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Borrower debt buybacks: the case becomes ever-more compelling

Feature

Borrower Debt Buybacks

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As syndicated debt trades ever-lower the temptation for borrowers to buy back such debt rises in inverse proportion. The article below is an attempt to de-mystify some of the legal issues involved in effecting a debt buyback.

KEY POINTS

- Debt buybacks have become increasingly attractive to borrowers as debt trades down and companies seek to deleverage.
- European LMA-style documents may be more permissive of debt buybacks than US law documents.
- The affiliate buyback route may be emerging as a preferred model.
- Residual concerns around whether 'debt forgiveness' requires consent of other lenders and whether bought-back debt is subordinated may be resolved by reference to English common law principles.
- Worries about the co-operation of the facility agent may be exaggerated.
- While lender sensitivities around voting and information rights and about unequal treatment in the buyback process will not usually prevent a buyback, the borrower may wish to address them in some way.

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WHY DO A BUYBACK?

If a borrower group has cash (whether as a result of operating revenues or as a result of an equity cure by its shareholders) and it wishes to reduce its indebtedness it traditionally would repay the debt at the face (par) value of that debt. However, if that borrower group's syndicated debt is trading in the market at below its par value, it would get a bigger reduction in its indebtedness (on a consolidated basis for the borrower's group) by using the same cash to purchase the debt at its market value.

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There can be few banking lawyers in the City who haven't scoured over syndicated loan documents in recent weeks, analysing whether the particular formulae of words in their documents permit open-market loan buybacks without the requirement for an amendment of the documents.

The problem is that invariably, European syndicated loan documents fail to expressly legislate for the acquisition of the debt by the borrower or its affiliates. This contrasts markedly with the position in typical bond documentation, where this situation is usually expressly permitted and provided for. This has led to considerable hand-wringing from London's Loan Market Association ('LMA'), who have led the formulation of standard form loan documentation which has been widely adopted in the European markets.

THE SURGE OF DEBT BUYBACKS IN THE US

In fairness, the problem is similar in the US, where there is less standardisation in the form of syndicated loan documentation. Similar, that is, in that debt buybacks aren't expressly dealt with. However, there are interesting differences in the results of the debt buyback analysis under the US forms when compared to that under LMA documents. The incidence of borrower buybacks is increasing in the US -- according to reliable sources there were five loan buyback amendment requests launched in the syndicated loan markets in the US in October and 11 in November. However, the US buybacks have apparently all (save for one, which was unusual in that it specifically permitted sub-par buybacks) been done with the consent of the lenders (sometimes by unanimous consent, sometimes by the 'requisite majority' of lenders (usually 50.1 per cent in the US)). Interestingly, there aren't reported cases of amendment-free buybacks on typical documentation such as we saw in the widely reported TDC and Fat Face transactions in Europe, and of which we expect to see more in the coming months.

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Pro rata sharing: under LMA wording the 'sharing' obligations only apply where an amount is applied against sums owed under the loan documents. They would not apply where a debt was sold, unless a court was prepared to 'recharacterise' that sale as a prepayment. Recent precedent on contractual interpretation suggests the courts would be reluctant to apply such a 'form over substance' interpretation.

Permitted transferee: LMA wording is wide. Essentially it permits any entity which has the making of loans listed as one of its corporate purposes to be a transferee of loans.

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In the US, the borrower seems to get caught by one or more of the provisions in the credit agreement, such as the pro rata payments, the sharing and the permitted transferee sections, which usually need to be amended to permit a buyback. This is often not the case in LMA type documents, as has been well documented1 (see BOX inset for a summary).

THE POSITION IN EUROPE CONTRASTED

Instead, European borrowers are usually left trying to get comfortable with residual concerns, such as understanding the correct interpretation of the documents in circumstances where the senior debt also falls literally

within the definition of intra-group debt (which is subordinated). In this article we share some thinking on these residual concerns, which involves some interesting analysis of established principles of English law.

THE BASIC ALTERNATIVES EXAMINED

We will examine some of these issues in the context of some of the basic schemes which may be available to do buybacks. We will assume that the intention is not just to purchase the debt at market prices but also to achieve a deleveraging effect on the borrower group's financial covenants (for example on its obligation to maintain a certain debt-to-earnings ratio). The points below are made in general terms and it goes without saying that the relevant documents need to be meticulously examined and any local law issues considered before a debt buyback can be sanctioned in any particular case.

OPTION 1: THE BORROWER BUYS BACK ITS OWN DEBT

There has been much discussion around the effect on the debt of a borrower-self buyback under English law and there is no need to go over that old ground again.[1] Suffice it to say that we believe the best view is that the debt would not be extinguished automatically until the debt becomes due for payment. However, there are different schools of thought on this[2] and for that reason (as well as, possibly, for tax reasons) many borrower groups will prefer the other options set out below.

OPTION 2: A COMPANY IN THE HOLDING STRUCTURE OF THE BORROWER GROUP BUYS THE DEBT AND FORGIVES IT

This option may be available if the shareholders of the borrower are prepared to contribute cash to the group, perhaps by way of an 'equity cure'. The key benefit of this scheme is that it is often neat from a documentary perspective, because the company doing the buyback is outside the borrower covenant group (and as such may not be regulated by the restrictions on the covenant group in the finance documents). However, in order to have the effect of deleveraging the covenant group, it may be necessary for the acquired debt to then be forgiven.[3]

Tax advisers will need to analyse carefully the 'forgiveness' of the debt and, if there are significant tax inefficiencies, option 3 may be preferred. Let's assume for a moment, however, that a borrower group prefers this option 2.

The interesting question that arises is whether a lender under a syndicated loan agreement is permitted to unilaterally forgive its debt. The fact that there is a question over this is counter-intuitive -- why should a lender need permission from other lenders if it wishes to forgive its claims?

Legally, the 'wrinkle' that needs to be considered is as follows. Once an entity is a 'lender', it will need to accede to the loan agreements and it will be bound by the restrictions on lenders. If the loan agreement has the usual 'amendments and waivers' section that requires that a 'waiver' which has the effect of 'reducing the principal amount of a payment payable under the finance documents' requires the approval of all or a specified majority of the lenders, one needs to consider whether this needs to be complied with.

The answer is no, there are good reasons why it may not be necessary.

The purpose of the amendments and waivers section is to streamline decision-making among the syndicated lenders by providing that all the lenders will be bound by a decision of the requisite majority (save that it creates an exception for certain fundamental commercial matters in relation to which the minority cannot be so crammed down). The purpose is not to prevent an individual lender from waiving its rights. It would be meaningless for other lenders to claim that such a unilateral waiver was ineffective against them in such circumstances. Moreover (and this is consistent with the above), if there is no materially adverse effect on the other lenders by reason of a lender forgiving its debt, on the basis of the established English law principle that a party to a contract who is vested with a discretion cannot exercise that discretion unreasonably or capriciously,[4] there is good reason to believe that an English court would permit a borrower group to disregard a refusal to give consent. For practical purposes the above points would seem to obviate the need for a consent process.

OPTION 3: A SUBSIDIARY OF THE BORROWER BUYS THE DEBT AND KEEPS IT OUTSTANDING

This is the method usually favoured by tax advisers because it avoids the need for debt forgiveness to get the benefit in the financial covenants. Debt forgiveness will often create a tax inefficiency. However, lawyers analysing the documents will need to be particularly careful to check whether any terms in the documents might be interpreted as a restriction on any aspect of this option, breach of which would constitute a default (which would be catastrophic).

One particularly interesting issue is that by virtue of being held by a member of the group, senior debt will usually come to fall literally within the definition of 'intra-group debt', which is typically subordinated to some degree under the intercreditor agreement.

The key to reconciling differences between the rights and benefits accruing to senior debt on the one hand and the restrictions on holders of intra-group debt on the other lies in remembering that the subordination of the intra-group debt is intended to protect and enhance the senior debt (all the senior debt), and it would be inimical to decide that in some cases it could actually detract from it.

Accordingly, where senior debt is permitted to be held by members of the group (by virtue of such entities being 'permitted transferees' and within the exceptions to the restrictive undertakings), there is good reason to believe that, absent express provisions to the contrary, a court would read it as implied that any restrictions on subordinated debt are subject to any conflicting rights and benefits that accrue to senior lenders under the finance documents on the basis that a contrary interpretation would 'flout business common sense'.[5],[6]

This would logically resolve questions around whether, for example, payments can be made in respect of the debt, whether the debt can be secured, whether the subordination effected by the intercreditor agreement is effective and whether the intra-group senior lender is entitled to be treated as *pari passu* with other senior lenders on an enforcement.

THE CO-OPERATION OF THE FACILITY AGENT

A practical question which may be a source of anxiety for both the borrower and for the facility agent (particularly where the lenders may be hostile to the debt buyback), is what is the extent of the facility agent's obligations to co-operate. The validity of the 'transfer certificate' in European syndicated loan agreements is typically stated to be conditional on counter-signature of that document by the facility agent. As explained below, on a typical European syndicated loan agreement the facility agent does not usually have any discretion to refuse to counter-sign.

Usually the senior credit agreement will contain an express obligation on the facility agent to countersign the transfer certificate promptly if it appears on its face to be in order and is delivered in accordance with the terms of the facilities agreement. The facility agent's obligation is usually stated to be subject to completion of all 'know your customer' and other checks relating to any person that it is required to carry out, but there will usually be no other criteria on the basis of which he could decide to refuse to countersign.

So, the facility agent's role is a perfunctory one for the efficacy of the administrative function that the facility agent performs in a syndicated loan agreement: to perform 'kyc' checks, if any, and then to countersign if the certificate contains the necessary information and it is delivered to him properly.

The agent does not typically have the right to refuse to countersign for other reasons, even if lenders have purported to instruct him otherwise. For these reasons, if necessary, it is to be expected that a court would be prepared to order a reluctant facility agent to countersign the transfer certificate.

VOTING AND OTHER INFORMATION RIGHTS

One of the most controversial aspects of a buyback is that as a lender under a syndicated facilities agreement, the purchaser of the debt will be entitled to all the rights of a lender, including the right to vote on mat-

ters to be decided by the lenders. As a lender the purchaser would also have the right to be included in the circulation of information by the facility agent. There is no reason why under English law this should not be the case, nor is there any reason why such a lender should not be entitled to vote in its own (or its group's) self-interest.

In some cases one of the purposes of the buyback may actually be to acquire these voting rights, to enable the group to exercise a degree of control over the bank group (or to exercise negative control by acquiring a blocking stake).[7]

In other cases the acquisition of voting rights may be seen by the borrower as an incidental benefit and one which he would be prepared to concede, whether gratuitously or upon conditions.

WHY MIGHT SOME BORROWERS HOLD A TENDER AUCTION?

One of the main complaints by investors in the debt markets is that debt buybacks fail to treat all lenders equally. For this reason, it is sometimes suggested that a borrower may appease its lenders by arranging a tender auction for the buyback.

Of course, there is no requirement to run an auction. Indeed, no auctions have been held for syndicated debt buybacks seen in Europe to date. Instead, the borrower group simply has effected a free-market purchase of the debt from a willing seller in a bilateral arrangement -- in the same way as syndicated debt normally is purchased.

How might an auction work? Briefly, the borrower (or the tender agent on its behalf) would issue an invitation to all the lenders of the term debt to offer the debt they hold for sale to the borrower. The invitation may specify a price at which the borrower group wishes to buy.

Or it might operate a so-called 'Dutch auction' where the borrower group would invite willing sellers to specify the price at which they would sell (with the implication that the lenders offering the lowest prices will be the first to be bought out).

PARTING THOUGHTS

Debt buybacks are complicated transactions requiring a careful analysis of the issues. However, for a determined borrower with typical LMA style documentation there may often be a way to navigate these issues. As market participants become more familiar with these issues and how they may be navigated and if the current financial crisis continues to make such transactions attractive commercially, we would not be surprised to see the incidence of loan buybacks increase in the coming months.

In the process of considering the English law legal issues raised by this article, the author consulted with Iain Milligan QC. The author is grateful to Mr Milligan for his assistance.

[1] See for example *Debt buybacks by borrowers -- a real option or a red herring?* by Kirkland & Ellis International LLP (available on www.kirkland.com).

[2] See for example 'Loan buy-backs: the analysis, the options and the future' by James, Johnson and Sweeting, (2008) 06 JIBFL pp 279.

[3] On some documentation it may not be necessary to forgive the debt to achieve the deleveraging, if the financial covenants exclude shareholder debt from the calculation of net debt.

[4] See *Office of Fair Trading v Abbey National PLC* [2008] EWHC 875 (Comm) at para 79.

[5] See *Investors Compensation Scheme Ltd v West Bromwich Building Society* [1998] 1 WLR 896 at 913D-E.

[6] Another way of looking at it is that the restrictions on intra-group debt should be read as if they were prefaced (as they often are) by the words 'save with the consent of the senior lenders' and where the debt concerned is senior debt, the finance documents themselves represent the necessary 'consent of the senior lenders'.

[7] It is worth considering two points in this regard: first, that the information received by the lender is confidential (and as such it should not be passed on to the borrower) and, secondly, if the information related to the taking of steps adverse to the lender as obligor, the lender would arguably not be entitled to receive it.