
Private equity

Briefing

MACFARLANES

Repurchases of bank debt

Background

Recent market conditions have resulted in some private equity investee companies having the opportunity to repurchase their own bank debt at a discount. There has been much media attention on the subject with particular focus on whether doing so is permitted by the LMA banking documents. Less attention has been given to the idea of private equity funds themselves acquiring their investee companies' debt and, in either case, how to structure the debt purchase.

This note sets out the alternative ways of structuring a debt buy-back together with the key legal and tax issues that need to be considered. The analysis assumes that the loan to be purchased was advanced under an LMA-style leveraged loan agreement.

Purchase by borrower

There are tax and (likely) legal reasons why a repurchase of debt by the borrower itself will not be possible and/or advisable.

First, a repurchase by the borrower would trigger a taxable profit in the borrower equal to the discount to face value paid to acquire the debt.

Second, such a structure is likely to be prohibited under the transfer provisions of the loan agreement which will regulate the types of entity to whom the loan may be

transferred. Typically these will be limited to banks or other financial institutions or entities established for the purpose of purchasing or investing in loans.

It is also arguable that the purchase of a borrower's own debt by the borrower will constitute a prepayment for the purposes of the loan agreement and, therefore, will be subject to specific prepayment restrictions (including as to parity between syndicate lenders) in the loan agreement.

Purchase by group company of borrower

While the borrower itself is unlikely to be a "permitted transferee" under the loan agreement, an affiliate of the borrower might, particularly if it is established specifically for the purpose of purchasing the loan. However, there are still a number of other legal and tax issues that arise under this structure.

On the legal side, a purchase by an affiliate of the borrower will be subject to any restrictions in the loan agreement as the affiliate is likely to be a member of the borrower's group. The restrictions which will be relevant to the debt purchase will include: any restriction on acquisitions (as the debt purchase may constitute an acquisition); any restriction on a member of the group being a creditor; any restriction on capital expenditure; and any restriction on the borrower funding the affiliate to purchase the loan.

Further, the UK tax rules provide that where third party debt is acquired by a company which is connected with the borrower, a tax charge will arise in the borrower on the amount of the acquisition discount. Importantly, there is an exception from this rule where the company acquiring the debt does so under an arm's length transaction and was not connected with the borrower company at any point in the period beginning four years before and ending one year before the acquisition (the "Recently Connected Exception"). Therefore, on its face, this exception could allow a newly incorporated group company of the borrower to acquire the debt without triggering a tax charge in the borrower.

However, this exception is intended to allow third party rescues (not group acquisitions of debt) and some advisers worry about whether the application of this exception might be challenged by HMRC if relied on by a group Newco, on the basis of a concern that there is an implicit requirement for the acquiring company both to have existed and not been connected with the borrower at some time during the relevant three year period.

Purchase by fund or fund affiliate

It may be possible to avoid the issues set out above if the purchase is made by the fund or an affiliate of the fund. While legal and tax issues also arise under this structure, as set out below, these are likely to be easier to overcome.

The obvious but important difference with this route is that the borrower group's debt will not be reduced, nor will its balance sheet change, by reason of the purchase.

Legal considerations

An affiliate of the fund established for the purpose of purchasing the loan (or, depending on the exact circumstances, the fund itself) can be used to satisfy the "permitted transferee" criteria in the loan agreement and, as neither the fund nor its affiliate will be a member of the group for the purposes of the loan agreement, neither the fund nor the affiliate will be bound by the undertakings contained in the loan agreement.

Tax issues

There are also fewer tax issues where the fund or a fund affiliate acquires the debt. This is because, where the fund is structured as a limited partnership with no majority investor, the fund (and any affiliate of the fund which is not a group company of the borrower) should not be treated as connected with the borrower company for these purposes. Under this structure, there is no need to rely on the Recently Connected Exception.

The fund acquiring the debt directly should avoid a tax charge in the borrower and (subject to the points discussed below) allow any profit on the acquisition discount to be returned to fund investors without any tax leakage. Furthermore, it may be beneficial for UK carried interest holders in the fund as, depending on the terms of the debt acquired, any "principal" profit from the acquisition may be tax free in their hands (as capital profit realised on certain debt instruments is exempt from tax for UK individuals).

A potential tax issue with the "direct fund acquisition" structure is avoiding withholding tax (WHT) (at 20%) on future interest payments on the acquired debt.

If the entire facility is being acquired by the fund, WHT is likely to be less of an

issue. First, the fund might refinance the debt soon after its purchase (with the result that the WHT cost will be short-lived). Second, with certain amendments, it may be possible to list the facility on the Channel Islands Stock Exchange and rely on the quoted Eurobond exemption from WHT.

Where only a tranche of a facility is being acquired or obtaining a listing of the debt is not possible for other reasons, WHT can be avoided by interposing a vehicle between the fund and the borrower. For the reasons set out above, this company should not be a group company of the borrower.

Interposing a UK Newco would solve the WHT issue but is not advisable for a number of reasons; in particular the UK Newco would be required to pay tax on any acquisition discount as it recognises the profit for accounting purposes (which might be on a "straight line to maturity" basis).

A solution to WHT which should not result in material tax leakage is for the fund to hold the acquired debt through a Luxembourg company held directly by the fund and funded for the acquisition with income sharing debt.

Provided the arrangements are appropriately structured, this should allow all future payments on the acquired debt to be made to the fund (via Luxco) without WHT and with minimal tax leakage in Luxembourg.

Finally, depending on the circumstances, tax charges can arise on a subsequent waiver or capitalisation of the acquired debt or on transferring any Newco holding the debt into the borrower group. While it should be possible to avoid these charges with appropriate structuring, a number of traps for the unwary exist.

LMA response

The LMA has recently added optional debt purchase language to its model

leveraged finance loan agreement. This has been done in order to expressly permit or, as the case may be, prohibit debt purchases and, where a debt purchase is to be permitted, to deal with the potential conflicts of interest that would arise between the purchasing entity and the other lenders in the syndicate.

There are two very different and mutually exclusive options. The first prohibits debt purchases by a borrower and members of its group. The second option permits such debt purchases subject to certain conditions. Both options accommodate debt purchase transactions by funds or their affiliates but on condition that that portion of the loan (and related commitment) purchased by the fund or its affiliate is disenfranchised for the purpose of syndicate voting on matters such as amendments, waivers and acceleration. The drafting also addresses the question (relevant to the second option) of what sources of cash a borrower may use for a debt purchase and (in all cases) regulates the purchase process, in particular by requiring an invitation to be made to all lenders in the syndicate in order to achieve parity between the syndicate lenders.

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