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Feature

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Strategies and Limitations of Sponsor Buybacks

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Equity sponsors holding a controlling interest in a distressed portfolio company have sometimes purchased substantial amounts of the company's debt in order to gain advantage or profit. The recent attempt by Apax Partners to buy back the debt of Cengage Learning Inc. is an example of both the opportunities and perils that may exist when a sponsor decides to buy back its portfolio company's debt.

If successful, sponsor debt buybacks can provide a significant upside to sponsors. A company's debt trading that is significantly below par might permit the sponsor to buy back that debt at a significant discount and realize a return on such debt should the company successfully turn itself around. A debt buyback could also allow the sponsor to gain a seat at the negotiation table with the company's lenders in order to exert influence over an out-of-court restructuring of a company, perhaps by extending debt maturities, loosening restrictive financial covenants or delaying a bankruptcy filing. Even if a company files a bankruptcy petition, by purchasing the debt of the company, the sponsor can still be in a better bargaining position to potentially retain a portion of its equity interest in the company.

Prior to employing any debt-buyback strategy, sponsors must consider the structure and terms of the underlying debt documents and any prohibitions or restrictions in such documents. In addition, with respect to bond debt, a sponsor should be vigilant to ensure that it is not trading with knowledge of nonpublic material information so as not to become exposed to insider-trading claims. Sponsors should also bear in mind that if the company files a bankruptcy petition, other creditors may attempt to equitably subordinate the debt held by the sponsor or seek to designate the sponsor's vote on a reorganization plan. It is therefore important for the sponsor to ensure that its debt buyback is made in good faith.

Credit Agreement and Indenture Restrictions on Sponsor Buybacks

Restrictions on a sponsor's ability to buy back company debt vary depending on whether the debt is issued under a credit agreement or an indenture. In response to sponsors' demands for flexibility to purchase the portfolio company's loans, credit agreements have recently developed "market" provisions regarding a sponsor's rights as a lender.

Restrictions in a credit agreement can take a number of forms. A credit agreement might contain an explicit prohibition on a sponsor becoming a lender.[1] Alternatively, the prohibition might be subtler, by providing that "affiliates" of a borrower are not permitted eligible assignees of the borrower's loans. A sponsor would almost always fall within the definition of an "affiliate," which usually applies to an entity that directly or indirectly controls anywhere from 5 to 10 percent of a company's voting stock. The buyback of debt by a sponsor may also fall within the credit agreement's transactions-with-affiliates covenant, which, depending on the wording of the covenant, could prohibit the sponsor's ability to make buybacks.

If a sponsor is permitted to buy back the company's debt, credit agreements will typically provide for an overall cap on the amount of loans that a sponsor may hold — usually in the range of 20 percent of the aggregate principal balance of the loans. The credit agreement will often provide that the sponsor's loans are not included in determining the calculation of the required number of lenders that

1 The restrictions discussed in this article would often not apply to a *bona fide* debt fund that is affiliated with the sponsor but has barriers in place with respect to the sharing of information between the sponsor and the debt fund.

are necessary to vote on an amendment. In addition, the credit agreement may provide that the sponsor will be deemed to have voted in the same proportion as the votes submitted by third-party lenders, as long as the amendment does not affect the sponsor in a disproportionate manner.

Restrictions in a credit agreement with respect to the sponsor's rights in a bankruptcy may include the prohibition on the sponsor objecting to (1) a DIP loan, (2) the use of cash collateral and (3) a § 363 sale supported by the lenders. The credit agreement may also provide that the sponsor is not entitled to vote on a restructuring plan and is deemed to have voted on the plan in the same proportion as the votes submitted by third-party lenders, subject to the requirement that the plan does not treat the sponsor in a materially less-favorable manner. These restrictions on the sponsor's rights in a bankruptcy might limit a sponsor's strategy to have any influence in a bankruptcy case.

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With respect to bond debt, the underlying bond indenture might restrict a sponsor from holding the bonds. Such restrictions may be found in the "transactions with affiliate" covenant or as an explicit restriction on affiliates of the company becoming bondholders. The indenture may require purchasing bondholders to provide the indenture trustee with a representation that it is not an affiliate. Indentures will sometimes provide that affiliates are not entitled to the registration rights that are afforded to other bondholders, impacting the liquidity of bonds that are held by the sponsor. An indenture may prevent the company from acquiring the bonds above a certain percentage and provide that the bonds held by the sponsor are deemed to be not "outstanding" for purposes of determining the percentage of outstanding bonds necessary for a vote. In most cases, indentures do not provide for the same specific provisions contained in a credit agreement regarding restrictions on sponsors in the company's bankruptcy. Each credit agreement and indenture is unique, and it is imperative that a sponsor review the debt documents before deciding whether to commence a buyback.

Legal Hurdles to Sponsor Buybacks

If the credit agreement or bond indenture permits a buyback, the sponsor may nevertheless encounter significant issues if the company files for bankruptcy protection. Other creditors, or the debtor itself, may object to the sponsor's debt claims, asserting that such claims should be "equitably subordinated" to other claims. In addition, they may seek to "designate" or disregard the sponsor's vote in connection with a reorganization plan.[2]

Parties may also allege nonbankruptcy claims against the sponsor, including claims for breach of fiduciary duty and, if repurchasing bond debt, insider trading. These claims could form the basis for equitable subordination and vote-designation claims in a subsequent bankruptcy proceeding. To protect itself, a sponsor should take actions to ensure that it is not usurping any corporate opportunity of the company and that it is not purchasing the company's debt based on material nonpublic information. For instance, the sponsor should consider disclosing its intention to the company's board of directors. In addition, if purchasing bond debt, the sponsor should consider a Rule 10b5-1 plan (*i.e.*, a written plan under which the insider would not have any influence over the how, when or whether to effect a purchase or sale of a security and the person making the purchase or sale is not aware of any material nonpublic information).

In a bankruptcy proceeding, if a court determines that inequitable conduct has occurred, it could equitably subordinate the sponsor's claim pursuant to § 510(c) of the Bankruptcy Code.[3] Equitable subordination, however, is a drastic remedy, requiring a finding that the claimant engaged in some type of inequitable conduct that injured creditors or conferred an unfair advantage to the claimant, and that subordination would not be inconsistent with the Bankruptcy Code.[4] The typical situations in which a claim of an insider, such as a sponsor, is equitably subordinated involve "(1) fraud, illegality or breach of fiduciary duty, (2) undercapitalization, and (3) control or use of the debtor as an alter ego for the benefit of the claimant."[5]

In addition, pursuant to § 1126(e) of the Bankruptcy Code, the bankruptcy court could designate — or disregard — the sponsor's vote on the plan if it found that the sponsor did not acquire its claim in "good faith." In applying § 1126(e), bankruptcy courts examine such issues as whether the sponsor purchased the debt for the sole purpose of blocking confirmation of a competing plan.[6] In a debt-buyback situation, a claim of vote designation typically would not be implicated unless the sponsor purchased additional claims after the release of the plan in an effort to block that plan. Although a sponsor may be exposed to significant liabilities in connection with a poorly designed debt buyback, such liabilities can be mitigated or eliminated through thoughtful planning and by always acting in good faith.

Cengage

A recent example of a debt buyback is that of Cengage, which was detailed in a report by Richard D. Feintuch that accompanied the reorganization plan in *In re Cengage Learning Inc.*[7] In the fall of 2012, Apax, which held 97 percent of Cengage's

2 Depending on the structure of the buyback plan, a company might incur significant tax liabilities, which are not discussed in this article. Competent tax counsel should be consulted in such transactions.

3 11 U.S.C. § 510(c).

4 *In re Mobil Steel Co.*, 563 F.3d 692, 699-700 (5th Cir. 1977).

5 *Official Committee of Unsecured Creditors v. Austin Fin. Servs. (In re KDI Holdings Inc.)*, 277 B.R. 493, 511 (Bankr. S.D.N.Y. 1999).

6 *See, e.g., In re S.P.M. Mfg. Corp.*, 984 F.2d 1305 (1st Cir. 1993).

7 Report of Richard D. Feintuch, Independent Director of Cengage Learning GP I LLC, Exhibit G to Disclosure Statement for Debtors' Joint Plan of Reorganization Pursuant to Chapter 11 of the Bankruptcy Code (Case No. 13-44106, ECF No. 553 (Bankr. E.D.N.Y. Oct. 3, 2013)).

equity, decided to buy back a portion of Cengage's debt.[8] Cengage's debt was trading below par on the secondary market, and Apax had the opportunity to buy back the debt at steep discounts. Apax also believed that the buyback would preserve its equity in Cengage and could yield high returns in the long run.[9] In addition, Apax anticipated using its purchase of Cengage's debt to facilitate debt-maturity extensions.[10]

As detailed in Feintuch's report, after reviewing Cengage's debt documents, Apax determined that it was expressly permitted to buy back Cengage's debt. In addition, Apax was aware that the first-lien credit facility restricted it from holding more than 25 percent of the aggregate principal amount of Cengage's first-lien loans at any one time.[11] Apax did not violate this covenant, according to Feintuch's report.

As a part of its buyback plan, Apax also sought and received informed approval from Cengage's board of directors.[12] Cengage's board also unanimously authorized Cengage to spend up to $50 million to buy back its unsecured notes.[13] After taking action to ensure that neither Apax nor Cengage was operating with any material nonpublic information, Apax ultimately acquired more than $1.2 billion of Cengage's debt for $832.9 million on the open market. Of the debt purchased by Apax, approximately 81 percent was first-lien debt in the form of loans and notes, according to Feintuch's report. The remaining debt purchased by Apax was second-lien and unsecured debt. Cengage purchased more than $168 million of its senior unsecured notes, senior subordinated discount notes and senior PIK notes for less than $50 million.[14]

The buyback of Cengage's debt, however, was insufficient to prevent a bankruptcy filing. Following Cengage's bankruptcy filing, the propriety of the debt buyback and the proper classification of Apax's debt claims have been contested. In fact, to review the efficacy of the buyback, Cengage's independent director hired Willkie Farr & Gallagher LLP to analyze the buyback. Feintuch's report concluded that Apax had likely not committed any violations of law by implementing the buyback. The effect of Feintuch's report, however, remains in question, and the bankruptcy court has appointed a mediator to mediate, among other disputes preventing Cengage's emergence from bankruptcy, "issues regarding Apax Partners LP."[15] In addition, the unsecured creditors' committee continues to investigate.

Conclusion

As seen by the challenges facing Apax in the Cengage proceeding, a badly executed buyback can create significant legal issues for a sponsor, both during and outside of a bankruptcy. A well-structured buyback, however, can create significant opportunities and long-term gains for both the company and the sponsor. Because of the significant benefits of a well-structured debt-buyback plan, a debt buyback can be a useful tool for sponsors seeking to maximize the value of a distressed situation. abi

8 *Id.* at 1.
9 *Id.* In fact, Apax had conducted an internal analysis showing that if Cengage's maturities were extended by five years, Cengage could refinance that debt or even conduct an initial public offering. *Id.* at 24.
10 *Id.* at 22.
11 *Id.* at 14.
12 *Id.* at 26-27.
13 *Id.* at 27.
14 *Id.* at 33-34.
15 Order Selecting Mediator and Governing Mediation Procedure, ECF No. 518, Case No. 13-44106.