KEY POINTS

- The COVID-19 pandemic has seen a renewed focus on loan buybacks. It is important for market participants to understand how credit agreements regulate buybacks and their commercial implications.
- Documentation typically regulates the method of transaction execution, including the price, source of cash to finance it, and type of loan that can be acquired.
- Borrowers and sponsors should carefully consider how to structure a buyback from a tax and regulatory perspective and lenders should be mindful of how the loan should be treated post-buyback.

Feature

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Structuring loan buybacks

In this article the authors consider the structure of loan buybacks with a consideration of the documentary changes made by the Loan Market Association (LMA) as well as some of the approaches that have evolved in the market to address buybacks.

CONTEXT

During the Great Recession, with debt trading at very low prices, loan buybacks became a hot topic. At a time of financial distress, borrowers and their shareholders could see opportunities to support their businesses by efficiently de-levering them. There was an established way to achieve this in the bond market, but it was evident that English law loan documentation did not facilitate this for loans. A myriad of issues arose and lender consent was generally required.

Loan agreements had not expressly provided for buybacks in part due to two general market principles. The first was that borrowers were permitted to manage their balance sheets by way of voluntary prepayments made *at par*; the second was that all lenders would be treated equally in respect of any prepayments (the *pro rata* treatment principle). By their very nature, loan buybacks depart from these principles: they provide for purchases of loans at *sub-par* prices where the loans may be acquired from a *sub-set* of lenders only. However, it is clear that documentation that enables buybacks enhances market efficiency as it provides lenders with an additional forum in which to sell loans that they hold in circumstances where they might not otherwise find a willing buyer.

Following on from this period, the form of credit agreement for leveraged transactions produced by the Loan Market Association (LMA) was adjusted to enable and regulate loan buybacks. With the COVID-19 pandemic putting financial strain on businesses, there has been a renewed focus on buybacks. The documentary changes made by the LMA, as well as some of the approaches that have evolved in the market to address buybacks, are discussed in this article.

WHO MAY BE A LENDER?

In the context of a loan buyback, the purchaser of the loan becomes a lender under the Credit Agreement. The transfer provisions in the Credit Agreement regulate which entities may become lenders.

- **Group buyback**: If the borrower (or one of its affiliates within the bank group, such as a subsidiary (Group Member)) is making the loan purchase, then the credit agreement will specify that the purchaser will be deemed to fulfil the requirements for being a lender. If the borrower is the purchaser, it will be treated as lending to itself.
- **Sponsor buyback**: If a sponsor-controlled entity outside of the banking group, often a holding company (Sponsor Affiliate), is making the loan purchase, then the credit agreement may be silent as to how this entity qualifies as a lender to the borrower for purposes of the credit agreement. The standard LMA transfer provisions are drafted to permit transfers and assignments of loans 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". English law construes this very broadly, following the decision of the Court of Appeal in *Argo Fund Ltd v Essar Steel Ltd* [2006] 2 Lloyd's Rep 134 and also of the High Court in *Re Olympia Securities Commercial plc (in administration) and others v WDW 3 Investments Ltd and another* [2017] EWCH 2807. As Auld LJ stated in *Argo*, "… it is not a necessary characteristic of a transferee that its business should include bank-like activities, such as the lending of money, whether on the primary or secondary debt market or otherwise, or indeed that it should exhibit any particular standard of suitability or probity as a financial institution". Depending on the purchaser, there may be useful factors which can be used to argue its eligibility as a transferee; for example, it could be an entity which performs a treasury function for the wider group or has been established for the purposes of making loans to its subsidiaries. For certainty, the credit agreement can also explicitly provide that the Sponsor Affiliate qualifies as a lender. In practice this is rarely done.
- **Independent debt funds**: With the growth of the private credit market, many private equity firms have expanded into other lines of business and become general asset managers with a separate private credit investment strategy. Documents will often make it clear that these "independent" debt funds are not Sponsor Affiliates and are not therefore captured by the provisions regulating investment in the borrower's debt by Sponsor Affiliates. For this to work properly, the definition of an independent debt fund should specify that it is a person managed independently from that part of the business that invests in equity.

HOW MAY LOANS BE PURCHASED?

Credit agreements prescribe how loan buybacks by a borrower are to be made, however they do not regulate the methods for

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effecting Sponsor Affiliate buybacks in the same way.

- **Method:** The LMA sets out two alternative methods for a borrower to follow in order to acquire interests in its term facilities:
  - The first option is called the "solicitation process". Under this method, all lenders in the relevant term facility are approached and any lender wishing to participate must provide: (i) the amount of loans that it wishes to sell; and (ii) the price at which it is willing to sell. Any offer is irrevocable for a short, prescribed period of time. The borrower may select which offers it wishes to accept but must accept offers in inverse order of the price offered, ie it must accept the offers with the lowest price first. Where there is more than one offer at the same price, offers must be accepted on a *pro rata* basis.
  - The second option is called the "open order process". In this instance, all lenders under the relevant term facility are notified that the borrower wishes to acquire up to a set amount of the term facility at a set price. Lenders that wish to participate will submit an offer of the amount of that term facility that they are willing to sell at that price. Each offer is irrevocable for a short, prescribed period of time. If there is more than one offer such that the aggregate amount offered by lenders exceeds the amount the group wishes to acquire, offers must be accepted on a *pro rata* basis.

  In each method set out above, the group is free to decide whether to accept an offer. However, where offers are accepted, loans must be acquired from lenders whose offers are at the same price point on a *pro rata* basis. This is a vestige of the principle of *pro rata* treatment.
- **Price**: Credit agreements generally provide that any loan purchased pursuant to a loan buyback must be purchased at a price below par. Any purchase at par should instead be made by way of a voluntary prepayment where each lender would receive its *pro rata* share of the prepayment. If the loan acquired is subject to a no-call premium or other prepayment fee, this will be taken into account as part of the price discovery with lenders who elect to participate in the buyback. The buyback itself will not constitute a "prepayment" of debt (see below under "Waiver of breaches").
- **Source of cash:** There is some sensitivity around the source of cash that a borrower group may use to fund a loan buyback for two main reasons. First, with the loan trading at a sub-par price, the business may be underperforming, in which case creditors have a heightened focus on preserving cash within the group. Second, lenders are more sensitive in these circumstances to cash payments being made to a sub-set of lenders only. The counterbalance to this is that the borrower is de-leveraging at a price cheaper than prepayment at par and at a price that is presumptively lower than any lender that does not participate was willing to sell at.
- In practice, the permitted sources of cash will vary from deal to deal, but the following would be customary:
  - retained excess cashflow from prior years and/or retained proceeds from disposals, insurance claims, or claims against a diligence report provider or the vendor of an acquired business that, in each case, were not required to be applied in mandatory prepayment; and/or
  - the proceeds of new shareholder funding injected into the borrower group.

  In some cases, permitted financial indebtedness may also be used to finance a buyback but this will generally exclude any revolving (or equivalent) credit lines. Although this is at odds with the concept of de-levering the business through the buyback, this may be acceptable to a senior lender if the debt that is incurred to finance the purchase is subordinated to senior debt.
- **Type of debt: junior debt buybacks:** For capital structures that include junior debt, the buyback provision may also permit junior loans to be acquired if immediately prior to, and pro forma for, the acquisition the group is in compliance with a senior leverage ratio.
- **Waiver of breaches:** The credit agreement will provide that any loan buyback implemented in accordance with the credit agreement will not constitute a breach of certain (or all) of the general undertakings. This is included to ensure that the operation of the buyback is not construed as a breach of operating covenants such as the restrictions on making acquisitions, making prepayments of debt (if a buyback by a borrower were to be so characterised), and making certain intra-group loans (where the debt is acquired by a Group Member, thereby giving rise to that Group Member becoming a lender to the borrower).
- **Waiver of pro rata sharing provisions:** The credit agreement will also provide that the acquisition of loans from a sub-set of lenders will not trigger the pro rata sharing provisions that apply in certain circumstances to money received by a lender from a borrower. If these provisions continued to apply, then a lender that has entered into a loan buyback transaction with a borrower might have to share the cash that it receives with the lenders who did not participate in the buyback.

CONSIDERATIONS FOR THE PURCHASER

A Sponsor Affiliate, borrower or Group Member acquiring loans from a lender should consider a number of issues, including:

- **Existing contract review**: A review of its existing contracts to ensure there are no restrictions that apply to the buyback, whether under the applicable credit agreement or otherwise.
- **Regulatory considerations**: While loans do not constitute "securities" for the purposes of the SEC rules, there are still considerations that apply, for example:

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  - Whether or not the Sponsor Affiliate, borrower or Group Member is in possession of material non-public information with respect to the borrower or the group, and if it is in a position to trade the loans on that basis (in addition, see "Market abuse" below). Aspects of this may be addressed in the trade documentation by express customary language excluding representations and warranties as to financial condition, whether express or implied, and through the use of "big boy" letters.
  - Whether the buyback itself triggers disclosure obligations.
- **Market abuse:** As mentioned, transactions in loans can give rise to different market integrity considerations than transactions in listed securities. Nevertheless, although loans themselves are not regulated investments, knowledge of transactions involving the buyback of loans can constitute price sensitive information where a listed issuer is involved. Accordingly, appropriate controls such as information barriers should be put in place to control information flows between the private and public facing side of businesses.

HOW ARE ACQUIRED LOANS TREATED?

- **Should the debt be extinguished?** The LMA form provides for a buyback by the borrower only. Where the borrower is the purchaser of the debt, the liability that it acquires may be automatically extinguished on the basis that the obligations of the borrower as "borrower" will merge with the claims that it has against itself as a "lender". Whether the debt would be automatically extinguished or a positive act would be required on the part of the borrower to extinguish it, the LMA form specifies that the debt is extinguished upon completion of its acquisition. Depending on the jurisdiction of the borrower, this could give rise to a taxable event by reference to the extent of the liability that it has extinguished at less than its face value. In practice, most credit agreements will instead permit a Group Member to acquire the loans so that the debt is preserved and any

Focus on UK tax considerations

The method used for any loan buyback will impact the anticipated tax treatment – typically each case will require a detailed analysis given the potential complexities involved. The taxation of UK corporate debt falls within the UK corporation tax loan relationship rules, which broadly tax or relieve a company's profits (credits) and losses (debits) arising from its "loan relationships". The general rule is that loan relationship credits and debits to be brought into account are the amounts that, in accordance with generally accepted accounting practice (GAAP), are recognised in determining the company's profit or loss (P&L) for the period, subject only to certain specific statutory overrides.

A UK corporate borrower acquiring its own debt (or a company connected with the UK borrower that is acquiring the debt of the UK borrower) at a discount should generally recognise a taxable credit (profit) in the UK borrower's P&L equal to the difference between the carrying amount of the financial liability and any release consideration paid to the creditor. The tax treatment for a UK corporate creditor will be symmetrical. For example:

> UK borrower (B) has a loan of £1,000,000 outstanding to a UK creditor (C). B buys back the loan from C for consideration of £800,000. Assuming that the loan is recognised in the accounts of C at £1,000,000, C will recognise a debit (loss) of £200,000 in its P&L. Assuming that B also recognises a loan of £1,000,000 in its accounts, B will now recognise a taxable credit (profit) of £200,000.

In such circumstances, it will be necessary to consider whether the UK borrower has any losses or other tax reliefs which may offset the liability. In addition, where the terms of any loan agreements are amended or modified, consideration needs to be given as to whether this could be capable of potentially triggering a taxable event.

Certain exemptions may be available to the UK borrower from having to bring into account a taxable credit on a buyback where a new creditor is connected with the UK debtor company – including where: (i) within 60 days after the connected creditor becomes a party, it releases the debtor from its liability to pay an amount; (ii) the acquisition of the debt by the creditor is an arm's length transaction; and (iii) immediately before the creditor acquired the debt it was reasonable to assume there would be a material risk that at some time within the next 12 months, the debtor company would not have been able to pay its debts (meaning where the debtor is either unable to pay its debts as they fall due or where the value of its assets is less than its liabilities, taking into account contingent and prospective liabilities). Connection in this context means where one of the companies controls the other or both are under common control. The exemptions are typically complex and would need to be carefully reviewed on a case-by-case basis, including analysis of both the accounting and tax treatment as well as having to circumnavigate certain anti-avoidance provisions.

In addition, the parties should consider whether any stamp taxes may be payable upon repurchase – vanilla debt (ie debt which is not convertible into equity or another security and on which the interest payments and repayment of principal are on reasonable commercial terms) should be capable of benefiting from an exemption in UK law, however this will be subject to a review of the specific documentation to ensure that there are no terms which would prevent the relevant exemption from applying.

Where the debt will be acquired by an entity other than the original debtor, up-front analysis on any withholding tax issues should be carried out, including the timely submission of any relevant treaty relief applications prior to payment of interest. Any debt arrangements made between connected parties may also need to be considered from a transfer pricing perspective.

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material costs that might arise from the debt being extinguished can be avoided. Credit agreements often also provide that the debt does not have to be extinguished if to do so would give rise to material costs for the borrower. As a related point, it will be important to ensure that any Group Member (and any Sponsor Affiliate) acquiring a loan is resident in a favourable tax jurisdiction for matters such as withholding tax. It is therefore important to seek tax advice when structuring a loan buyback.

- **Credit support**: Where the loan is acquired by a Group Member, the Group Member becomes a lender of record of that loan and will benefit from any guarantees and security that attach to it. Some credit agreements specify that the loan held by the Group Member will not have the benefit of any guarantee, any transaction security, or any covenant to pay contained within a security document.
- **Prepayments**: Where the loan is acquired by a Group Member, the credit agreement may provide that the Group Member is not entitled to receive its share of any partial prepayment made by the borrower. The amount that the Group Member would otherwise have received could be treated in a number of ways. For example, the total amount of the prepayment could be reduced by the amount that the Group Member would have received, or it could be added to the amount applied in prepayment of the other lenders.
- **Intercreditor treatment**:
  - The credit agreement will specify that any loan acquired by a Group Member will be treated as intra-group debt and the Group Member, if not already party to the intercreditor agreement (ICA) as an intra-group lender, will accede to the ICA in that capacity. A standard ICA will subordinate intra-group debt to other third-party debt in the capital structure.
  - If a Sponsor Affiliate has acquired the loan, then depending on the drafting of the ICA, the debt that it holds may be captured by the provisions regulating subordinated liabilities. If the debt would be characterised as a subordinated liability, then payments on the debt will not be permitted without consent being obtained from all relevant parties under the ICA. This can be avoided if it is addressed when the ICA is negotiated.
- **Equitable subordination**: In some jurisdictions there is a doctrine of equitable subordination pursuant to which debt held by a shareholder could be reclassified and given a lower ranking priority to all secured and unsecured creditor claims. For example, in Germany, on the insolvency of a German company claims for the repayment of a shareholder loan (and any claims considered economically equivalent to shareholder loans) are settled after the claims of all the secured and unsecured creditors of that company have been fully satisfied. It is therefore important to take advice on this when structuring a Sponsor Affiliate debt purchase.
- **Voting**: Under the credit agreement the purchaser of the loan (whether that is the borrower, a Group Member or a Sponsor Affiliate) will be disenfranchised. For the purposes of calculating lender support for amendments and waivers, the purchaser will not be considered a lender and the loan it holds will not count as a commitment. However, it is customary to include the following exceptions to this rule so that the purchaser will have a voice in respect of amendments:
  - relating to an increase in its commitments under a facility;
  - relating to certain other amendments affecting a facility in which it holds commitments; and
  - pursuant to which all lenders under a facility are not treated in the same manner.
- **Information**: Under the credit agreement the purchaser of the loan (whether that is the borrower, a Group Member or a Sponsor Affiliate) will not be entitled to:
  - attend or participate in, or receive the agenda for, or the minutes relating to, any lender meetings or conference calls; or
  - receive any report or other document prepared at the request of one or more other lenders.

  These provisions are designed, in particular, to address concerns with sharing strategically sensitive information with a shareholder or borrower, such as discussions about the financial performance of the business.
- **Financial covenants**: If the borrower or a Group Member acquires the loan, the credit agreement will normally provide that this debt is not included in leverage calculations on the basis that intra-group debt is not counted as debt for these purposes and, as an accounting matter, the debt should also be neutralised on consolidation of the group's accounts. However, depending on the drafting of the credit agreement, the buyback may have other impacts on financial ratio calculations. In the past, some documentation enabled both:
  - a deduction of the amount of the loan purchased from the calculation of debt; and
  - an add back to EBITDA, as an unusual or non-recurring item, of the gain made from acquiring the loan at less than its face value.

  In practice, most credit agreements will include broad language that provides that the impact of any loan buyback transaction on EBITDA is ignored. ■

Further Reading:

- Loans in the time of COVID-19: how loan documentation has fared in this challenging environment (2020) 7 JIBFL 441.
- Borrower debt buybacks: the case becomes ever-more compelling (2008) 11 JIBFL 589.
- LexisPSL: Banking & Finance: The evolution of debt buybacks.