For a company facing financial challenges, the balance sheet restructuring glass is neither half full nor half empty; it is simply filled with opportunities. One of these is the strategic buyback or repayment of outstanding syndicated bank debt or debt securities at below par prices, through a process instituted by the issuer or an affiliate.

Debt buybacks are prevalent in times of economic turmoil. Discounts in the secondary market create enticing opportunities to de-leverage. Depending on the circumstances and an issuer’s goals, the buyback program can be accomplished through a public tender offer or privately, in the form of negotiated transactions or open market purchases, otherwise known as “street sweeps”.

The case for buybacks

Buybacks are appealing because they reduce leverage and lower interest expenses. When coupled with an exit consent, they can also amend restrictive and other covenants in underlying credit agreements or indentures. Ultimately, they can allow the issuer or private equity sponsor to amass a controlling position in a debt security that is now the fulcrum (the security that will not be paid in full because the enterprise value is sufficient to satisfy some but not all of the outstanding obligations of that security). Occasionally, the issuer can repurchase its equity in this way. Moreover, if the buyback program is initiated as part of an overall restructuring to rightsize the balance sheet through an out-of-court process, the issuer achieves a more realistic, and therefore sustainable, capital structure while instilling confidence in the market and in some cases preventing a Chapter 11 filing.

Debt buybacks are often preferable to an equity purchase for an issuer. If the business does not improve and Chapter 11 becomes necessary, equity is a lower priority for payment in bankruptcy. Moreover, if an issuer acquires its own equity, it is increasing leverage; with a debt buyback, it achieves the much-desired leverage reduction.

For the holder of the debt, buybacks tend to be more attractive than exchanges for equity, with the original purchasers of the debt generally being resistant to moving down the capital structure. In addition, equity exchanges often result in massive dilution, which may cause disquiet among shareholders and trigger further selling — which, in turn, can exacerbate an issuer’s financial troubles. Moreover, most debt holders are wary of owning stock in a company facing economic or industry-wide challenges.

Ironically, in order to take advantage of steep discounts in debt, an issuer needs cash. Many investors have their own economic pressures, and the ability to monetize a distressed position may be a motivating factor upon which an issuer can capitalize. Cash is an exit and not a recommendation to the credit. It can be redeployed in other investments. It is a currency used to exploit deal fatigue among long-term creditors.

However, issuers facing economic hardship do not, as a general matter, have pools of spare cash to effect a buyback or debt repayment program. In those circumstances, they could consider debt
Exchanges. These can seem uncertain, especially in the current economic environment when debt holders are unlikely, without a strong enough financial incentive, to accept a transaction that will adversely affect their existing rights. But a compelling reason for an issuer to pursue the debt exchange, and for the holder to consent, is that the exchange will forestall a bankruptcy filing. The holders should prefer that an issuer remains in control of a restructuring process that can unfold out of court without the associated cost, uncertainty and delay.

If, however, a debt exchange is not possible, an issuer may seek an increased equity contribution from a private equity sponsor. Alternatively, if the affiliate is not willing to compound its equity investment but is intent on helping the issuer ride through the current economic downturn, it could pursue the de-leveraging program itself — especially if the secondary markets price the debt very low.

Below, we address the public and private options for de-leveraging, and outline the strategic decisions an issuer (or affiliate) might consider as it crafts and embarks on a debt buyback or repayment program.

Public tender offers
Here a company makes an offer to its debt holders to repurchase a predetermined amount of debt at a specific price for a set period. Tender offers may be the preferred method of deleveraging when an issuer wants to purchase a substantial percentage of its debt securities and to control the conditions precedent to the buyback. In addition, where there are covenants that restrict a repurchase of the debt, a tender offer can be coupled with a consent solicitation, which, if approved by the requisite number of debt holders, amends those covenants.

A tender offer has several benefits for an issuer:
• It provides broad access to the market and debt holders.
• It ensures equal treatment among the debt holders.
• It is particularly efficient if the debt is widely held.
• It may provide an issuer with advantages such as speed and efficiency over the course of a series of privately negotiated transactions, which in turn means that management spends less time being distracted from running the business.
• It allows structuring on price and conditions (including, for example, a related consent solicitation to amend the terms of the securities, or a condition that the amount of debt tendered must satisfy the requirements for a vote in support of a reorganization plan in a Chapter 11 proceeding).
• It may alleviate shareholder pressure on the board of a company, with excess cash to de-leverage the capital structure.

A tender offer also carries burdens:
• It is subject to SEC rules, which add both disclosure requirements and costs.
• When there are relatively few debt holders, it may take longer to complete than a series of privately negotiated or open market purchases, because a tender offer must usually remain open for at least 20 business days.
• In some tender offers, there is a risk that the issuer might misjudge the market and overspend for the debt.
• The issuer may have reasons not to disseminate knowledge of the repurchase program.
• A rating agency may downgrade the issuer’s credit status — regardless of its financial health — at the mere announcement or anticipation of a distressed buyback. (Ironically, once the buyback is completed, the untendered portion of a loan could be upgraded, due to the company’s de-leveraged capital structure.)
• There is a risk that the issuer’s conditions precedent for the tender offer might not be satisfied, requiring it to abandon a publicly disclosed program.
• There is a liability risk arising from claims of inadequate or inaccurate disclosure in the offering documents.
• It leads to higher transaction costs.

Public exchange offers
When there is insufficient cash to buy debt or to engage in private or open market purchases, an issuer in distress can pursue a debt exchange. Here an issuer trades debt for debt and the creditors absorb the impact of below-par prices, longer maturities, lower interest rates, or junior ranking in the capital structure.

An exchange offer, like a tender offer, can also be useful when the terms of the underlying agreement need to be amended to repurchase/exchange debt, and those changes would be so significant that the securities constitute a new issue. Examples of such changes are those in interest rates, maturity, subordination provisions, and terms related to collateral or relief from financial covenants.

The benefits and burdens of an exchange offer
are similar to those of a tender offer. The principal beneficial difference is that an exchange allows the issuer to de-lever without using cash.

Privately negotiated or open market purchases of syndicated bank debt or bonds
These purchases are effective ways of de-leveraging the capital structure when an issuer is looking to buy a small percentage of securities, or when ownership of the securities is concentrated among very few holders. In this regard, the issuer can avoid the risks of a public transaction and still take advantage of distressed debt pricing.

The potential benefits of private transactions and open market purchases are as follows:
• They can provide greater flexibility in negotiating price and timing with the sellers.
• Under certain circumstances, these transactions may take place below the radar of secondary debt traders.
• They may be completed quickly, enabling the issuer to react to secondary market shifts without making a commitment to purchasing large quantities of debt or to long-term buyback programs.

However, there are also potential limitations and problems:
• They must remain small, one-off transactions, or they might fall foul of the SEC’s prohibition on “creeping tender” offers.
• They can be distracting and time consuming for an issuer’s management, as well as for restructuring advisors who are engaged in a broader balance sheet and/or operational restructuring.
• They may be difficult to achieve if the issuer is not aware of willing sellers.
• They may expose the issuer to allegations of unequal treatment of investors.
• There could be disclosure issues.
• A bond repurchase program may not give the issuer or the purchasing affiliate an advantage with a consent solicitation. (Since the provisions of the agreement or indenture governing the debt are likely to provide that bonds held by the issuer or affiliates are treated as not outstanding for purposes of determining whether requisite consents have been obtained, a buyback program may not affect the outcome of a consent solicitation. Ironically, by reducing the number of bonds deemed outstanding for purposes of a consent, a bond repurchase program could have the undesired effect of providing a few holders with extra leverage in a consent solicitation.)

Moreover, investors will in all likelihood base their decisions on an issuer’s financial condition. They may want to form an ad hoc group and hire their own financial advisors and counsel at an issuer’s expense. Providing the ad hoc group with financial information may also create the problem of restricting the holders from trading. As a result, an issuer will have to navigate the quandary of how much information it can divulge and the holders will accept.

Avoid the “creeping tender” offer
This offer refers to a privately negotiated or open market purchase of securities that should have been structured as a conventional tender offer, subject to SEC rules. If an issuer initiates a repurchase program that is later held to have been a non-compliant tender offer, it could face a variety of sanctions, including money damages, injunctive relief and enforcement actions by the SEC. Resulting entanglements with the commission could hit the value of the program and might also color public perceptions of the issuer (particularly relevant if other tranches of debt remain in the market). Since one of the critical advantages of a private transaction over a public tender or exchange offer is the ability to avoid SEC rules, it is imperative that any buyback program does not “look or walk” like a public offer.

While there is no bright-line test for whether, or under what conditions, privately negotiated or open market purchases of securities constitute a tender offer, courts tend to rely on certain signs. They look to whether: (1) the offers to purchase or the solicitation of offers to sell were disseminated in a widespread manner; (2) the purchase price offered represented a premium over the market; (3) there was a meaningful opportunity for negotiation of price and terms; (4) a substantial percentage of the bonds was solicited; (5) the offer was contingent on a minimum or maximum amount of bonds being tendered or purchased; (6) the offer was for limited duration; (7) the issuer may have pressured the holders; and (8) there were public announcements of the acquisition program, followed by a rapid accumulation of large amounts of the company’s bonds.

Repurchase programs that are truly private transactions should not be carried out in ways that mimic the public option. For example, they should take place over a meaningful period. There should
Evaluating strategic debt buybacks

be no deadline for purchases. The pricing and terms should not be uniform and non-negotiable. Participation, where possible, should be limited to sophisticated institutional investors.

Buyback programs and the underlying agreements

The caveat to a debt buyback program is the need to understand the type of debt involved, and the terms and conditions of the underlying agreements governing that debt. These facts will control how (and if) an issuer or affiliate may repurchase debt. For example, syndicated loans are generally considered not to be securities. They are, therefore, not subject to the tender offer rules and 10b-5 disclosure obligations associated with securities. (Even though syndicated loans are typically not securities, bank regulations and common law fraud restrictions do apply.) Furthermore, contractual restrictions in the loan documents often impact a borrower’s ability to repurchase its debt and may dictate the terms and conditions for buying discounted debt.

While agreements vary significantly, common issues include assignment restrictions, required consents, pro rata sharing or turnover provisions, and other contractual restrictions that control and limit the economic downside to the lenders or holders caused by a repayment prior to maturity.

By way of illustration, in a capital structure involving first and second lien loans, the first lien credit agreement is likely to place restrictions on: (1) the borrower’s ability to prepay or repurchase its second lien loans; (2) the excess cash-flow sweep and obligations to prepay loans; and (3) the ability of an issuer or affiliate to participate in votes, including with respect to amendments or waivers of the credit agreement (presuming the issuer or affiliate is allowed to own loans in the first instance).

When formulating a bond repurchase program, an issuer must pay particular attention to the indenture and to the need for the indenture trustee to exercise its fiduciary duties on behalf of the bondholders. Among other duties, a distressed-debt trustee may be bound to seek par value. All covenants must be carefully examined before the program is commenced.

Aside from the contractual impediments, bear in mind that holders of debt (both originating banks and secondary market traders) normally have a set expectation on the return, especially when the loans are secured, and this is usually at or near par. This mindset may affect the success of any buyback program. Distressed bank debt trades with the expectation that the buyer will achieve — either through a restructuring, bankruptcy or improvement in the issuer’s performance — a recovery that exceeds the trader’s discounted purchase price. It is not unusual for the trader to anticipate repayment at a considerable profit even if debt was acquired at a discounted price.

A discounted basis such as this cannot guarantee that a consensual buyback will be easier to achieve. Distressed bank debt traders are sophisticated institutions that do not fear a Chapter 11 filing by an issuer; some even relish bankruptcy as an opportunity to improve recovery. And since the fees and expenses of the lenders (for lawyers and financial advisors) are typically borne by the company, the economic imperative to avoid bankruptcy is not always present for bank debt traders. On occasion they seek to halt a program when they perceive the buybacks (and the resulting boost to reported earnings) as threatening other aspects of the capital structure — through breaches of covenants, say, or the attainment of targets that might force rifts among various classes of creditors in the capital structure.

Even in the absence of having to appease distressed bank debt traders, originating banks, funds or institutions also have expectations for par recovery. These expectations are often memorialized in the underlying credit agreements, which, without amendment, do not generally permit issuers to buy back debt at less than par.

Recently, we have noticed increased resistance to buybacks from loan participants. In particular, disputes over agents are emerging. Specifically, what actions can they take on their own authority and what actions require lender consent? Agents become frustrated and, as a result, intransigent. Attention should be paid to their contracted rights and duties.

SEC filing and disclosure obligations of public offers

If a buyback is carried out in a public forum, the issuer will be subject to all SEC filing obligations, including a report on Form 8-K and the general anti-fraud provisions of Rule 10b-5 of the Securities Exchange Act.

Most importantly, it will have to consider with counsel whether it is in possession of material non-public information that needs to be disclosed to holders, or if the repurchases will have a material adverse effect on the business.

Disclosures can be made in a variety of ways,
including a press release or a Form 8-K report. Prior to making any purchases of its own debt securities, the issuer (or the purchasing affiliate) must analyze whether it is in possession of material non-public information that would prevent it from going to the market to repurchase bonds at below par prices.

SEC-reporting companies must also be careful not to have communications with holders that trigger Regulation FD. This prohibits disclosure of material non-public information to certain types of people unless a confidentiality agreement is in effect. In some circumstances, the mere fact that a repurchasing of bonds or loans is under way may itself be a material fact that triggers obligations under Regulation FD. Similarly, the possibility that the success or failure of the buyback program will impact the issue may constitute material non-public information.

Of course, not all debt repurchases will result in disclosure of material non-public information. Depending on the situation, and to be ultra safe, it may be prudent simply to disclose the initiation of the buyback program publicly. This may have positive and negative consequences, so the well-conceived strategy includes a careful analysis of the potential impact of disclosure on the market. The threshold inquiry is whether the fact that an issuer is formulating, or embarking on, a repurchase program is in itself material, non-public information. That said, each case is different. If it is determined that the program itself is material, non-public information, additional disclosure may be required to avoid falling foul of the reporting regulations.

If the effect of the repurchase program is not material either to an issuer’s financial condition or to the trading market for its bonds, it may be that no prior disclosure of the commencement, pendency or conclusion of the program is required. If the trading price of the debt is sufficiently and consistently below par, an issuer may want to disclose the implementation of a general program of debt repurchase in its regular reporting. In a distressed economic environment, it will not come as a surprise to the market.

**Possible tax consequences**

An issuer’s repurchase of its own debt at a discount could have tax implications in terms of cancellation of debt income (CODI) and a reduction in net operating losses. A repurchase can also have tax consequences for the exchanging holders.

Generally, the purchase by an issuer (or by a related party) of its outstanding debt securities at a discount gives rise to CODI to the issuer, which may also be the case in an exchange of debt for equity and, in certain instances, for new debt for the equity.

The amount of CODI is generally the difference between the principal amount of the debt repurchased (or its accreted value, if applicable) and the repurchase price. If debt is exchanged for equity or new debt, the price will generally be the fair market value of the equity or new debt. General tax principles require that CODI be included as taxable income of the issuer.

The Internal Revenue Code provides exceptions to this general rule in the case of CODI that occurs when the issuer is in bankruptcy or insolvent (but only up to the amount of the insolvency). Under these exceptions, an issuer that recognizes CODI does not pay tax on it but is instead required to reduce its tax attributes, including net operating losses, capital losses, credits and tax basis in assets.

Recent legislation generally allows an issuer recognizing CODI in connection with a reacquisition of debt in 2009 or 2010 to defer including it in income until 2014, at which time the issuer would include the CODI in taxable income ratably over a five-year period. This deferral rule could apply to all issuers, including those in bankruptcy or insolvency. But taxpayers must choose to apply the bankruptcy/insolvency exceptions to recognition of CODI or the deferral rules. They cannot apply both.

If the reacquisition is an exchange offer, there are tax considerations for the holders. For example, unless the exchange qualifies as a “reorganization” within the meaning of the tax law, holders of debt that receive new debt and/or equity for their debt will generally recognize a taxable gain or loss on the exchange.

The gain or loss will generally be equal to the difference between the value of the consideration received by the holder (other than interest and some consent payments) and the holder’s adjusted tax basis in the debt surrendered. Consent payments may also be subject to taxation, potentially as ordinary income.

The taxation of consent payments will usually depend on the circumstances. Most likely, they will be treated either as additional consideration in exchange for the tendered debt — which means the payments will be taken into account in determining the gain or loss on the exchange — or as separate consideration in the nature of a fee for consenting to the proposed amendments.
Conclusion

The opportunity to buy back debt at large discounts and to adjust the capital structure to achieve greater balance requires a concerted effort by the board, management and restructuring counsel. An issuer has to present persuasive economic reasons for bondholders or lenders to sell back the debt at distressed prices. A properly orchestrated program that navigates the underlying agreements and other controlling documents — as well as SEC rules and regulations, tax laws and the Bankruptcy Code — can help an issuer or an affiliate to take advantage of distressed trading prices and propose a transaction that appeals to the holders and lenders. For an issuer facing economic challenges, a repurchase program can be an effective tool for exerting control over the restructuring process and/or profiting from below par debt pricing.

Being proactive is critical to the success of the program, as is timing the market. Wait too long, and if the debt trades up, the chances of a successful buyback program are reduced. Conversely, if the market further downgrades the debt or bankruptcy appears more imminent, such a development can be fatal. Allowing debt to trade at a steep discount, for a prolonged period, sends a negative message to the market.

While the initiation of a buyback program can alter such perceptions and send out a positive signal while an issuer restructures, if the message becomes too ingrained in investors’ minds then it may be impossible to alter the march to bankruptcy.

Naturally, the challenges and hurdles are different for each issuer, but all the options outlined above form an overview that can be explored with your counsel as you embark on a program of debt repurchase and de-leveraging.
Grouped into seven sections, Navigating Today’s Environment consists of 45 separate “conversations” with the leading restructuring voices of our generation. Much of the knowledge and experience conveyed in these pages is relevant to leaders of public and private companies of all sizes, whether small-cap, middle-market or Fortune 1000. Navigating Today’s Environment is a resource guide for US officers and directors, as well as those who are interested in and follow the management and corporate governance of US companies.

This publication is intended to provide a general guide to business and legal practice. The information and opinions that it contains are not intended to be a comprehensive study or to provide specific professional advice, and should not be treated as a substitute for such advice concerning particular situations. Legal and/or other professional advice should always be sought before taking any action based on the information provided. The content reflects the individual views of the authors, and those views are not presented as those of their firms, other contributors or the editors. The publishers, sponsors and authors bear no responsibility for any errors or omissions contained herein.

To view the book in which this chapter was published, and to order hard-copy versions, please go to: www.navigatingtodaysenvironment.com