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Sponsor Debt Purchases as Affiliated Lenders

In response to changes in the marketplace, it's possible that borrowers will employ debt buybacks as a way to ease their overall net leverage levels (either as a means to cure financial covenant defaults resulting from the pandemic or to strengthen their balance sheet and business profile). [Company Debt Buybacks.] Another possible tool that private equity funds may deploy on behalf of their portfolio companies is to purchase their portfolio companies' debt from the existing lender group (and in so doing become an Affiliated Lender). This Client Alert analyzes why financial sponsors may choose to purchase their portfolio companies' debt and then turns to considerations for existing lenders with respect to Affiliated Lenders.

WHY SPONSORS BUY THEIR PORTFOLIO COMPANIES' DEBT

While debt trading at a steep discount to par often indicates a company is distressed, for some investors, it presents an opportunity. In particular, private equity sponsors might elect to buy their portfolio companies' debt and become an Affiliated Lender under a credit agreement. A sponsor's decision to buy the portfolio company's debt at a discount provides several potential opportunities:

- sponsors may realize a return on the purchased debt if the portfolio company turns itself around and the debt trades above the price of purchase,
- if the portfolio company heads to an out-of-court workout, sponsors could have a seat at the lenders' table to help influence certain decisions about helping the portfolio company avoid an in-court restructuring, such as modifying the documents to extend the maturity date or loosening or waiving financial covenants, and
- if messaged to existing lenders thoughtfully, a sponsor's decision to further invest in a company's balance sheet via a debt acquisition can have a positive and even calming effect on lenders to a stressed or distressed company—it can demonstrate that a sponsor believes in the

future of the company and wants to increase its upside in connection with the eventual turnaround.

No matter the underlying strategy, existing market forces – including record amounts of dry powder at private equity sponsor's disposal – could drive sponsors to purchase portfolio company debt at a discount in the coming months.

IMPORTANT CONSIDERATIONS WHEN PERMITTING AFFILIATED LENDERS

As a threshold matter, sponsors and lenders must confirm whether the applicable credit agreement permits sponsors to repurchase debt. To the extent the credit agreement permits a non-debt fund affiliate of the sponsor to purchase debt from existing lenders, the non-selling lenders should consider the following:

- What is the cap on such purchases? Generally, the credit agreement should restrict the amount of loans a sponsor and its affiliates may hold (usually between 20% and 30%) to avoid disproportionate sponsor influence.
- How does the presence of Affiliated Lenders affect voting rights? Credit agreements often disenfranchise Affiliated Lenders from voting other than with respect to certain "sacred rights", or only permit sponsors to vote in the same manner as unaffiliated lenders for any required lender votes. Again, these are important mechanics to avoid inordinate influence from the equity holders.
- What information rights does the sponsor have? Affiliated Lenders typically only receive information that the borrower is entitled to receive.
- What happens if the company goes into bankruptcy? Are the appropriate protections for existing lenders in place? Consider the following:
  - if the borrower or any guarantor is the subject of an insolvency proceeding, any Affiliated Lenders usually grant to the agent a power of attorney giving the agent the right to vote the Affiliated Lenders' claims in bankruptcy on all matters submitted to the other lenders for a vote, and such claims shall, in any event, be voted in the same proportion, for and against, as votes were cast on each matter by lenders that are not Affiliated Lenders
  - as a matter of law, sponsors cannot, by themselves, implement a cram-down plan under the bankruptcy code given their status as an "insider" for plan voting purposes
  - prepetition voting proxies and other assignments of plan voting rights between lenders may not be enforceable in bankruptcy, and, at a minimum, will be subject to heightened scrutiny from the bankruptcy court as it relates to any potential defects with respect to the proxy grant or assignment (whether as a matter of contractual deficiencies or failure to satisfy applicable non-bankruptcy law)
- How can sponsors circumvent some of these restrictions? To the extent a borrower's incremental facility is not shut off and capacity for incremental loans remains thereunder, a sponsor could provide an incremental facility that only includes minimal protections for the remaining lender group. Additionally, a sponsor may be able to motivate (either through non-pro rata economics or retrenching of loan priorities) a majority of lenders to waive or modify the limitations on Affiliated Lenders (in particular, the amount that such Affiliated Lenders may hold).

As the market evolves following the downturn, sponsors will look to their existing portfolio as well as new opportunities in an effort to maximize returns and alleviate stress on their existing investments. As they take steps to do so, we are here to help you navigate to find the optimal path forward.

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