Purchasing Portfolio Company Debt – Threshold Issues for Private Equity Sponsors

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Introduction

The coronavirus (COVID-19) emergency has led to the debt of many companies in private equity portfolios trading at a significant discount. As a result, an increasing number of private equity sponsors are strongly considering whether to purchase portfolio company debt in the secondary market as an investment opportunity. At the same time, the portfolio companies themselves are considering repurchasing their own debt to accomplish the twin goals of increasing equity value by retiring debt at a discounted price and reducing leverage during this volatile period in the global financial markets.

This memo highlights several legal issues for private equity sponsors and their portfolio companies to consider in evaluating a potential purchase of portfolio company debt.

Key Issues to Consider

Do fund documents permit private equity funds to make this purchase?

Private equity funds' partnership agreements, side letters or other fund documents may restrict the ability of the private equity fund to purchase portfolio company debt. For example, these documents may contain concentration limits that limit the percentage of total commitments that may be invested in the debt or equity of a single company, limitations on investing in debt where an affiliated investment fund owns equity in the issuer of the debt and restrictions on the types of instruments that may be acquired by the fund. As such, it is critical that fund documents are reviewed when a private equity sponsor is considering a purchase of portfolio company debt.

Could buying portfolio company debt result in a conflict of interest even if it is permitted by the fund documents?

An acquisition of debt of a portfolio company in which an affiliated investment fund (which can include aggregators or special purpose vehicles through which co-investors participate), managed by the same sponsor, holds a pre-existing interest (*e.g.*, in the common equity) can raise potential conflicts of interest, even if the purchase is not otherwise prohibited by the acquiring fund's fund documents. For instance, if the acquisition of debt is being made through a different fund than holds the equity, the sponsor may face a conflict of interest by virtue of advising two funds in different parts of the company's capital structure. In distressed scenarios, this conflict can be more acute. Resolving these conflicts may require consultation with, or approval by, each fund's investors or limited partner advisory committees.

Do the portfolio company's credit agreements permit the purchase of the company's debt by the private equity fund or the repurchase of the company's debt by the company itself?

Most credit agreements entered into by portfolio companies over the past decade permit the borrower and its subsidiaries to repurchase, and affiliates of the borrower (*e.g.*, the sponsor or a debt fund affiliated with the sponsor) to purchase, term loans of the company (the purchase of revolving loans and commitments, on the other hand, is still generally restricted and in many cases prohibited).

However, some (typically mid-market) credit agreements continue to prohibit any purchase of loans by the borrower or its affiliates (including the sponsor). In these situations, the affiliate or the borrower may be able to enter into a participation with a lender; if this option is not available, an amendment (which may require a 100% lender vote) will be required to permit a debt purchase/repurchase.

Set forth below is a high-level overview of common terms in credit agreements that may restrict a sponsor or the portfolio company from purchasing or repurchasing debt.

- *Purchases by the private equity sponsor or its affiliates.*
  - Restrictions on affiliates purchasing term loans vary from agreement to agreement, but generally include some or all of the following: prohibitions on the affiliate receiving information, or attending phone calls or meetings, intended solely for third party lenders; a cap (typically 25%, and, in a few cases, 30%) on the aggregate amount of term loans permitted to be purchased by the affiliate; limitations on voting rights; limitations on certain rights in a bankruptcy of the portfolio company; and in some cases, the consent of the administrative agent is required for assignments to the affiliate.
  - Most recent credit agreements include exceptions from these requirements if the debt is purchased by a debt fund affiliated with the sponsor, subject to a cap on the aggregate amount of debt held by the debt fund affiliate that may count towards a required lender vote.
  - Some credit agreements permit the affiliate to contribute term loans it acquires to the portfolio company for cancellation, which contribution will typically increase any "available amount" or "cumulative credit" builder basket under the credit agreement.
  - Certain credit agreements (even those with robust debt buyback mechanics) may include a requirement that an affiliated purchaser represent that it is not in possession of material nonpublic information at the time of the purchase. Others may provide the flexibility for the parties to make a "big boy" acknowledgement (an acknowledgment from the assignor that the purchaser may have material nonpublic information that the assignor does not have).
- *Repurchases by portfolio companies.*
  - Credit agreements that permit a borrower or its subsidiaries to repurchase its own debt typically impose limitations on repurchases, and these limitations should be carefully reviewed in light of the particular provisions and the facts and circumstances that the borrower is facing. Particular attention should be paid to the following provisions:
    - *Event of Default Blocker*. Many credit agreements restrict a borrower from repurchasing its own debt while an event of default is continuing.
    - *Source of funds*. Most credit agreements do not permit a borrower to use revolver borrowings to repurchase term loans, although an increasing number of recent credit agreements do provide this flexibility.
    - *Pro rata sharing requirements*. Credit agreements uniformly contain "pro rata sharing" provisions, which require that payments received from the borrower must be shared ratably among all lenders. While most credit agreements expressly carve out debt repurchases by the borrower that are otherwise permitted under the credit agreement from the sharing provision, careful attention should be given to these provisions if the repurchase is on an open market basis and intended to be on a non-pro rata basis.

        - *Covenant restrictions*. If there are multiple layers of debt in the capital structure and the portfolio company intends to repurchase junior lien, unsecured or subordinated debt, the company should consider whether there are any restrictions on the repurchase of such debt in any of its debt instruments.

    - *Ability to "reload" incremental debt capacity*. Many credit agreements permit a borrower that voluntarily pays down its term loans (including through repurchase at or below par) to, in the future, re-borrow debt (and thereby re-lever) up to the principal amount of the term loans that are repaid or repurchased. Such a "reload" is typically not subject to the borrower meeting a ratio or other test at the time of the reload and so may have the additional benefit of providing the borrower with additional debt capacity.

    - *Calculation of excess cash flow*. Credit agreements typically require borrowers to use a portion of excess cash flow to pay down term loans at par. When calculating excess cash flow, most recent credit agreements give the borrower dollar-for-dollar credit for the amount of the cash used to repurchase loans; if the credit agreement does not provide for this credit, the implications of using cash to repurchase debt on a future excess cash flow sweep should be considered.

    - *Impact of repurchase on EBITDA and leverage ratios*. A repurchase of outstanding loans at a discount may result in an accounting gain for the borrower, and thus increase EBITDA. A repurchase at a discount will also result in a reduction in the debt outstanding (with less than a dollar-for-dollar use of cash). Because leverage ratios are such an important metric in credit agreements, borrowers should consider the impact of such a repurchase on financial covenants, debt incurrence ratios and other ratio-based provisions.

    - Typically, credit agreements provide for or require the cancellation of any debt repurchased by a portfolio company or its subsidiaries. Some indentures may also require this result. Some recent credit agreements exempt unrestricted subsidiaries from this requirement.

What considerations should we think about if the debt in question is senior notes or another debt security?

If the debt takes the form of a security such as senior notes issued under an indenture (in contrast to loans outstanding under a credit agreement), the private equity sponsor or portfolio company should consider the following:

- *Material nonpublic information*. The purchaser should consider whether it possesses material nonpublic information about the debt or the issuer, such as unreleased recent operating results, the impact on the business from the ongoing COVID-19 pandemic or other unannounced material activities. U.S. securities laws, stock exchange regulations and/or common law fraud principles may require disclosure or result in liability for those who purchase debt while in possession of such information. A purchaser may also use a Rule 10b5-1 plan to execute a number of purchases over a period of time. Rule 10b5-1 provides an affirmative defense to an insider trading claim, and a purchaser may enter into a Rule 10b5-1 plan that instructs a broker to execute transactions in the future subject to certain pre-agreed criteria without further input from the purchaser entering into the plan.

- *Re-sales of purchased securities*. In most cases, the debt securities being purchased will be "144A for life" securities that trade among certain large institutional investors called "qualified institutional buyers," or QIBs. In that case, purchasers may resell any purchased securities on a private basis to QIBs, but caution should be taken to review the underlying indenture pursuant to which the debt securities were issued or other contracts such as the purchase agreement to ensure there are not any contractual restrictions on resales by "affiliates" or otherwise.

- *Method of making any purchase*. Purchases of debt securities can be made through the open market or through privately negotiated transactions with individual holders, or alternatively by launching a tender offer. A portfolio company engaging in open market purchases or a tender offer should also consider any disclosure obligations it may have under the rules of any stock exchange where the company's equity or debt instruments are listed.

Will a purchase of debt have any adverse U.S. federal income tax consequences?

As described below, the purchase of portfolio company debt at a discount will generally trigger taxable cancellation of debt ("COD") income to the portfolio company and may cause the purchased debt to no longer be fungible with the remaining debt (which may impact the ability to resell the debt into the market). The precise tax consequences depend on whether the debt is repurchased by the portfolio company itself or by the private equity fund.

- *If the portfolio company repurchases its own debt*.
  - *Amount of COD income*. If a portfolio company repurchases its debt at a discount, the company will generally have COD income equal to the excess of the face amount of the repurchased debt (or, if the debt has original issue discount ("OID"), the "adjusted issue price" of the debt) over the amount paid to repurchase the debt.
  - *Corporate portfolio company.*
    - *Use of NOLs*. If the portfolio company is treated as a corporation for U.S. tax purposes, the company may be able to offset all or part of the COD income with net operating losses ("NOLs") of the company. In some cases, the use of NOLs may trigger a payment to a former owner of the portfolio company under a so-called "transaction tax benefit" provision of the original purchase contract.
    - *Insolvency exception*. A corporate portfolio company can exclude COD income if and to the extent that it is able to demonstrate that it is insolvent at the time it repurchases the debt. In this event, the company will be required to reduce various favorable tax attributes (such as NOLs or tax basis in depreciable assets). Insolvency for this purpose is determined using a balance sheet test (*i.e.*, it is insolvent to the extent the amount of liabilities exceeds the fair value of its assets, including goodwill).
  - *Portfolio company organized as LLC (or other flow-through entity)*.
    - *Flow-through of COD income*. If the portfolio company is treated as a partnership for U.S. tax purposes, the COD income will flow through as taxable income to the partners, including the general partner and any blocker corporations.
    - *Blocker use of NOLs and insolvency exception*. A blocker corporation may be able to shield the COD income with any available NOLs or to the extent it can establish that it is insolvent. As a general matter, neither the partnership nor the other partners will be able to take advantage of the insolvency exception.
  - *Debt modifications*. COD income can also arise if portfolio company debt is modified in a manner that is considered material for tax purposes, including certain changes to the timing of payments or changes that sufficiently impact the yield.
- *If the private equity fund purchases portfolio company debt*:
  - *If related to fund, portfolio company still has COD income and discount becomes OID*. If a private equity fund purchases debt of a portfolio company at a discount and (as will often be

the case) the portfolio company and the fund are treated as "related" for U.S. tax purposes, then:

- The portfolio company will be treated as though it repurchased the debt at a discount. As a result, the portfolio company will have COD income under the rules discussed above.
- In addition, the debt purchased by the private equity fund will be treated as if it had been reissued by the portfolio company to the private equity fund for an amount equal to the price paid for the debt by the private equity fund. As a result, the discount paid by the fund will effectively be converted to OID on the debt. The OID will accrue ratably over the remaining term of the debt. The private equity fund will generally be required to include the OID in income as "phantom income" as it accrues.

- *Simple example*. For example, if a private equity fund buys $100 of debt of a related portfolio company for $75, the portfolio company will generally have $25 of COD income and the debt will be treated as having been reissued to the fund with an additional $25 of OID.
- *Limits on the portfolio company's deduction for the OID*. The portfolio company's ability to deduct both the interest actually paid and/or the OID may be subject to a variety of limitations, including:
  - the Section 163(j) rules, which very generally limit the interest deduction of a portfolio company to 30% of the company's EBITDA (for years ending before January 1, 2022) and 30% of the company's EBIT (for taxable years beginning thereafter), with EBITDA and EBIT computed using tax principles;
  - the so-called AHYDO rules, which generally limit deductibility on certain debt instruments with terms exceeding five years where specified thresholds of OID and yield to maturity are exceeded; and
  - Section 163(e), which defers until payment deductions for OID in respect of debt held by foreign related persons.
- *Use of corporate acquisition vehicle as a potential workaround*. If a private equity fund and a portfolio company are not treated as related for tax purposes, the purchase of debt of the portfolio company by the private equity fund will be taxed under the market discount rules but no COD income or OID will be created under these rules. Moreover, if a corporate acquisition vehicle owned by a private equity fund is used to purchase debt of a corporate portfolio company, the related party rules may not apply. However, in such a case, it is important to consider the extent to which the corporate acquisition vehicle will be taxed (or subject to withholding) on any income or gain attributable to the purchased debt.

Will an investment in portfolio company debt be a "good VCOC investment" for the private equity fund?

As with any investment by a private equity fund that intends to operate as a "venture capital operating company" ("VCOC") (because either it has at least 25% ERISA investors or it has less than 25% ERISA investors but elects to operate as a VCOC as a back-up or for reassurance), the fund should consider whether the purchase of portfolio company debt would be a "good VCOC investment" for purposes of the fund's qualification as a VCOC. While most private equity funds that operate as VCOCs make their good VCOC investments in the form of equity investments in portfolio companies, debt investments can also qualify as good VCOC investments so long as the investment is in an "operating company" and the fund obtains the requisite contractual "management rights" in the operating company.

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A common structure for private equity investments results in the private equity fund owning equity securities of a parent holding company, with the debt issued by a lower-tier operating company, so the contractual management rights that made the fund's equity investment a good VCOC investment may not be sufficient for the fund's investment in debt issued by a subsidiary. Accordingly, it may be necessary for the private equity fund to obtain contractual management rights with respect to the lower-tier operating company, to ensure that the debt investment will also qualify as a good VCOC investment.

Similarly, if the debt will be purchased by a different fund (even if by an affiliated fund), the purchasing fund will need to obtain its own contractual management rights in order to qualify the investment as a good VCOC investment.

A private equity fund that purchases portfolio company debt through one or more intervening entities may not be able to treat its debt investment as a good VCOC investment because it may not be considered to have invested in an "operating company." The intervening entity may not be considered an operating company because it may not be engaged, directly or through one or more majority-owned subsidiaries, in the production or sale of a product or service other than the investment of capital. That said, the Department of Labor has indicated that any intervening entity that is wholly-owned by the fund can generally be disregarded in determining whether the fund has invested in an operating company.

What risks are there for a private equity sponsor if the portfolio company later files for bankruptcy?

If the portfolio company later files for bankruptcy, all of its transactions with the sponsor are likely to be rigorously scrutinized, especially those effectuated close in time to the filing. For example, other stakeholders in a bankruptcy of the portfolio company may make various allegations against the private equity sponsor, including seeking equitable subordination of any claims held by the sponsor to those of other creditors. Even if those allegations are meritless, the private equity sponsor could incur substantial legal costs defending or settling such claims.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your usual Davis Polk contact.

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