CORONAVIRUS: LEVERAGED FINANCE - KEY CONSIDERATIONS FOR LOAN BUY-BACK TRANSACTIONS

While there has been some recent re-bound in the secondary market for loans, the Coronavirus (COVID-19) pandemic continues to impact global markets, with many loans quoted at a significant discount to their par value.

Following on from our "Coronavirus: Leveraged Finance – Key considerations in respect of debt buybacks and other liability management transactions" briefing which focussed on capital markets transactions, we will look at some of the key considerations for financial sponsors, borrowers, management teams and investment banks in the context of loan buy-back transactions.

Key issues

- The Coronavirus (COVID-19) pandemic has created pricing dislocation in secondary loan markets, potentially giving borrowers and related parties the opportunity to re-purchase loans at a significant discount to par
- While credit agreements in the leveraged market will typically regulate loan buy-back transactions, there remain key considerations which will impact the viability of any loan buy-back transaction

All of our Coronavirus (Covid-19) briefings and other related materials can be found here:
https://www.cliffordchance.com/insights/thought_leadership/coronavirus.html

TYPICAL LOAN BUY-BACK STRUCTURING

Structuring a loan buy-back transaction will primarily be driven by the commercial intention of the purchaser and any restrictions or permissions in the underlying credit agreement, but are typically conducted:

1. **By the borrower or another member of its group**: by way of a solicitation process or open order process directly with the lender syndicate or via a purchase agent or broker, although bilateral processes may be permitted. The loans purchased are typically required to be extinguished or treated as intra-group liabilities.

2. **By the financial sponsor or majority shareholder**: through open market purchases with individual lenders, either directly or via a purchase agent or broker. The loans purchased will continue in the same form but the financial sponsor or majority shareholder which controls the loan will typically be disenfranchised for voting and information purposes under the underlying credit agreement.

KEY CONSIDERATIONS IN EXECUTING LOAN BUY-BACK TRANSACTIONS

While increased regulation of loan buy-back transactions in credit agreements for leveraged loans since the financial crisis of 2008 has created some consistency across outstanding leveraged loans, consideration will have to be given to each loan on a case-by-case basis:

- ***Source of funds***: cash sources readily available to a borrower such as other debt or operational cashflows may be a restricted source for funding loan buy-back transactions. While new equity is likely to be a permitted funding source, financial sponsors or shareholders may be reluctant to risk their own money if it cannot be readily returned at a later date.

- ***Contractual considerations***: conditions such as the absence of defaults may prevent loan buy-back transactions by borrowers. Where loan buy-backs are not regulated by the credit agreement, complex structures may also be required to navigate restrictions such as the acquisitions and debt incurrence covenants and requirements around pro rata prepayments to give effect to the commercial aim.

- ***Maintenance and incurrence financial covenants***: If effected, credit agreements may or may not allow borrowers to benefit from gains realised on loan buy-back transactions when calculating EBITDA and financial ratios.

- ***Eligible transferees***: SPVs created by financial sponsors or majority shareholders may not be eligible transferees, even with borrower consent. Similar issues may arise with borrowers themselves where loan buy-back transactions are not regulated in the credit agreement.

- ***Confidentiality***: loan buy-back transactions will typically have to be notified to the syndicate at the point they are commenced or upon completion. This is liable to impact loan pricing and syndicate sentiment among other things.

- ***Tax concerns:*** a borrower buying backs its own loans at a discount may recognise a profit which is taxable. Anti-avoidance rules adopted since the financial crisis of 2008 may prohibit the use of structures which can avoid that tax arising. In contrast, sellers of loans will want to make sure that any economic loss they make on a loan buy-back is recognised for tax purposes.

- ***Unintended consequences***: overriding intercreditor terms may recharacterise the loans as intra-group or investor liabilities and issues such as equitable subordination may potentially arise which may affect the entirety of the lender syndicate.

- ***Purchase agent or broker liability***: any financial institution acting as a purchase agent or broker will need to consider its own liability, even if it does not take the credit risk on the purchased loan. The FCA principles or similar regulation may impact a financial institutions ability to structure or execute loan buy-backs for clients in a particular form.

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