

Memorandum

Open Market Debt Repurchases – Key Considerations

March 17, 2020

With the COVID-19 pandemic and the recent dislocations in the energy markets, many entities are experiencing significant declines in the trading value of their debt securities and bank loans. This memorandum is intended to provide a summary of key considerations under U.S. law that should be addressed by borrowers, issuers, financial sponsors and other parties contemplating the repurchase of debt securities or loans. The issues are complex and each situation is fact specific, requiring a careful analysis of the underlying debt agreements, relevant securities laws, tax regulations, bankruptcy implications, corporate governance considerations, covenant compliance and, in certain cases, the agreements that govern the activities of funds established by financial sponsors, as well as potential litigation risks.

Material Non-Public Information (MNPI); Blackout Periods

- Notes/bonds are securities subject to U.S. federal securities laws and accordingly issuers, financial sponsors and other potential purchasers should carefully consider with counsel whether they are in possession of MNPI regarding the issuer, such as an impending debt financing, broader debt restructuring, equity infusion or unexpectedly positive financial results.
 - While bank loans are not typically subject to U.S. securities laws, fraud claims could be brought if the purchaser is aware of potentially market-moving information, and LSTA guidelines generally recommend against trading on confidential information unless the counterparty is reasonably believed to be in possession of, or have access to, such confidential information.
 - Consideration should be given as to whether a debt repurchase is of such a significant magnitude that the repurchase is, in itself, MNPI.
 - In this regard, if a borrower/issuer has not already done so, consider adding disclosure to its periodic filings (typically in the Liquidity portion of the MD&A section) regarding the potential for future debt repurchases by the borrower/issuer or an affiliate (including sponsors) in advance of such activities to alleviate potential MNPI issues.
 - Blackout periods and other internal securities trading policies should be considered in connection with potential debt repurchases, even if the purchaser, including an affiliate, is not covered by the policy.
 - Issuers and sponsors may consider establishing a 10b5-1 trading plan to manage purchases of debt securities and related MNPI issues.

- Potential equitable subordination issues are discussed below under the heading “*Certain Bankruptcy Considerations for Purchases by Sponsors and Affiliates*”.
- Non-disclosure agreements, wall cross procedures and “big boy” letters (in which parties disclaim reliance on their counterparties) may be considered of use where appropriate to address MNPI issues and non-reliance, but such arrangements are not foolproof and may also require cleansing disclosure.
- The MNPI and blackout period analyses discussed above should be refreshed in connection with each subsequent prospective trade.

General Debt Agreement Issues

- Debt held by the issuer or an affiliate of the borrower/issuer is often subject to limitations on voting, which should be reviewed in the context of any debt repurchase.
 - The effects of these voting limitations should also be considered in the context of a blocking vote in a potential future restructuring or bankruptcy.
- Purchases by a borrower/issuer must also be permitted under relevant covenants in any applicable debt agreements. For example, a repurchase of junior lien secured, unsecured and/or subordinated debt is sometimes restricted in secured debt agreements or there may be a limitation on the use of revolver borrowings (though cash is fungible).

Notes/Bonds

- Notes held by an issuer are often not permitted to participate in any vote, waiver or consent from holders (e.g., waiver of an event of default or amendment).
- Tender Offer Rules
 - Extensive repurchases of notes/bonds (based on number of holders, percentage of the tranche sought, or both) should be structured to avoid being considered a “creeping” tender offer, which implicates additional regulatory and documentary requirements.
 - If a potential tender offer to all holders is contemplated, open market purchases should be planned carefully to avoid being “integrated” with the tender offer.

Bank Loans

- Credit agreement provisions typically exclude loans held by an affiliate of the borrower (other than any affiliated bona fide debt fund) from most voting, or deem such loans to be voted proportionately with loans held by non-affiliated lenders (in each case, other than with respect to certain “sacred rights”), and include other limitations (including limitations on the percentage of the applicable class of loans that may be purchased) on such affiliate purchases (including sponsor purchases).

- Generally, loans repurchased by a borrower are deemed to be canceled (so no restrictions on voting are required); however, other limitations on loan purchases by borrowers may be applicable (e.g., prohibition on funding with borrowings under the company’s revolving credit facility; no purchases during a continuing default).
- Some credit agreements may limit the mechanism for affiliate purchases to offers via Dutch auctions open only to all lenders of the applicable class on a pro rata basis.

Purchases by Sponsors and Other Affiliates

- The Board of a borrower/issuer should generally be informed of potential debt purchases.
 - Board discussion may be required if a sponsor beneficially owns a significant percentage of the borrower’s/issuer’s equity.
- Repurchase of debt at a price below par may also be considered a “corporate opportunity” under relevant state corporate law that should be offered to the borrower/issuer by a sponsor or its board appointees.
 - Purchasers should consider seeking a board resolution regarding renunciation of specific corporate opportunities even if exempted under the borrower’s/issuer’s organizational documents.
- In a distressed situation, conflicts may arise when an equity holder purchases debt. If the interests of debtholders and equityholders diverge in a potential course of action by a distressed borrower/issuer, sponsor directors may not be able to participate in decision-making.

Fund Level Considerations

- Many private equity fund partnership agreements restrict (either entirely or by establishing a basket) the amount of capital that can be used to effect open market purchases of securities.
- To the extent the portfolio company is held as a “club deal” or the sponsor invested alongside co-investors or other shareholders (which may include members of management), consider whether a purchase of debt securities triggers preemptive or other participation rights of these shareholders.
 - These rights can have implications on the timing and method of effecting such purchases, although they are often structured to allow the sponsor to move quickly and then syndicate the securities to other shareholders that elect to participate.
- Having one fund purchase debt securities of a portfolio company of an affiliated fund will give rise to conflict and fiduciary duty issues, and typically require the consent of the limited partner advisory committee (or, in certain cases, the limited partners) of both funds to approve the affiliate party transaction and give the sponsor some protection against the inherent conflicts involved in such a transaction.
 - Even if the affiliate party transaction is not restricted under the partnership agreement, these transactions implicate fiduciary obligations arising under the Investment Advisers Act and sponsors should review the conflicts and other disclosure provided to limited partners in the relevant private

placement memorandums and Form ADV existing at the time the limited partners committed to the fund as these issues are considered.

U.S. Federal Income Tax Considerations

- Cancellation of Debt (“COD”) Income. If a U.S. borrower/issuer (or a person related to the borrower/issuer for tax purposes) repurchases its debt at a discount, it will generally result in COD income to the borrower/issuer at the time of purchase equal to the amount of such discount and taxable at ordinary income rates.
 - COD income may be partially offset by NOLs and certain other tax assets, and exemptions for insolvent or bankrupt borrowers/issuers may be available in certain situations.
- Acquisitions by Sponsors or Other Affiliates. Where debt of a portfolio company is purchased by a sponsor, it will likely be treated as acquired by a related party and result in COD income as described above.
 - The borrower/issuer will be deemed to issue a new debt instrument with original issue discount (“OID”), which is deductible over the life of the instrument and may offset the COD income over time (however, given the significant limitations on the deductibility of business interest, it is unlikely that OID deductions would result in a full offset).
 - i. As a result of the OID, the acquired debt may also no longer be fungible with the existing debt for tax purposes and may need a separate CUSIP number.
 - Consequences to limited partners should be considered, including phantom income from OID to U.S. taxable limited partners, potential withholding tax costs to non-U.S. limited partners (as the “portfolio interest exemption” will likely not be available) and, if the acquisition is debt-financed, “unrelated business taxable income” to tax-exempt limited partners.
 - In certain situations, there may be alternative structures that can be utilized to mitigate the incurrence of COD income where debt is purchased by a sponsor.

Certain Bankruptcy Considerations for Purchases by Sponsors and Affiliates

- If the purchaser holds equity in the borrower/issuer, other parties in a bankruptcy case may argue that the purchaser’s debt claim should be equitably subordinated to the claims of other creditors.
 - This risk can be mitigated through not trading on MNPI and ensuring that there is no usurpation of a “corporate opportunity” because an equitable subordination claim requires, among other elements, some inequitable conduct on the part of the purchaser.
- Other parties in the borrower’s/issuer’s bankruptcy case may seek to have the purchaser’s vote on a proposed plan “designated” by the bankruptcy court, i.e., declared not to count.
 - Grounds for designation can include use of the purchased debt as part of a “loan to own” strategy or in a strategy other than maximizing recovery on the debt.

- If the purchaser is an insider (including an entity having voting control of 20% or more of the borrower's/issuer's equity), payments received in the year prior to bankruptcy may be subject to avoidance as preferences and potentially repaid to the bankruptcy estate.

Litigation Considerations

- In addition to potential enforcement exposure, a seller might pursue claims against the buyer in private civil litigation.
- A seller of notes could try to make out a claim for securities fraud under Section 10(b) of the Exchange Act. For example, a seller could try to leverage a circumstance where a purchaser was in possession of undisclosed MNPI at the time of sale that allegedly would have induced the seller not to agree to sell its bonds at or near the agreed price. Such claims would face many hurdles, however, including proof of scienter, among other facts.
- A seller of notes or bank loans also could claim that a buyer fraudulently concealed a material fact in connection with the buyback. Such state law claims generally require proof of a duty to disclose, omission of material facts, scienter, reliance, and damages. Additionally, the seller would need to establish that the purchaser had a duty to disclose such information to the seller.
- By evidencing a lack of reliance by the counterparty, “big boy” and no reliance letters can be useful in reducing, but not necessarily eliminating, the risk of counterparty liability.

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