Simpson Thacher

Memorandum

Open Market Debt Repurchases in the United States and Europe—Key Considerations

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The last time we published a note on open market debt repurchases, the world was plunging into a global pandemic. With global inflation, rapidly increasing interest rates, dislocation in the credit markets, the war in Ukraine and ongoing volatility in energy markets (and the list could go on), we are once again receiving frequent inquiries with respect to open market debt repurchases as many debt issuers and borrowers are experiencing significant declines in the trading value of their debt securities and bank loans. As a result, we thought it would be helpful to provide an updated summary of key considerations under U.S., EU and U.K. law for 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 careful analysis of the company's business outlook and liquidity position, underlying debt agreements, relevant securities laws, tax regulations, bankruptcy or insolvency implications, corporate governance considerations, covenant compliance and, in certain cases, the agreements that govern the activities of funds established by financial sponsors. Additionally, if there is the potential for a restructuring or liability management transaction in the future, any repurchases should be strategically designed to ensure that they support that process, and the parties considering the repurchases should analyze whether their cash is best deployed in buybacks or reserved to be part of a solution presented to creditors in such a process.

We hope that the below summary of key legal considerations will be a useful primer if you are considering a debt repurchase. Since each situation raises unique issues, we encourage you to reach out to any member of your Simpson Thacher client team or contact us at DebtRepurchases@stblaw.com to assist you.

Material Non-Public Information ("MNPI"); Blackout Periods

- Notes/bonds are securities subject to U.S. federal or other applicable 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 unexpected financial results (to the upside or downside).
    - 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. Accordingly, a similar MNPI analysis is typically applied to repurchases of bank loans.

- 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 periodic reports (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/borrowers and sponsors may consider establishing a 10b5-1 trading plan to manage purchases of debt securities/loans and related MNPI issues.
- Potential equitable subordination issues are discussed below under the headings "*U.S. Bankruptcy Considerations for Purchases by Sponsors and Affiliates*" and "*U.K./European Restructuring and Insolvency Considerations*."
- Specific rules may apply to European-listed securities, as discussed under the heading "*EU and U.K. Listed Debt Issues*" below.

- Non-disclosure agreements, wall cross procedures and "big boy" letters may be considered of use where appropriate to address MNPI issues and non-reliance concerns, 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 borrower/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 potentially effectively lowering the threshold to third parties acquiring a blocking position 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 debt agreements or there may be a limitation on the use of revolver borrowings (though cash is fungible).

Notes/Bonds Considerations

- Notes/bonds held by an issuer or its affiliates are typically not permitted to participate in any vote, waiver or consent from holders (*e.g.*, an amendment or a waiver of an event of default).

- Tender Offer Rules
  - Extensive repurchases of notes/bonds (based on number of holders solicited, percentage of the tranche sought, or both) should be structured to avoid being considered a "creeping" tender offer, which implicates additional disclosure, regulatory and documentary requirements.
  - If a potential tender offer to holders is contemplated, open market purchases should be planned carefully to avoid being "integrated" with the tender offer.
- In the European market, notes/bonds are frequently listed on stock exchanges, whose fair treatment requirements may restrict purchases without making an offer to all holders. See "*EU and U.K. Listed Debt Issues*" below.

Bank Loan Considerations

- 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).
  - Loan agreements in the European market frequently restrict loan purchases by a borrower and disenfranchise the voting rights of their affiliates.
- Generally, in the U.S. market, 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; restrictions on repurchases while there is a default under such agreement). By contrast, in the U.K. market, loans are not usually required or deemed to be cancelled and there is no limit on the percentage that may be purchased by affiliates of the borrower.
- Some credit agreements may limit the mechanism for purchases by the borrower or affiliates of the borrower 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 by a sponsor who beneficially owns a significant percentage of the borrower's/issuer's equity.
- Repurchase of debt may also be considered a "corporate opportunity" under relevant state corporate law that should first 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 also owns debt. If the interests of debtholders and equityholders diverge with respect to a potential course of action by a distressed borrower/issuer, sponsor directors may not be able to participate in the related Board deliberations.
- If the issuer is a reporting company, a sponsor or other affiliate may be required to disclose holdings and purchases of debt securities if it is a Schedule 13D filer (and in certain cases, plans related to debt purchases could trigger a 13D amendment).

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 or loans 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 debt to other shareholders that elect to participate.
- Having one fund purchase debt securities or loans of a portfolio company of an affiliated fund may 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 to par 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*. When debt of a portfolio company is purchased by a sponsor at a discount, it will likely be treated as acquired by a related party for tax purposes and result in COD

income as described above. 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 at a discount.

- 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).
    - 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.

EU/U.K. Tax Considerations

Debt buybacks in European jurisdictions will often give rise to very similar issues to those described above in "*U.S. Federal Income Tax Considerations*":

- In many European jurisdictions (such as the U.K., France, Germany, Luxembourg, Spain and Portugal), when a borrower/issuer repurchases its debt at a discount, this will generally result in taxable income (referred to in this section as "debt waiver income") for the borrower/issuer in an amount equal to the discount. Such debt waiver income is generally taxable at normal corporate income tax rates and the borrower/issuer will often be able to utilize available losses to mitigate the tax charge, subject to the applicable limitations and restrictions in the relevant jurisdiction.
- In certain European jurisdictions (such as the U.K., France, Luxembourg and Spain), debt waiver income will also arise to the borrower/issuer where the debt is bought back at a discount by a related party of the borrower/issuer. These rules may apply if the debt of a portfolio company were to be purchased by a sponsor entity.
- In other jurisdictions (such as Germany and Portugal), debt waiver income should generally not arise on a repurchase by a related party unless there is a subsequent cancellation of a portion of the debt following its acquisition.
- Depending on the circumstances of the repurchase, certain reliefs or exemptions may be available in the borrower/issuer's jurisdiction which prevent debt waiver income arising. For example, some jurisdictions provide an exemption for a waiver of debt that is held between related parties. An exemption may also be available where the relevant borrower/issuer is bankrupt, insolvent or subject to certain other administration processes.

- There may also be ways to restructure debt without giving rise to debt waiver income. However, specific advice should be sought in the relevant jurisdiction to determine what options might be available to the relevant borrower/issuer and ensure that the relevant requirements are met.

U.S. 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" (which is broadly defined to include, among others, an entity having voting control of 20% or more of the borrower's/issuer's equity and any of its direct or indirect subsidiaries):
  - its vote generally will not be counted for purposes of determining whether a class of impaired creditors has voted to accept the proposed plan (a requirement for plan confirmation); and
  - payments received in the year prior to bankruptcy may be subject to avoidance as preferences and potentially repaid to the bankruptcy estate.
- If the purchaser becomes the target of an avoidance action, all of its debt claims may be temporarily disallowed until the avoidance litigation is resolved and, if the avoidance action is successful, its debt claims will continue to be disallowed until the relevant amounts are repaid to the bankruptcy estate.

U.K./European Restructuring and Insolvency Considerations

- Whether financial debt claims held by an affiliated purchaser will be equitably subordinated in the insolvency of the debtor company varies by jurisdiction. The U.K. and a number of EU jurisdictions do not have any doctrine of equitable subordination, meaning debt held by an affiliated party should enjoy the same ranking as equivalent debt held by a third party.
- However, in some European jurisdictions, *e.g.*, Germany and Spain, any financial debt claims held by affiliated purchasers will, in principle, be equitably subordinated irrespective of the circumstances under which they have been acquired. Equitable subordination can also become relevant for debt instruments held by other funds of the same sponsor and may even travel to a subsequent third party purchaser of the debt instrument.

- As noted above, debt acquired by the borrower/issuer or affiliates may be disenfranchised or excluded from voting under the terms of the finance documents. However, neither the inherent connected party status of the holder, nor such contractual restrictions (even if drafted broadly on their face), will necessarily exclude the debt from being voted (and admitted) in the context of any U.K. or European insolvency or restructuring process.
  - For example, in the context of a U.K. scheme of arrangement, restructuring plan or company voluntary arrangement, debt held by related parties could vote in the same class as any other holder of the same debt instruments. However, the related party status of the holder would be taken into account by the court in a scheme or plan when appraising the fairness of the process (in terms of whether collateral interests had materially swayed the vote). It would also be relevant in a company voluntary arrangement in that at least 50% of the unconnected creditors (by value) need to vote in favour.
  - The position may be nuanced in European jurisdictions, particularly those in which equitable subordination applies. For example, in a German StaRUG, debt held by a related party would be placed in a different (subordinated) class to third party holders of the relevant debt instruments. While it could still be voted, it is unlikely that the debt would confer meaningful leverage on the sponsor in this process (and, as subordinated debt, it could potentially be crammed down and substantially impaired/wiped out).
- In principle, a debt buyback conducted by a debtor or other obligor could be the subject of an avoidance action in a subsequent insolvency of the purchaser company, depending on the circumstances. For example, in the United Kingdom, the transaction could potentially be challenged as a preference if the buyback was intended to improve the position of the relevant creditor or even a transaction at an undervalue if acquired for more than fair market value. However, this is unlikely to be a material risk in circumstances where the debt is acquired at a material discount and for good commercial reasons.

EU and U.K. Listed Debt Issues

- If notes/bonds are traded on a relevant European or U.K. exchange, the EU Market Abuse Regulation or the UK Market Abuse Regulation (as applicable) (together, "MAR") will apply. To alleviate any inside information concerns under MAR, issuers should consider adding a statement that they may purchase notes/bonds in the open market from time to time to their regular periodic reporting.
  - In addition, MAR requires an inside information analysis consistent with the MNPI discussion above.
- MAR closed periods and other internal trading restrictions in place should be considered even if the purchaser itself is not covered by the restrictions.
- The rules of the stock exchange where the notes/bonds trade may require additional disclosure. In addition, some exchanges may take the view that a purchase of securities, without giving the opportunity to all to participate, may infringe on equal treatment rules imposed by such exchanges, and so local rules will need to be consulted if there is a listing.

If you are considering a debt repurchase transaction or have any questions, please reach out to any member of your Simpson Thacher client team or any other member of the **Banking and Credit**, **Capital Markets**, **Investment Funds**, **Private Capital and Special Situations**, **Restructuring** and **Tax** Practices, or contact us at DebtRepurchases@stblaw.com—we would be happy to assist.