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BANKRUPTCY

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Tanking bond prices spell opportunity for issuers

Buying back discounted debt might make sense, but there are pitfalls.

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special to the national law journal

THE LIQUIDITY CRUNCH, withdrawals from hedge funds and deteriorating traditional lender balance sheets have helped drive debt-trading prices to unprecedented lows. These low prices for debt—overselling, perhaps—have created opportunities to unlock value either by using balance-sheet or sponsor/equity cash to repurchase debt at deep discounts to face value. Capitalizing on these opportunities often comes at a price, however, and a variety of legal and economic pitfalls can confront both the repurchasing issuer and creditors that benefit from the buyback. Practitioners should become familiar with certain hurdles associated with debt repurchases outside of bankruptcy as well as some of the implications of a subsequent Chapter 11 filing by the borrower.

Bond indentures typically do not prohibit the repurchase of the bonds by the borrower, and almost never prohibit the repurchase of debt by equity by the company or its affiliates. However, most indentures, reflecting § 316 of the Trust Indenture Act, will bar the issuer or its affiliates from voting the notes repurchased with respect to most consents or waivers that might be embedded in a supplemental indenture.

Although the typical indenture will not prohibit the issuer from buying back debt, agreements governing other debt obligations of the issuer often will prohibit the buyback of bonds through a "restricted payment" or similar covenant. These covenants, among other things, prevent issuers from prepaying junior creditors ahead of senior creditors in the capital structure.

Nonetheless, holders of senior debt may—given the implied improvement to the balance sheet and interest coverage—support a proposal to repurchase junior debt at a discount and be willing to grant a waiver to any "restricted payment" covenants. These same holders of senior debt will almost certainly, however, require a fee for such an amendment, and may require other things, such as a partial prepayment of their debt at par.

Repurchases of credit-agreement debt by the issuer or affiliate present different complications.

The process may complicate bankruptcy later.

Unlike indentures, credit agreements usually do not disqualify affiliate votes. Yet almost all credit agreements (again, unlike indentures) limit which institutions can be an assignee in the first place. The typical "eligible assignee" definition limits assignments of credit agreement debt to persons that are commercial banks, financial institutions or funds engaged in the purchase, sale or origination of credit, having a net worth above a designated amount. Often, but not always, the approval of the administrative agent can render a person an "eligible assignee," even if such person would otherwise not be qualified.

Equity sponsors may or may not have funds under their control that qualify as an "eligible assignee," but few borrowers will meet the "eligible assignee" requirements. This obstacle usually may be navigated, however, through amendment to the credit agreement. A majority of the outstanding principal amount of the debt and unused commitments under most credit agreements have the power to modify eligible assignee requirements.

When an issuer or its affiliate purchases debt at a discount, it could be argued—and some credit agreements expressly provide—that such a purchase should be deemed a payment by the issuer to the selling lender. This is problematic because credit agreements typically provide that any prepayment by the issuer must be made to, and shared by, all lenders on a pro rata basis. By purchasing a loan from one lender, the issuer or its affiliate, or the selling lender, could be burdened by compliance with these provisions (with a lot depending on how the provisions are drafted).

A typical credit agreement will contain two provisions dealing with ratable payments. The first expressly prohibits the borrower from making nonratable payments (often requiring that all payments be made through the administrative agent). The second is a "sharing" provision requiring any lender that receives such nonratable payment to share the payment with other lenders. Modification of these provisions typically requires a vote of all lenders or each affected lender—an impossibility in most cases—which presents a stumbling block for issuers and equity sponsors hoping to execute a debt repurchase.

Limitations on making (as opposed to receiving) non-pro rata payments, in most cases, apply only to the borrower. These provisions typically do not obstruct a repurchase of debt by persons other than the borrower (such as an equity sponsor), and ordinarily would not prohibit the sponsor from contributing that debt to the borrower as long as the sponsor receives no payment for the debt. Provisions addressing payments by the borrower often are narrowly drafted to apply to payments of the debt and arguably do not include payments in consideration for an assignment or participation.

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However, even if the credit agreement does not expressly regulate "repurchases" as opposed to "payments" in respect of debt, the administrative agent's consent may still be needed. A cautious administrative agent may refuse consent on this point, forcing an amendment to clarify the issue.

While a prohibition against the borrower making non-pro rata payments is a borrower problem, a limitation on receiving payments is a selling-lender problem. Because the "sharing" provisions of the credit agreement represent an intercreditor issue, the borrower, to the extent otherwise permitted, could effect a debt repurchase that does not trigger an event of default, but does trigger burdensome sharing obligations among the lenders.

A variety of complications

Complicating this issue is a surprising variety in the boilerplate provisions relating to sharing of payments. Some are drafted narrowly and address only setoffs and involuntary payments triggered by a lender. Others are broad and require the lender to share any payment from any source. Some expressly provide that the benefit of a payment received by one lender must be shared with other lenders via the first lender's purchase of a participation from the other lenders without addressing the pricing of the participation. Others indicate that the participation must be paid for cash at face value.

The least problematic sharing provisions are those that expressly apply only to payments from setoffs or similar involuntary payments. Also less problematic are those that are ambiguous—they neither state that they apply to consideration for assignments and participations nor do they require repurchase for cash at face value. For these provisions, a non-pro rata repurchase may, on a number of legal theories of contract construction and estoppel, be executed without material risk with respect to the triggering of onerous payment-sharing obligations, particularly if the offer of debt repurchase is made pro rata to all lenders.

The most problematic sharing provisions are those that expressly apply to all payments (including consideration for assignments or participations to the issuer and affiliates alike) and require the selling lender to purchase participations from other lenders for cash at face value. These provisions present the selling lender with express language that points to the possibility of selling at a discount and sharing the proceeds of the sale with other lenders by purchasing participations at face value. If these provisions require a vote of all lenders or each affected lender to carry out the debt repurchase, the problem may prove insurmountable.

Given this variety, there is no "one size fits all" way to address a debt repurchase when the sharing provision stands in the way. Furthermore, selling lenders may not always safely assume that because the borrower has undertaken the debt repurchase, that the selling lender does not need to consider with care the sharing provisions.

Debt repurchases can also trigger issues with excess cash flow sweeps and financial covenants in the issuer's governing debt documents. The cancellation of indebtedness resulting from a debt repurchase may trigger income under Generally Accepted Accounting Principles that could affect the calculation of financial ratios for incurrence or maintenance financial tests. This could trigger an increase in excess cash flow, which in credit facilities with an excess cash flow sweep could require a repayment of the loan even though cash was not actually generated. Furthermore, a borrower repurchase may result in the use of excess balance sheet cash to repurchase debt but may not reduce the excess cash flow sweep requirements. Lenders and borrowers negotiating an amendment to permit a debt repurchase need to keep a careful eye on these provisions.

Moreover, debt repurchases can trigger taxes on cancellation of indebtedness income. These taxes can be triggered both by a borrower repurchase using balance sheet cash and by a sponsor repurchase. Under the Internal Revenue Code, the acquisition of debt by a "related person" triggers the cancellation of indebtedness income, and a "related person" includes (among other things) a stockholder owning more than 50% of the value of the borrower company. Under some circumstances, the repurchase of debt by an equity sponsor could result in a deemed reissuance of the debt, which (in addition to triggering cancellation of indebtedness income) could introduce applicable high-yield discount obligation limitations on future interest deductions. Legislation pending in Congress would ease some of these tax issues, in particular by deferring recognition of cancellation of indebtedness income for a time.

Cancellation of indebtedness may trigger income.

The tax effect of a repurchase of debt needs to be considered both for tax reasons and with respect to its effect on the credit agreement financial covenants. Taxes resulting from the repurchase of debt may be included in earnings before interest, taxes, depreciation and amortization, distorting financial tests under the credit agreement or elsewhere in the capital structure.

As discussed above, outside Chapter 11, the governing agreement or applicable law may disqualify affiliates of the issuer from participating in any lender vote. In contrast, § 1126(a) of the Bankruptcy Code expressly provides that any holder of an allowed claim may vote to accept or reject a plan. Interested parties can seek to disqualify the insider's vote (the Bankruptcy Code defines an "insider" as including affiliates and entities in control of the debtor) as cast in bad faith. 11 U.S.C. 1126(e)). However, barring unusual circumstances, the mere fact that an affiliate purchased debt prepetition at a discount is not likely to render the vote cast in bad faith.

The Bankruptcy Code does provide some limits on an insider's ability to vote its claim. Bankruptcy Code 1129(a)(10) provides that a plan that impairs the rights of any class of creditors can be confirmed only if at least one impaired class votes in favor of the plan, not taking into account the votes of any insiders in favor of the plan.

Bankruptcy Code 1129(a)(10) does not completely undermine an insider holding a large claim, however, and that insider may still have substantial leverage in the plan process. Acceptance by any class of impaired noninsider creditors will satisfy the § 1129(a)(10) requirement. Assuming there is another impaired accepting class willing to accept the insider's plan, the plan can be confirmed, and an insider holding a controlling class position can vote in favor of the plan, obviating the "cramdown" protections typically afforded to a dissenting class of creditors (i.e., requiring that the plan not "discriminate unfairly" and "is fair and equitable" with respect to each dissenting class).

Moreover, although § 1129(a)(10) disqualifies insider votes for purposes of determining an impaired accepting class, it does not disqualify insider votes against a plan. Hence, an insider holding a controlling position may be able to block competing plans of reorganization.

Additional risks

There are other bankruptcy-related risks that an issuer (and any selling lender) will need to consider. For example, to the extent that the debt is purchased within 90 days of the bankruptcy, the purchase is potentially subject to avoidance as a preferential payment. Moreover, as noted above, and depending on the circumstances of the particular case, any insider vote (either for the debtors' plan or against a competing plan) could be disqualified as being cast in bad faith pursuant to Bankruptcy Code 1126(e).

In addition, insiders who purchase debt of the issuer face a potential risk of equitable subordination of the claim. Equitable sub–ordination is a remedy used by the bankruptcy court whereby the applicable claim will not be paid until other claims are paid in full. Although bankruptcy courts typically will equitably subordinate claims only when there is evidence of egregious conduct such as fraud or breach of a fiduciary duty, insiders are held to a higher level of scrutiny than are unrelated creditors. Accordingly, although the case law is clear that the mere purchase (or repurchase) of debt by an insider does not expose the insider/creditor to equitable subordination, some courts have held that a fiduciary that uses its insider position to its advantage by purchasing a claim against an insolvent debtor should have its claim written down to the amount the insider actually paid for the claim, as opposed to the claim's face value. NLJ