Sponsor Purchases of Portfolio Company Debt: Key Considerations in an Uncertain Environment

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The ongoing COVID-19 pandemic and resulting global economic fallout continues to disrupt credit markets, particularly the secondary trading markets for debt of financial sponsor-controlled portfolio companies. The resulting market conditions may present an opportunity to purchase debt securities and syndicated bank loans of portfolio companies at discounted prices. Before repurchasing portfolio company debt, financial sponsors should be mindful of the various legal and practical considerations that affiliated debt purchases present. This discussion highlights a number of these considerations, including U.S. federal securities law considerations, restrictions under existing company debt agreements, governance and fiduciary obligations, tax consequences, and bankruptcy treatment.

U.S. Federal Securities Law Considerations

Disclosure. As an affiliate of a portfolio company, a financial sponsor must consider whether it possesses material nonpublic information ("MNPI") prior to commencing any purchase of portfolio company debt securities to avoid potential liability under Section 10(b) and Rule 10b-5 under the Securities Exchange Act of 1934 (as well as under state securities laws and common law fraud principles). The following are the most significant types of information that should be assessed prior to undertaking any purchase of debt securities:

- *Financial Information*. A company's unannounced financial results for an annual or quarterly fiscal period generally represent MNPI. For a company with an insider trading policy, a trading "blackout" period will typically commence at or around the end of a fiscal quarter and conclude one to two trading days after the release of

financial results for the relevant fiscal period. In the absence of an insider trading or similar policy or, when considering whether or not the sponsor is in possession of any MNPI, notwithstanding an open (or closed) trading window, the degree to which the results are consistent with prior periods for the company and analyst expectations, among other factors, should be considered. In the event that the sponsor is in possession of MNPI, the company must "cleanse" the market prior to the sponsor trading. To "cleanse" the market sufficiently of MNPI concerning financial results of a recently completed fiscal period, a company would need to "pre-release" its results to the market (commonly known as "flash numbers"). This brief disclosure often includes a range or approximate amounts of the company's most important reporting metrics (*e.g.*, a top-line and bottom-line figure) and, if meaningful, a narrative description of the key drivers for changes in results as compared to the prior year period. The end-of-period cash balance or other liquidity information might also need to be disclosed if considered material, particularly in light of current market conditions and investor concerns about liquidity generally.

- *M&A Activity and Other Undisclosed Information*. In addition to financial results, a sponsor should consider if there are any other undisclosed developments that may also constitute MNPI. Other examples of potential MNPI include: significant and extraordinary cash payments or other uses of liquidity; securing a new, or losing a current, key customer or supplier; material developments relating to litigation or government investigations; activity relating to other forms of indebtedness, including redemptions, defaults or incurrences of new debt; changes to management or other key personnel; potential acquisition targets; new products or services; or changes in strategy.

- *COVID-19*. Given the widespread and dramatic impact the coronavirus (COVID-19) pandemic has had across industries and geographies, many companies have experienced, or anticipate experiencing, significant operational and financial issues, the full extent of which remains unknown. The SEC has stated that, while it is difficult to assess or predict with precision the broad effects of COVID-19 on industries or individual companies, "the effects COVID-19 has had on a company, what management expects its future impact will be, how management is responding to evolving events, and how it is planning for COVID-19-related uncertainties can be material to investment…decisions."[1] Although each company will be affected differently, COVID-19 could negatively impact, among other things: a company's sources of liquidity or financial condition, assets or credit losses; operations,

[1] *See* Securities and Exchange Commission, Division of Corporation Finance, CF Disclosure Guidance: Topic No. 9 (March 25, 2020) ("For example, where COVID-19 has affected a company in a way that would be material to investors or where a company has become aware of a risk related to COVID-19 that would be material to investors, the company, its directors and officers, and other corporate insiders who are aware of these matters should refrain from trading in the company's securities until such information is disclosed to the public.").

including through remote work arrangements; demand for products or services; and supply chain or distribution channels. Accordingly, to cleanse a sponsor of COVID-19-related MNPI, disclosure of the impact that COVID-19 has had, or may have, on a company's business and financial condition may be necessary, including in the form of additional risk factors, actual or anticipated effects of COVID-19 and related regulations on operations, liquidity or results of operations or, in some cases, withdrawing or updating previously issued financial guidance.

- *Affiliate Purchase Activity*. In addition, a financial sponsor's debt security purchase program itself could constitute MNPI, and disclosure considerations should be taken into account prior to initiation of a debt purchase program, in light of relevant circumstances. In some cases, the company's existing disclosure may already provide that an affiliate may undertake purchases of the company's debt securities. The need for disclosure of potential affiliate purchases of debt securities should be considered in light of the parameters of the contemplated debt purchases, taking into account the materiality of the reduction in the total "float" of a particular series of debt securities purchases and any tax consequences to the company triggered by the purchases (as discussed below). For sponsors that are Schedule 13D filers in respect of public portfolio companies, existing disclosure in the Schedule 13D should also be evaluated in terms of whether possible purchases of debt securities of the company are contemplated or if an amendment to describe the sponsor's investment intent is appropriate prior to initiating any purchases.

Given the need to assess MNPI on an ongoing basis, and a sponsor's routine exposure to undisclosed information about its portfolio companies, in practice, the open trading window to effectuate a purchase may be limited. One way to address this concern is for the sponsor to enter into a Rule 10b5-1 plan during an open trading window and at a time when it does not otherwise possess MNPI to allow for debt purchases in the future, subject to certain pre-agreed criteria set out in the plan, without further input from the purchaser entering into the plan. Purchases made pursuant to a compliant Rule 10b5-1 plan would provide an affirmative defense to an insider trading claim, even if the purchase were made at a time when the sponsor was in possession of MNPI.

A financial sponsor, particularly with respect to public portfolio companies, should be mindful of any insider trading or similar policy adopted by the company to ensure compliance with any applicable "trading windows" or pre-approval requirements, regardless of whether the sponsor is directly subject to the policy.

Tender Offer Rules. A financial sponsor intending to purchase debt securities of a portfolio company must ensure that the purchases do not constitute a "tender offer." Although the SEC's rules applicable to tender offers for debt securities are less stringent than those applicable to registered equity securities, the typical open market debt

purchase program would likely not satisfy SEC rules that apply to unregistered debt securities if it were deemed to constitute a tender offer, including the requirement that a debt tender offer remain open for no fewer than 20 business days. As the securities laws do not define the term "tender offer," to mitigate risk of a noncompliant tender offer, the sponsor should consider implementing several general guidelines, including by structuring debt purchase programs that limit the percentage of the issue to be purchased, limit the number of sellers, involve independent negotiations with prospective sellers that are each sophisticated, and involve terms that lack a fixed deadline and reflect a "market" (not premium) price.[2] If a sponsor intends to coordinate its purchases with other third parties, pursuant to a contractual obligation or otherwise, purchase activities should be evaluated in the aggregate for purposes of the tender offer rules. In addition, if an actual tender offer is later commenced, there should be a meaningful delay between the cessation of open market purchases and the commencement of the tender offer, to avoid having the earlier purchases be deemed part of the later tender offer.

Subsequent Resales. As it contemplates repurchasing portfolio company bonds, a financial sponsor should be aware of restrictions applicable to subsequent resales, given the sponsor's status as an "affiliate" of the company for purposes of the Securities Act of 1933. In particular, the ability to resell bonds under the exemption from registration provided by Rule 144 will be limited by the holding period requirements applicable to resales of restricted securities (six months for an issuer that has satisfied the SEC's reporting requirements for the prior 12 months; one year for all other issuers) and restrictions applicable to resales of debt securities by affiliates. Most significantly, these restrictions require that any sale by an affiliate of debt securities utilizing Rule 144 must be limited in amount to 10% or less of the outstanding principal amount of the relevant debt issue during any three-month period (taken together with other sales by the seller, and any person with which it is acting in concert, over the prior three months). In addition, resales by affiliates of debt securities pursuant to Rule 144 must also be disclosed to the SEC by the filing of a Form 144, occur at a time when the company has made publicly available basic financial and operational information, and comply with certain manner of sale requirements. Alternatively, a subsequent resale could be accomplished through a private resale transaction in accordance with Section 4(a)(1½) or Section 4(a)(7) of the Securities Act or to a "qualified institutional buyer" under Rule 144A (assuming the securities are Rule 144A eligible), subject to compliance with the provisions of the indenture governing the bonds and implementation of appropriate transfer restrictions that would apply to the purchaser.

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[2] *See Wellman v. Dickinson,* 475 F. Supp. 783 (SDNY 1979), aff'd, 682 F.2d 355 (2d Cir. 1982), cert. denied, 460 U.S. 1069 (1985).

Term Loans. Syndicated bank loans are not considered securities under the U.S. securities law and are therefore not directly implicated by the requirements discussed above. Nonetheless, it is a good practice generally for financial sponsors to observe such disclosure guidelines as a matter of uniform best practices across all types of debt, for both potential common law fraud liability risks and reputational considerations. In addition, if the company is an SEC-reporting issuer, considerations should also be given as to whether disclosure related to purchases of bank loans is required pursuant to Regulation FD or in the company's SEC periodic and current reports.

Sponsor Fund Considerations

Fund Terms. A sponsor must consider the governing documents of its participating funds when evaluating a purchase of portfolio company debt.

- *Investment Limitations*. These governing documents may include investment limitations that constrain the sponsor's ability to effect a debt purchase by the fund invested in the equity of the portfolio company or, where more than one fund is involved, to effect the purchase by the funds on a pro rata basis relative to their equity holdings. For example, a fund may be prohibited under its governing documents from making debt investments or from investing in publicly traded securities or other relevant instruments or it may have concentration limits applicable to its investments in any one portfolio company, industry, sector or geography that would be breached by the debt purchase. Alternatively, the investment period of the fund may have expired and the fund may have no ability under its governing documents to make a post-investment period follow-on investment in its existing portfolio companies because these investments are subject to a time limit that has expired or an aggregate follow-on investment cap that has been exceeded.

- *Additional Considerations*. If the sponsor intends for a fund to hold the portfolio company debt on a temporary basis (typically less than 18 months), the sponsor should also consider whether the debt may be considered a bridge investment under the fund's governing documents and, if so, whether a higher diversification or other applicable limitation may apply. It may also be the case that the fund simply has no remaining capital to deploy in the debt purchase or, depending on whether the debt purchase is viewed as defensive or purely opportunistic, the sponsor may not view the investment as aligned with the target return profile or other target investment criteria of the relevant fund.

- *Waivers and Amendments*. Certain investment restrictions or other constraints on a fund's ability to purchase portfolio company debt may be waivable by the fund's limited partner or investor advisory committee, which will typically be comprised of representatives of a relatively small subset of the fund's investors. Other restrictions, however, may be hardwired into the fund's governing documents and could require the sponsor to seek investor consent for an amendment (with the consent of a majority or two-thirds in interest of investors typically being needed). In a volatile market, this may be difficult to achieve within a time frame that permits the fund to take advantage of the investment opportunity.

Conflicts of Interest. Purchases of portfolio company debt also raise potential conflict of interest issues, which vary depending on which fund or combination of funds managed by a sponsor participates in the debt purchase.

- *Allocation Considerations*. In cases where the same fund or funds that hold the equity in the portfolio company cannot execute the debt purchase or cannot execute the purchase on a pro rata basis, a sponsor may consider, for example, having a successor fund or, if applicable, an affiliated fund (such as an affiliated credit fund) managed by the sponsor (or its affiliate) participate in the transaction. The interests of debt and equity holders in the same portfolio company are not aligned, particularly where the company is experiencing financial difficulties. Accordingly, if the debt is not purchased on a pro rata basis by the funds that hold the company's equity, decisions made by the sponsor in respect of these equity and debt positions may have a disproportionately adverse or beneficial impact on the participating funds. This conflict between the interests of different funds managed by the same sponsor can be particularly challenging to manage where the portfolio company debt has conversion features or other rights that permit debt holders to substantially dilute existing equity holders or where financial stress experienced by a portfolio company turns into distress and a potential bankruptcy situation. Additionally, the sponsor should consider conflict issues that may arise if third party co-investors also hold portfolio company equity alongside the sponsor's funds but those co-investors do not participate, or do not participate pro rata, in purchasing the portfolio company debt.

- *Process Considerations*. The sponsor will generally need to discuss debt purchase opportunities with fund counsel and with its in-house compliance function to ensure, where appropriate, that a robust process has been followed for reviewing and managing any applicable conflicts of interests and, as appropriate, for properly allocating these opportunities across the sponsor's funds.

- *Disclosure*. Care should also be taken to ensure that appropriate conflict and investment risk disclosures are provided to the fund's investor advisory committee

or, if applicable, to fund investors if they are being asked to approve waivers of investment limitations or amendments to governing documents needed to enable a fund to participate in a debt purchase. Similar disclosures may also be appropriate for co-investors investing alongside the fund, particularly if the co-investors have the ability to elect to participate or not in the debt purchase. The sponsor should also discuss with fund counsel whether the performance of a portfolio company debt position should be reported by a fund together with its equity investment as part of a single portfolio company investment or whether it should be reported as a separate investment.

Other Contractual Considerations

Bond Indentures. Bond indentures typically do not prohibit affiliates from repurchasing the bonds issued under the related indenture. However, almost all indentures treat bonds held by the affiliates as "not outstanding" for voting purposes (*i.e.*, they will be disregarded for purposes of both the numerator and the denominator in determining whether a majority has consented on a particular matter, such as in a consent solicitation). In addition, purchase agreements for the initial offering of debt securities frequently include limitations on the ability of affiliates to resell purchased securities.

Term Loans. While credit agreements differ and need to be analyzed prior to any purchase, some common provisions relevant to purchases of term loans include:

- *Assignment Restrictions*. The credit agreement may expressly prohibit the assignment of loans to affiliates, thus effectively prohibiting purchases. In other cases, the credit agreement may permit the sponsor to acquire term loans, subject to certain conditions, including in respect of limitations on amounts that may be held of a given class and voting.

- *Required Consents*. Many credit agreements require consent from the administrative agent to assign loans to entities other than existing lenders (or their affiliates).

- *Voting Restrictions*. Generally, credit agreements restrict the ability of affiliated lenders (other than bona fide debt funds) to participate in lender votes, with some exceptions for votes that would disproportionately impact the affiliated lender or affect the affiliated lenders' fundamental rights. However, the specific credit agreement should be reviewed carefully.

- *Affiliate Transactions*. Credit agreements typically impose certain approval and other requirements on transactions between the company and its affiliates. In most cases, however, the portfolio company could be viewed as having no involvement in the loan purchase by an affiliate, thereby placing the purchase outside the scope of this restriction.

Governance Considerations

Prior to initiating a debt purchase program, financial sponsors should consider whether there are any other agreements that may impose restrictions on a purchase, such as a shareholder agreement.

Sponsor-appointed directors should also bear in mind their duties as directors of the portfolio company. These would include consideration of whether the purchase of the portfolio company's debt may be claimed to represent a "corporate opportunity" that should be available to the portfolio company itself. This may not be a concern if, for example, the company does not have the capacity to make the purchase itself, or if the organizational documents of the company contain an advance waiver of interest or expectancy to certain corporate opportunities in its organizational documents. Other facts and circumstances, including the size of the purchase relative to the total amount outstanding, may have a bearing on this question.

Following the debt purchase, the sponsor would need to be mindful of obligations of disclosure and, if appropriate, recusal from decision-making on issues relating to the debt, such as considerations regarding subsequent refinancing.

Tax Considerations

Cancellation of indebtedness income ("CODI") may be generated where a person "related" to the company purchases debt at a discount. Generally, a corporation would be related to any stockholder holding more than 50% of its shares. CODI is taxable to the company, potentially imposing current cash tax obligations (or using up tax attributes), even though the company realizes no cash from the related party acquisition. The amount of taxable CODI is the difference between the issue price of the debt (generally, the face amount of the debt, unless the debt was issued at a discount) and the purchase price.

Another potential tax consequence of related party debt purchases is a deemed reissuance of the debt securities. The purchased debt is generally treated as if the

company acquired the debt at the price paid by the related party and reissued the debt to the related party for the same amount. As a result, the "reissued debt" held by the sponsor will typically have a different amount of original issue discount than the "original debt," causing the reissued debt to not be "fungible" with the original debt. A lack of fungibility can meaningfully affect liquidity and limit the sponsor's ability to exit into the market.

Although debt purchases by a fund that owns more than 50% of a portfolio company will generally implicate the related party rules, there are a number of structures that can be used to navigate the complex and sometimes counterintuitive attribution rules that apply to determine relatedness. For example, a fund could form one or more "alternative investment vehicles" (known as "AIVs") that can purchase the debt, rather than the fund itself. Relatedness can be avoided in many cases (if not all) if the AIVs are correctly structured. However, the AIV structures can be complex. In particular, if (as is typical) an offshore AIV is used, care must be taken to avoid withholding tax on the interest paid on the AIV-held debt. In many cases, the offshore AIV is organized in a treaty country (such as in Luxembourg or Ireland), which in turn imposes additional requirements for the treaty benefits to apply.

The appropriate tax structure for any debt purchase will depend on the specific facts and needs to be determined by analyzing the tax profile of the portfolio company, the structure of the fund and the composition of the fund's investor base.

Bankruptcy Treatment

If a portfolio company later files for bankruptcy, all transactions with its sponsors, including those involving its debt securities, are likely to be scrutinized. In the context of a bankruptcy filing, there are a variety of claims that disgruntled creditors may bring against sponsors to attempt to deny them the benefit of their bargain as bona fide creditors. These claims can include attempts to designate or disregard the voting of claims held by sponsors in the context of plan approval, arguments that sponsor-held debt claims should be re-characterized as equity and efforts to equitably subordinate sponsor claims to those of third-party creditors. In each case, creditors will be advancing theories that a sponsor inappropriately used its influence over or control of the portfolio company to achieve an inequitable benefit to the detriment of other stakeholders.

While such claims are not frequently successful in practice, if invoked, they can be both expensive and distracting to defend against in the context of a Chapter 11 bankruptcy proceeding. Accordingly, sponsors, in consultation with their advisors, should take extra care to observe all appropriate corporate formalities in connection with debt-buyback

transactions and balance the benefit of aggressive transaction features against the optics of such features in the context of a subsequent challenge. While the risk of litigation cannot be wholly eliminated by following—and documenting—a robust process that is attentive to the governance considerations described above, sponsors and their portfolio companies can be better positioned to defend their decision-making and rebut any allegations of bad faith.

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Despite the considerations and potential challenges discussed above, purchases of portfolio company debt can be executed effectively, and the acquired debt may represent an attractive return on investment given current market conditions. Ownership of debt of a portfolio company also provides a financial sponsor with exposure to additional levels of a company's capital structure in the event of a downturn. Ultimately, the ability to purchase debt securities or loans will depend on the specific terms of the company's debt instruments and other agreements, and thus requires advanced planning.

For more information regarding the legal impacts of the coronavirus, please visit our Coronavirus Resource Center.

Please do not hesitate to contact us with any questions.

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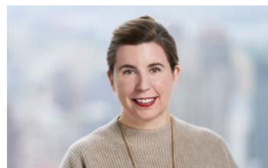

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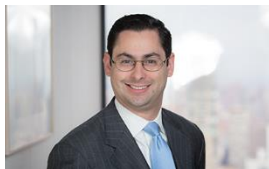

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