

Financial Services

Providing Strategic Legal Guidance to the Global Financial Services Industry

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Company Debt Buybacks

As market uncertainty continues, companies are taking proactive measures to ensure short- and medium-term liquidity, including by fully drawing on revolving credit facilities. In turn, financial institutions would be wise to focus on another tool companies (especially those with financial sponsors willing to infuse additional cash onto the balance sheet) might use once the immediate liquidity crunch passes – permitted debt buybacks.

In general, syndicated credit facilities follow the same axiom with respect to prepayments: senior debt is repaid first, on a dollar-for-dollar basis (plus interest) for amounts loaned and ratably to all lenders. Debt buybacks turn this scenario upside down. When a Borrower buys back its debt, it is incentivized to (a) repurchase junior, more expensive debt first (to the extent otherwise permitted under the credit documentation), (b) buy such debt from those lenders willing to sell, and (c) repurchase such debt at the greatest discount to par available. This Client Alert briefly analyzes why and how Borrowers extinguish their own debt and then considers standard limitations most credit agreements have on such activities. It concludes by noting practical steps lenders can take to prepare before Borrowers begin buying back debt.

WHY BORROWERS REPURCHASE DEBT

Debt buybacks permit Borrowers to reduce their overall net leverage in an economically advantageous manner as compared to traditional voluntary prepayments. For example, consider the case where a Borrower has a \$100,000,000 term loan outstanding and a healthy balance sheet that would permit the Borrower to make a \$10,000,000 debt prepayment. If the debt is trading at 75% to par, rather than voluntarily prepaying \$10,000,000 of the outstanding term loan on a dollar-for-dollar basis, the Borrower could use the \$10,000,000 to repurchase and retire \$12,500,000 of its own debt. In addition to reducing overall net leverage, it has the corresponding effect of reduced interest and amortization expense.



HOW BORROWERS REPURCHASE DEBT

Borrowers repurchase the debt through one of two ways: a Dutch auction or an open market purchase. Most credit agreements contain provisions for Dutch auctions, whereas open market purchases are a less common option for Borrowers.

Dutch Auction

In a Dutch auction, the Borrower notifies an auction manager of its willingness to purchase an aggregate amount of term loans from the existing lenders at a specified price. The Borrower also notifies the auction manager of the range of discounts to par at which it would be willing to purchase the term loans. Each lender thereafter notifies the auction manager of its willingness to sell term loans to the Borrower, including the amount of term loans such lender is willing to sell as well as the discount to par at which such lender is willing to sell. The auction manager then calculates the lowest purchase price that will allow the Borrower to complete the auction by purchasing the full offered amount (or such lesser amount for which there are qualifying bids made by the lenders). Dutch auctions are viewed as more lender-favorable because all lenders are given the opportunity to sell their loans, the Borrower is buying at lowest cost and not favoring any party otherwise and the Borrower must incur significant economic and time costs engaging the auction manager and running the auction.

Open Market Purchases

In an open market purchase, the Borrower approaches all or a subset of the lenders (or even just one lender) and inquiries about its willingness to sell its term loans to the Borrower at a discount to par. To the extent permitted under the credit agreement, this approach circumvents the basic tenets of a syndicated facility described above: it allows the Borrower to shop around to first buy back the most expensive debt that a lender is willing to sell, including on a non-pro rata basis, and gives the Borrower significant leverage to encourage lenders to down-bid against one another, especially in the instance where one or more lenders desires to exit the facility. It also allows the Borrower to cherry-pick which Lenders are permitted to exit the facility. Thus, open market buybacks are viewed as more Borrower-favorable.

COMMON LIMITATIONS ON DEBT BUYBACKS

Most credit agreements that permit debt buybacks also include certain customary limitations on the Borrower's right to buyback debt:

- Any debt repurchased is automatically and permanently cancelled upon acquisition thereof by a loan party (this may also result in the cancellation of indebtedness income, potentially increasing tax distributions required to be made to the Borrower and its parent entities);
- The Borrower is often not permitted to make any debt buyback if any event of default has occurred and is continuing; and
- No proceeds from any revolving loans shall be used to fund such purchase.

In the context of current market considerations, the third bullet is particularly interesting. As Borrowers continue to draw significant amounts down on their revolving loan facilities, it is incumbent on the administrative agent and the lenders to ensure that such drawings are not later used to repurchase term loans. Given the fungible nature of cash, it is important that the Borrower be able to trace the in-flow of cash being used to repurchase the loans to a source other than the revolving draw.



PRACTICAL CONSIDERATIONS FOR LENDERS

- Be active managers of your portfolio! Stay abreast of where the debt is trading on a regular basis and understand your risk tolerance (i.e., how far below par you would be willing to sell) will enable you to make decisions quickly when you receive notice of a Dutch action or an unsolicited solicitation from the Borrower.
- Understand how repurchases might otherwise flow through the credit agreement and open up the potential for further leakage. For example, many credit agreements increase the Available Amount by the amount spent to buy back the debt. For deals currently being negotiated or amended, be sure this amount correlates to the amount being repurchased, not the par amount being retired.

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