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Debt Buybacks: Opportunities and Considerations for Private Equity Investors in Asia Pacific

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As the COVID-19 global pandemic continues to devastate economies, trading prices for many bank loans have fallen significantly. Private equity sponsors are looking at debt buybacks as a potential opportunity to de-lever their portfolio companies at a significant discount. This client alert highlights some of the critical issues for private equity sponsors when considering these opportunities.

Debt Buybacks: Loan Documentation in the Asia-Pacific Region

Compared to the US and European markets, it is much harder to make generalisations about loan documentation in the Asia-Pacific region as many countries within the region have distinct approaches to loan documentation. However, it is fair to say that where the loan documents contemplate debt buybacks at all they most typically follow (with a few negotiated points) the Loan Market Association ("**LMA**") options of permitting debt buybacks by the borrower provided that specific processes and conditions are followed (and by sponsors and affiliates subject to disenfranchisement provisions (discussed below)). There are exceptions to this, particularly in the context of US-style Term Loan B facilities which typically permit debt buybacks subject to certain conditions and similar Dutch auction processes; however, they also often allow open market purchases without prescription as to the process. Additionally, there are many loan agreements in the Asia-Pacific region that do not contemplate debt buybacks at all. The LMA's standard form also provides an option for debt buybacks to be expressly prohibited, but this is rarely seen in practice.

Liquidity Considerations

When considering debt buybacks, a threshold issue to address is who will purchase the debt and how will they fund the purchase. For borrowers (or other companies within the borrowing group) considering a debt buyback, they must first be comfortable that they have sufficient liquidity to continue to meet their debts as they fall due after giving effect to the cash outlay required to effect the purchase. Where there would be insufficient liquidity, sponsors can consider either funding the purchase through the injection of new equity or subordinated debt or making the purchase directly themselves, through an affiliate or an unrestricted subsidiary.

We have also seen purchases of unfunded commitments where the purchaser is paid to assume the unfunded commitments (note that the LMA standard form does not provide an option for the purchase of revolving loans or other unfunded commitments). These situations require special consideration as they can create additional issues; for example, whether the purchaser is sufficiently credit-worthy to fund future drawdowns, and in the case of buybacks by the sponsor, the potential conflicts for sponsor directors of whether to drawdown on such facilities where it would be prudent for the company to do so but there is a significant risk that the sponsor would not make a full recovery. In some purchases of unfunded commitments, sponsors/companies have used the proceeds received by them

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for the purchase to fund further buybacks of funded debt.

LMA Debt Buyback Processes

Where debt buybacks by a member of the group are to be permitted, the LMA has proposed certain conditions that must be satisfied before the borrower can effect a debt buyback. These conditions are:

(i) the borrower makes the purchase (often negotiated to include other members of the restricted group);

(ii) the consideration for the purchase is below par;

(iii) no default is continuing at the time of the purchase (sometimes this standard is negotiated to event of default);

(iv) the consideration is funded from retained excess cash (with an option to restrict this to the immediately preceding financial year), or new equity/subordinated debt (this condition is often negotiated also to permit funding from (a) excluded disposal proceeds, excluded insurance proceeds, excluded acquisition proceeds and excluded IPO proceeds; (b) permitted financial indebtedness; (c) cumulative retained cash; (d) any overfunding amounts; and (e) cash and cash equivalents to the extent that it could be used to fund certain (highly negotiated) permitted payments); and

(v) the purchase is implemented using either the solicitation process or the open order process.

The solicitation process provides for the parent to approach all of the relevant term loan lenders to enable them to offer to sell an amount of their participation to the relevant borrower. Any lender wishing to sell provides details of the amount of the participation that they want to sell and the price at which they are willing to sell. The parent has no obligation to accept any of the offers from the lenders. However, if it agrees to any such proposals, it must do so in inverse order of the price offered (with the lowest price being accepted first). If two or more offers to sell a particular term facility at the same price are received, such offers may only be accepted on a pro rata basis.

The open order process provides for the parent (on behalf of the relevant borrower) setting out to each of the lenders of a particular facility the aggregate amount of such facility it is willing to purchase and the price at which it is willing to buy. The lenders then notify the parent if they are willing to sell on such terms. If the aggregate amount which lenders are willing to sell exceeds the aggregate amount that the parent had notified the relevant borrower it was willing to purchase, then such offers shall be accepted on a pro rata basis.

In respect of a debt purchase transaction complying with the LMA conditions:

(i) the relevant portion of the term loan to which it relates are extinguished, and any related repayment instalments will be reduced pro rata accordingly;

(ii) the borrower shall be deemed to be a permitted transferee;

(iii) the extinguishment of any portion of any such loan shall not constitute a prepayment of the facilities;

(iv) no member of the group shall be in breach of the general undertakings as a result of such purchase;

(v) the provisions relating to sharing among the finance parties shall not apply; and

(vi) no amendment or waiver approved by the requisite lenders before the extinguishment

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shall be affected by such extinguishment.

The LMA debt buyback provisions are drafted widely and apply not only to purchases by way of assignment or transfer but also to sub-participations and any other agreement or arrangement having an economic effect substantially similar to a sub-participation. This is to safeguard against such methods being employed to circumvent restrictions relating to assignments or transfers.

There are also obligations on any sponsor affiliate who enters into a debt purchase transaction (whether as the direct purchaser of the loan or as a participant) to notify the agent by no later than 5.00 pm on the business day following entry into such transaction. The agent is then obliged to disclose this to the other lenders.

Tax

Depending on the jurisdiction, extinguishment of debt can create taxable income on the amount of the cancellation of debt. For this reason, sponsors often negotiate for debt buybacks to be permitted by any member of the group (rather than only the relevant borrower). Tax advice should be obtained before entering into a debt buyback to address this and other issues such as ensuring that the lender is in a favourable tax jurisdiction for withholding tax purposes.

Disenfranchisement

Where the loan documentation contemplates debt buyback transactions, purchases by the sponsor are typically permitted without following the solicitation or open order processes but subject to certain conditions. These include:

- in determining whether any applicable lender thresholds have been met to approve any consent, waiver, amendment or other vote under the finance documents the commitment of the sponsor shall be deemed to be zero and the sponsor shall be deemed not to be a lender;
- the sponsor shall not attend or participate in any lender meeting or conference call or be entitled to receive any such agenda or minutes of such meeting or call unless the agent otherwise agrees; and
- in its capacity as a lender the sponsor shall not be entitled to receive any report or other documents prepared on behalf of or at the instructions of the agent or any lenders.

These conditions also apply to affiliates (broadly defined) of the sponsor unless they have been established for at least [6] months solely for the purpose of making, purchasing or investing in loans or debt securities and are managed or controlled independently from all other trusts, funds or other entities managed or controlled by the sponsor. Sponsors will typically expressly carve-out any existing affiliated bona-fide credit funds. Again, the drafting is broad to also capture transactions effected by way of sub-participation and any other agreement or arrangement having an economic effect substantially similar to a sub-participation. Typically in the Asia-Pacific region there is no cap on the amount of the commitments which can be held by the sponsor or its affiliates. An exception to this is found in US-style term loan B facilities which typically have caps of 20-30% of the term loan commitments. The disenfranchisement provisions can typically be amended with majority lender consent (66.66% in most deals in the Asia-Pacific region) and in some cases we have seen sponsors purchase a majority stake but require the selling lenders to consent to the removal of such restrictions as a condition precedent to the buyback becoming effective. In such circumstances the sponsor then has the ability to strip the covenants and, depending on the documentation, may have the ability to restructure its acquired debt as super-priority.

Equitable Subordination

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Sponsors should also consider whether there is a risk that the purchased debt could be subject to equitable subordination. Equitable subordination is a doctrine that enables the court to lower the priority of a creditor claim to that of equity. It can have the effect of converting certain senior secured claims into claims that rank pari passu with other unsecured claims (or in some jurisdictions even behind unsecured creditor claims and treated as equity). It is not a universal doctrine; for example, there is no doctrine of equitable subordination under English, Hong Kong or Singapore law and often where the doctrine does exist it is used sparingly by the courts and cases often have elements of inequitable conduct, breach of fiduciary duty, fraud, illegality or undercapitalisation. However, this is not always the case and in some jurisdictions all shareholder loans are automatically ranked behind all unsecured creditor claims.

Regulatory Issues

Another issue to be considered on a case-by-case basis is whether there are any applicable regulatory issues; for example, is the potential purchaser required to be a licensed lender under applicable laws and regulations? Similarly, consideration should be given to whether any rules relating to material nonpublic information, insider trading or analogous rules apply – typically, in the case of loans (as opposed to bonds) they do not apply; however, this should be confirmed before entering into the transaction.

Equity Cure

How debt buybacks impact the financial covenants turns on the drafting in the loan document and the purchaser. Typically, intra-restricted group debt is excluded from the covenant calculations, but if the debt is purchased by an affiliate outside of the restricted group it will not benefit in this way. In many loan agreements in Asia, equity cures can be added to EBITDA. In these cases, can a debt purchase by the sponsor be contributed to the borrower and added to EBITDA? In some cases it can but more often the equity contribution must be received in cash – in which case the sponsor can contribute the cash to the borrower group to increase EBITDA and the borrower or another member of the restricted group can effect the debt buyback. In such circumstances, can the borrower also claim the benefit of the reduction in debt thereby gaining a double benefit? Often there are restrictions around this. However, it is not unusual that the cure amount added to EBITDA cannot be used to reduce net debt with respect to the test period in which the cure was made but may be included in subsequent test periods.

During the great recession where the agreements typically didn't contemplate debt buybacks there were examples of some very aggressive positions taken by sponsors, including where they: (i) contributed the purchase price to the group which was deemed to be added to EBITDA as a cure amount; (ii) deducted the face amount of the debt purchased from net debt; and (iii) the amount of the discount to face value being added back to EBITDA as a one-off item to obtain a triple benefit for covenant purposes.

Key issues to consider when the Loan Agreement is silent on Debt Buybacks

Where the loan agreement is silent on debt buybacks, in addition to the liquidity, tax, equitable subordination and regulatory issues, it is necessary to consider a number of other issues.

First, is the proposed purchaser a permitted transferee? Careful analysis of the loan document and the specific facts regarding the potential purchaser are required here as to the scope of permitted transferees. In the Asia-Pacific region, in many cases, even where the loan agreement does not follow the LMA, the permitted transferee language tracks the LMA position and permits transfers to "another bank or financial institution or to a trust, fund or other entity which is regularly engaged in or established for the purpose of making, purchasing or investing in loans, securities or other financial assets". This is extremely wide and from an English law perspective a relatively low threshold to meet. In fact, even where the language is limited to "another bank or financial institution", under English law

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this is still a relatively low bar as the Court of Appeal decision in *The Argo Fund Ltd v Essar Steel* [2006] held that “the terms ‘financial institution’ meant an entity having a legally recognised form or being, which carried on its business in accordance with the laws of its place of creation and whose business concerned commercial finance”. In a number of jurisdictions in Asia-Pacific such as Hong Kong, Singapore and Australia this may be persuasive; however, this must always be considered in the context of the applicable governing law of the loan agreement.

Second, if the potential purchaser is a permitted transferee, whether there are any other contractual restrictions in the finance documents; for example, the holding company undertaking in the loan agreement or where the debt will not be extinguished, restrictions in the intercreditor agreement requiring such debt to be unsecured and subordinated?

Third, does the buyback constitute a prepayment? Where the debt is purchased by an entity other than the borrower (another member of the group or a sponsor affiliate) the debt will clearly continue to exist and the purchase cannot be characterised as a prepayment. However, the position may be less clear where the buyback is by the borrower of its own debt. Again, this needs to be considered under the applicable governing law. From an English law perspective there is case law that a party cannot contract with itself (as it cannot sue itself) and is argued that by extension, a party cannot owe a debt to itself and therefore a buyback by the borrower may cause the debt to be automatically extinguished. This position is not settled under English law in the loan buyback context. Section 61 of the Bills of Exchange Act 1882 states “When the acceptor of a bill is or becomes the holder of it at or after its maturity, in his own right, the bill is discharged”. This provides an argument that an unmatured debt can be held by that debtor. However, it is fair to say that the more widely held market view is that under English law a buyback by the borrower of its own debt triggers an automatic extinguishment. The relevance of this issue is that if the extinguishment constitutes a prepayment, the provisions relating to prepayments would apply and the sharing among finance parties provisions would also likely apply. Whether such an extinguishment could be recharacterised as prepayment has not been settled as a matter of English law. However, the more widely held market view is that under English law, the extinguishment resulting from a borrower buyback would not constitute a prepayment. Therefore the prepayment provisions should not apply.

If the buyback is by the borrower and the debt extinguished, then the borrower is not a lender and would have no right to vote or receive information. However, if the buyback is by another member of the group or an affiliate and the debt is not waived or forgiven then, typically, absent any contractual disenfranchisement, the purchaser will be able to vote, attend lender meetings and receive lender information on the same basis as it would if it was an unrelated party.

Where there are contractual impediments to a debt buyback in a loan agreement which is otherwise silent on debt buybacks (for example, the potential purchaser not being a permitted transferee), it may be possible to structure around such restrictions through a sub-participation, total return swap or similar arrangement. Note, however, that while it may be possible to confer voting discretion on the sub-participant, such methods will not usually assist the borrower from a financial covenant perspective.

How We Can Help

Reviewing the finance documents to understand the potential options available to buyback debt is a complicated task. Each case will need to be examined based on the particular facts and the specific drafting (or lack of drafting on the issue) in the finance documents. We have extensive experience in guiding sponsors and their portfolio companies through successful debt buybacks both in circumstances where there are processes prescribed by the finance documents and where the finance documents do not contemplate debt buybacks at all. Gibson Dunn's global finance team is available to answer your questions and assist in evaluating your finance documents to identify any potential issues and work

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with you on the best strategy to address them.

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Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding these developments. Please contact the Gibson Dunn lawyer with whom you usually work in the firm's Global Finance or Private Equity practice groups, or the authors:

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