CLIFFORD

CHANCE

CORONAVIRUS: LEVERAGED FINANCE – KEY CONSIDERATIONS IN RESPECT OF LOAN BUYBACKS AND OTHER LIABILITY MANAGEMENT TRANSACTIONS

The Coronavirus (COVID-19) pandemic continues to significantly impact global markets, resulting in price reductions for corporate loans such that many of those loans are now trading below par, some significantly so. As of April 2, 2020, no single loan on the S&P/LSTA Leveraged Loan Index (the "LLI") was trading above par, with less than 1% of loans bid above 98. Debt buybacks and other liability management options are on the minds of a number of investment banks, borrowers and their financial sponsors. Here, we discuss similar liability management options that borrowers, their affiliates and their private equity sponsors are currently exploring in respect of their loans.

Key issues

- Economic downturn may create a window to buyback loans at a discount or a need to explore other liability management techniques (in particular, strategic facility amendments)
- In determining and executing a path forward, borrowers and their affiliates must closely consider the terms of their binding loan agreements as well as potential tax and other implications

In addition to the significant stresses caused on borrowers and their businesses, the extreme market volatility triggered by the COVID-19 pandemic has caused syndicated loans to be trading at discounts. March 2020 figures show that 39% of the secondary loan market is being bid between 80 and 90, and 24% below 80. Over the same monthly period, the LLI reported a 12.37% loss. By comparison, the LLI has only incurred monthly losses of greater than 5% three other times, all of which occurred in and around the third quarter or 2008. Whether a borrower or related party should consider buying back such discounted loans or exploring other methods of managing liability will require an individualized and fact-specific analysis; however, this briefing will set out some general considerations. In particular, we will discuss some of the key loan buyback and amendment considerations for borrowers, their financial sponsors and lenders.

LIABILITY MANAGEMENT OPTIONS

The term "liability management" is used to describe a variety of options and techniques that borrowers utilize to manage their balance sheet liabilities. The current market downturn and the global response by governments and central banks have produced a situation where some syndicated loans are trading at prices significantly below their face value, creating a window for borrowers and other market players to buy loans at a discount by way of the methods discussed below. Similarly, current market conditions are causing borrowers to confront liabilities and risks raised by covenant breaches, approaching maturities and potential defaults. To manage such liabilities, we also discuss some key considerations with respect to modifying credit agreements.

Loan Buybacks

While term loan buybacks are a relatively common feature of sponsor-backed credit facilities in today's syndicated loan market, they were generally prohibited by the terms of credit agreements until about ten years ago, when they arose as a vital liability management tool during the global financial crisis. Where loan buybacks are permitted within the loan documentation, they are typically subject to certain conditions which primarily dictate the method and limitations of buying back outstanding term loans. Where loan buybacks are not expressly permitted, the borrower would have to seek some form of amendment to pursue them (*see* below discussion on *Strategic Amendments*). Although borrowers should consult the terms of their loan agreements for the precise options that are available, the most common buyback scenarios are summarized below.

1. **Key Buyback Options**:
   - ***Dutch Auctions***. A Dutch auction is a loan buyback procedure whereby the borrower or its affiliate offers to the full lender syndicate on a pro rata basis to purchase a specific amount of outstanding term loans at a stated price (or within a stated price range), expressed as a discount to par, and a deadline by which willing lenders must respond. The administrative agent will often play a key role in the auction process by delivering and collecting offers and responses on behalf of the parties. Typically, the agent and borrower-side will determine the lowest price offered by the lenders that will allow for the purchase of the desired amount of loans or, if no such price exists, the borrower may either cancel the auction or sell at the highest price offered within the previously specified range. Following a successful auction, the subject loans shall be purchased from the selling lenders.
   - ***Open Market Buybacks***. Open market loan buybacks permit the borrower or its affiliate to negotiate and execute a buyback privately with individual lenders (either directly or through a broker or other intermediary). This option may facilitate an efficient, less costly and expeditious path to purchase portions of outstanding term loans from such lenders, without the potential delays and requirements of a more layered tender/auction process. The ability to source such open market purchase opportunities will be deal-specific and may depend on availability in the secondary market and/or the borrower's contacts and relationships with its lenders.
2. **Common Requirements, Conditions and Results**:
   - ***Certain Conditions***. For any loan buyback (whether by way of a Dutch auction or open market transaction), borrowers are typically subject to certain conditions, including that (i) there be no default or event of default, (ii) only term loans and not revolving loans may be purchased, and (iii)

the purchase not be funded by revolver drawings. The borrower should also be sensitive to any restrictions in its credit agreement on the use of its cash to fund a buyback. In addition, while some credit agreements condition buybacks on the borrower's disclosure of material non-public information, many others do not and instead require the assigning lender to acknowledge that it is not relying on any such disclosures (i.e., a "big boy" disclaimer).

- ***Pro Rata Provisions***. Although credit agreements contain requirements to share loan repayments ratably among all lenders, exceptions are typically made for buybacks. While the offer process for Dutch auctions is typically to be made on a pro rata basis to all lenders, the actual purchase from the selling lenders is not and open market purchases may be offered and executed without any pro rata sharing requirements at all.
- ***Certain Results***. Any loans purchased by the borrower (or purchased by an affiliate and contributed to the borrower) are typically required to be cancelled immediately. Cancellation of the loans will naturally reduce the principal amount of loans required to be amortized as well as the interest the borrower pays on those loans, and may result in a positive contribution to the borrower's financial results by realizing the difference between the discounted purchase price and the par value of such loans. In addition, in many modern credit agreements, buybacks will result in a dollar-for-dollar reduction in any "excess cash flow" sweep requirements as well as an increase in "dry powder" borrowing capacity (under incremental debt provisions). Credit agreements often limit the benefits here to the amount of cash actually paid in the buyback (versus the face amount discharged). Of course, the deleveraging achieved through such buybacks may also improve calculations for financial covenants (whether maintenance or incurrence-based), which could increase flexibility for the borrower.

3. **Affiliate Lender / Sponsor Buybacks**: Sponsor buybacks are where a private equity sponsor acquires the term loans of one of its portfolio companies and, as a result, becomes a lender (i.e., an "affiliate lender", as characterized in most credit agreements). These features, when permitted, may be advantageous where the borrower does not have the cash resources to execute the buyback itself and/or where the sponsor may realize a strategic financial improvement to its overall investment, avoid restrictive covenants imposed on the borrower, and (in some limited scenarios) exert influence over the syndicate. Depending on the loan documentation, affiliate lender buybacks may be similarly effectuated via Dutch auctions or open market transactions, but are distinguished by some key differences and limitations, including the following:

- There is typically no condition on the absence of defaults.
- Term loans purchased by an affiliate lender are not typically required to be cancelled, but an affiliate lender may have the option to contribute the loan to the borrower, resulting in its cancellation.

- Unlike Dutch auctions commenced by a borrower, auction-style sponsor buybacks may not be required to be made on a pro rata basis to the full lending syndicate.
- Unless an affiliate lender qualifies as a bona fide debt fund (see below), such affiliate lender is typically (i) limited in the principal amount of term loans that it can hold at any time (often capped at 20-30% of the outstanding term loan facility), (ii) barred from voting on credit agreement amendments and other lender matters, unless the vote applies to "sacred rights" or a matter that disproportionately affects the affiliate lender, (iii) prohibited from attending most lender-only meetings, and (iv) barred from voting in bankruptcy proceedings, particularly on chapter 11 plans (subject to similar exceptions – e.g., if the plan disproportionally affects the affiliate).
- Affiliate lenders that do qualify as bona fide debt funds (i.e., separate credit funds of a sponsor that invest in loan products in the ordinary course) are typically exempt from the limitations for affiliate lenders described above. However, debt fund affiliate lender voting powers are typically capped at 49.9% of the overall syndicate (so that they can never independently represent a majority of lenders for voting purposes), regardless of the percentage of the credit facility that they come to hold.
- Lastly, affiliate lenders could be subject to at least some risk of equitable subordination to other creditors in a bankruptcy proceeding of the borrower if the court determines that the affiliate used its influence to gain unfair advantages over other creditors. Equitable subordination, however, is an extraordinary remedy and likely only a realistic risk where very bad facts are at play. In addition, the typical limits on affiliate voting and information rights (described above) may serve to avoid this type of outcome.

Strategic Amendments

As borrowers face increasing liquidity, covenant compliance and maturity issues, borrowers may consider pursuing strategic amendments to their credit documents that provide a measure of relief to them. Each such pursuit will be fact-sensitive and borrowers must closely examine the terms of their credit agreements (in particular the amendments section) to determine the level of lender consent required in order to make modifications.

Generally, consent of the holders of a majority in the principal amount of loans and commitments is required to modify or waive provisions of credit agreements, which may include obtaining relief from financial and other covenants as well as mandatory prepayment provisions. In addition, where a covenant benefits only a subset of lenders (e.g., a financial covenant that benefits only term A or revolving lenders), typically only a majority of such lenders are needed to support an amendment to such covenant.

Modification of other key provisions that govern payments of principal and interest, amortization and maturity of the loans (i.e., lender "sacred rights"), typically require consent from all lenders or all affected lenders and, thus, are more difficult to execute. Voting requirements for amendment of pro rata sharing provisions are often similar to the "sacred rights", but in some deals a simple majority of lenders can agree to modify these provisions. Such modifications may be necessary to execute buybacks (where a document does not otherwise permit them) or may be pursued to potentially facilitate a strategic restructuring that favors a majority group of lenders. Notably, in many credit agreements, the borrower can execute amendments with at least the consenting lenders (e.g., to extend maturity) and leave the non-consenting lenders in an original tranche subject to the original terms.

In addition to the consent-related obstacles to achieving a strategic amendment, in many cases lenders may expect consent fees or other consideration. The borrower-side may consider offering unencumbered assets as additional credit support or agreeing to new restrictions that do not impact its objectives.

OTHER KEY CONSIDERATIONS

From a practical standpoint, loan buybacks are only viable for borrowers (or sponsors) with sufficient cash to acquire the loans. But the ability to consummate these transactions requires careful consideration of the key contractual provisions (described above) as well as potential tax and regulatory issues (described below).

Tax Considerations: A borrower (and in some cases its sponsor) buying back loans for less than the value of the corresponding liability in its balance sheet is likely thereby to generate income which may be liable to tax. Some borrowers buying back loans in the immediate aftermath of the financial crisis were able to structure the transaction so no tax in fact arose. Many jurisdictions introduced anti-avoidance rules to stop that. A borrower contemplating a buyback of its loans would be well-advised to take appropriate tax advice at an early stage.

Regulatory and Disclosure Considerations: Although loans are not considered "securities" and, therefore, not subject to the robust regulations and requirements imposed by the Securities and Exchange Commission and other regulators, reporting companies may still consider whether a loan buyback program or transaction is a material event that requires disclosures. Otherwise, the buyback of loans are subject only to the terms and conditions of the loan agreements themselves, which, for example, may not require the borrower-side to disclose material non-public information it possesses to assigning lenders.

Borrowers and financial participants should carefully evaluate the foregoing considerations with counsel and the appropriate specialists when pursuing buybacks and other liability management options.

Our briefings on "Coronavirus: Leveraged Finance – Key Considerations in Respect of Debt Buybacks and Other Liability Management Transactions" and "Coronavirus: Leveraged Finance – Immediate Financing Considerations for Financial Sponsors, Underwriters and Debt Investors" and other Coronavirus (Covid-19) materials can be found here:

https://www.cliffordchance.com/insights/thought_leadership/coronavirus.html

CONTACTS

Gary Brooks
Partner

T +1 212 878 8242
E gary.brooks@cliffordchance.com

Daniel Winick
Partner

T +1 212 878 4918
E daniel.winick@cliffordchance.com

Leah Edelboim
Counsel

T +1 212 878 4969
E leah.edelboim@cliffordchance.com

Andrew Young
Counsel

T +1 212 878 8012
E andrew.young@cliffordchance.com

Rebecca Isaacs
Associate

T +1 212 878 8261
E rebecca.isaacs@cliffordchance.com