



# PORTFOLIO COMPANY RESTRUCTURING CONSIDERATIONS

Sponsor Debt Purchases

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# Sponsor Debt Purchase: Benefits

- Investment purposes (i.e., to have the benefit of the gain on any discounted purchase of debt).
- De-levering through contribution of debt to portfolio company.
- Separate consideration needs to be given to terms and conditions of any such contribution, including with respect to pricing of equity issued in exchange for such contribution, the pricing of the debt that is contributed and participation rights of other investors.
- Retaining ownership in the event of insolvency.

# Sponsor Debt Purchase: General Considerations

## Contractual Restrictions

- Debt agreements may restrict:
  - i. the amount of debt that may be purchased by affiliated lenders (the maximum amount typically permitted is 25%) – note, however, that limitation is unlikely to apply in the case of bond purchases;
  - ii. the voting rights of an affiliated lender;
  - iii. control in a restructuring process (restrictions are unlikely to apply in the case of bonds); and
  - iv. conditions to a portfolio company's purchase of debt (including restrictions on the use of proceeds of any revolving debt to purchase any term debt and whether debt should be cancelled or held in an unrestricted subsidiary).
- Voting rights restrictions may concentrate the voting power of friendly (or unfriendly) investors.
- Shareholder agreements may limit amount of debt held by equity owners or require debt purchase opportunity to be shared with other equity investors.

## Securities Laws

- Purchaser should consider whether it has material non-public information about the issuer.
- Knowledge of material non-public information may limit ability to buy and, once purchased, sell back into the market.
- Risk higher with bonds than bank debt because:
  - i. greater information available to bank debt holders; and
  - ii. bonds are securities for purposes of securities laws; loans are not, although we cannot rule out that a court might, for the first time, decide that they are on the right facts.
- Tender offer rules may apply for sophisticated or coordinated repurchases.
- “Big Boy” letters may limit reliance claims by trade counterparty.

# Sponsor Debt Purchase: General Considerations

## Fiduciary Duties

- Debt purchases may be considered a corporate opportunity belonging to the company.
- Most sponsor-backed companies address risk through a waiver of corporate opportunities.
- Sponsor should still consider disclosing its intention to purchase debt at a discount to the Board of Directors in advance of purchase and whether or not to give the opportunity first to the issuer.
- For portfolio companies with potential liquidity or insolvency concerns, unless limited or waived, the Board of Directors and the sponsor must be especially mindful of their fiduciary duties (e.g., duty of care and duty of loyalty).
- Fiduciary duties may be limited or waived in LLC agreements or limited partnership agreements but not in the case of a corporation.
- Sponsor may consider appointing independent directors or a special committee to authorize transactions with insiders, including the sponsor, during any period where liquidity or insolvency could be an issue.

## Conflicts of Interest

- If different funds will hold debt and equity, conflicts may arise between the funds, including when exercising voting rights or consenting to amendments and waivers, or failing to take action.
- Sponsor directors need to be attentive to potential conflicts in their position as an equity holder and their position as a debt holder. In addition, sponsor directors should not take actions that prefer their debt position over similarly situated debt holders.
- Conflicts may arise between the debt purchaser and equity holders who do not purchase debt.

# Sponsor Debt Purchase: General Considerations

## Bankruptcy Opportunities and Potential Risks

- Sponsor purchase provides unique opportunities in the event of a bankruptcy; it allows the sponsor to maintain an economic interest in a company in which the sponsor was already invested.
- Potential for equitable subordination if (a) the sponsor engages in improper conduct related to the purchased debt or otherwise and (b) the improper conduct results in harm to one or more creditors. Conduct could include breaches of fiduciary duties or violations of the securities laws in the purchase of the debt or purchase of debt with material non-public information.
- As an insider, actions taken by sponsor as debt holder will be subject to heightened scrutiny.
- Insider voting limitations in bankruptcy – votes by an insider of a debtor, including a sponsor fund, will not count for purposes of determining the acceptance of a Chapter 11 plan. However, sponsor debt holdings may give sponsor better “seat at the table” during restructuring negotiations.
- Extended preference period for insiders (one year vs. 90 days) exposes sponsor to additional risk with respect to payments on the purchased debt.
- Arguments to limit right to credit bid because sponsor is an insider.
- Debtor must pay professional fees of any creditors’ committee that is appointed, which may incentivize creditors to pursue claims against sponsor.

# Sponsor Debt Purchase: Tax Considerations

## U.S. Tax Consequences of Issuer Debt Repurchase

- *Cancellation of Debt Income (“CODI”).* Purchases of a portfolio company’s debt by the issuer generally will, and purchases by a related party at a discount may, give rise to CODI to the issuer.
  - i. *Exception:* No CODI to the extent of company’s insolvency if company is a corporation.
  - ii. For sponsor purchases, related-party rules (which vary based on sponsor’s percentage ownership and whether issuer and/or purchaser is a corporation or partnership) may, depending on the facts, be managed through AIV structures.
  - iii. Potential CODI offset over time through OID deductions (limited by AHYDO rules and EBITDA interest deduction limitation).
- *CODI Offset by NOL Carryforwards.* Even if there is CODI, consider whether the issuer will not have a material tax liability in light of its tax attributes, such as NOL carryforwards.
- *30% Withholding to Non-U.S. Investors.* In general, a 30% withholding tax applies to U.S.-source interest income realized by non-U.S. investors/blockers. The “portfolio interest exemption” often is not applicable when buying debt of portfolio companies.
- *Utilizing Treaty Structures to Buy Debt.* Tax issues may be managed in some cases by using corporate AIV structures. Due to changes in European laws in recent years, additional analysis will be necessary to assess viability of any proposed structure.
- *Potential Phantom Income.* Certain PE fund investors may realize phantom income:
  - i. in connection with any OID on purchased debt (i.e., the regular “market discount” rules may not apply); or
  - ii. as a result of any purchaser entity being a “passive foreign investment company” or CFC.
- *Pass-Through or Non-U.S. Portfolio Companies.* Special considerations in addition to (or differing from) the above may apply.