rather than in cash. In second lien financings, lenders may require that the maturity of any repurchased first lien loans be extended to match that of the second lien loans and that the "creditor" rights attaching to the repurchased

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6 By contrast, in the United Kingdom, syndicated bank debt repurchases have been effected under the London Loan Markets Association (LMA)'s standard form credit agreement without lender consent (i.e. without an amendment), based on pro rata payment, sharing and assignment provisions different than those commonly found in U.S. credit agreements. This result is contrary to the expectations of many market participants and has led the LMA to revise its standard form credit agreement to include alternative provisions permitting the parties to specifically address loan repurchases.

7 Occasionally, the pro rata payment provisions will also expressly apply to proceeds received from a sale to an affiliate of the borrower.

8 Note however that affiliate purchases can, in certain circumstances, give rise to the risk of equitable subordination, i.e. the risk that the debt acquired by the affiliate is subordinated in a bankruptcy of the borrower to the claims of other creditors of the borrower.

loans be "silenced" even more significantly than in the typical first lien/second lien intercreditor agreement. In addition, lenders may require that the amendment restrict the borrower's use of revolver or asset sale proceeds to fund the buyback. They will also want comfort that all material information about the borrower and its business has been disclosed to them and that the buyback process is being conducted in a fair and transparent manner.

Where lenders have demonstrated a willingness to consent to buyback-related amendments, it is often because the price to be paid by the borrower or its affiliate to repurchase the loans, while still at a discount to par, is in excess of the price at which the loans are trading in the secondary markets. In addition, lenders generally favor the reduction in borrower leverage and interest cost, and the secondary market trading support, that result from buybacks.

PROCEDURAL MATTERS

Buybacks are generally structured in one of two ways: either as an offer at a single price, or as a reverse or modified Dutch auction with a range of acceptable prices. Where Dutch auctions are involved, these usually take place over a period from 90 days up to one year. It is of note that not all initiated loan buybacks succeed; indeed, a number of early attempts failed even where only requisite majority lender consent was required, although borrowers have been more successful in obtaining lender consent and take-up in recent months. In some failed attempts, lenders were suspicious of borrower motives, believing that borrowers were seeking to avoid future defaults rather that acting opportunistically to take advantage of low trading prices. Significant thought must be given to how best to approach lenders, and what to offer to them in exchange for their consent, in order to maximize the likelihood of lender consent and take-up. In many cases, the administrative agent will be engaged to coordinate the buyback, often in exchange for a fee and indemnity from the borrower.

For public companies, it is also of note that loan repurchases may need to be publicly-disclosed (since the mere fact that a repurchase is to be undertaken may constitute material non-public information). Finally, borrowers must consider whether they have made full disclosure of material information to their lenders, lest borrowers face potential liability for buying back their loans on an unfair basis.

TAX PROVISIONS IN THE U.S. STIMULUS PACKAGE AND OTHER TAX CONSIDERATIONS

Broadly speaking, a loan buyback by a borrower for less than the amount owed generally results in the borrower recognizing "cancellation of debt" (COD) income equal to the outstanding principal amount of the repurchased debt plus accrued interest less its repurchase price. The concept of COD income reflects the notion that, if a borrower satisfies a debt for less than the amount owed, the borrower has economically benefited in a way that is equivalent to earning additional income. To avoid circumvention of these

rules, a borrower will also generally recognize COD income if a person *related* to the borrower (which may include a sponsor or another affiliate) acquires the debt at a discount. In such a case, there is said to be a "deemed" repurchase of the debt by the borrower – i.e., the debt is generally treated as having been acquired by the borrower for the price paid by the related person and deemed reissued to the related person for the same price.

The potential recognition of COD income by the borrower on a direct or related-party loan buyback could be prohibitive. Fortunately, the U.S. stimulus package provides some relief by generally allowing a borrower, subject to certain exceptions, to elect to defer including COD income resulting from a debt repurchase (or deemed debt repurchase) occurring in 2009 or 2010. Instead of recognizing COD income currently, an electing borrower will generally include the COD income rateably over the borrower's 2014 tax year and its next four tax years.[9] Such a deferral could materially lessen the tax cost of a loan buyback.

In addition, if a related person repurchases debt for less than the amount owed and the debt is not extinguished, the repurchased debt will generally be deemed reissued with "original issue discount" (OID) that may give rise to OID deductions for the borrower and corresponding income inclusions for the debt holder. These OID deductions may be available to offset, over time, some or all of the COD income recognized by the borrower on the debt repurchase, subject to some potentially significant limitations[10]. Borrowers electing to defer COD income must also defer OID deductions attributable to the repurchased debt, up to the amount of the COD income.

Notwithstanding these potential offsets to COD income, the tax consequences of any loan buyback must be carefully analyzed. Among other areas of inquiry, particular focus must be given to whether direct or indirect changes made to the borrower's outstanding debt (including amendments to permit the loan buyback, other covenant amendments, or even changes in payment expectations on outstanding debt resulting from a subordination or extinguishment of repurchased debt) could give rise to additional COD income from a deemed re-issuance of the outstanding debt for U.S. federal income tax purposes. Accordingly, companies considering a loan buyback are urged to consult their tax advisers.

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9 For a more detailed explanation of the tax provisions in the U.S. stimulus package, see the Osler Update of February 18, 2009.

10 These potentially significant limitations on the deductibility of OID include the earnings stripping rules (restricting the deductibility of interest paid to or guaranteed by related foreign persons), rules that defer deductions on interest (including OID) accrued to related foreign persons until actually paid and the applicable high yield debt obligation (AHYDO) rules (restricting the deductibility of interest paid on obligations with a maturity of more than five years that have a high yield and significant OID). The stimulus package has provided relief from the AHYDO rules in the case of certain AHYDO instruments created as a result of debt restructurings in 2008 and 2009, but this relief does not apply to related party debt.

Given the continuing credit market turmoil and the depressed prices at which many loans are trading in the secondary markets, U.S. borrowers with sufficient resources are likely to continue to actively pursue repurchases of their loans - all the more so given the deferral of COD income potentially available under the U.S. stimulus package.

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