

Client Alert

Jointly prepared by Goodwin Procter's Financial Restructuring, Leveraged Finance and Private Equity Practices

Portfolio Company Debt: A New Investment Focus

Loan to Own/Buy Your Own

The current freeze in the credit markets and the resulting general downturn in the leveraged buy-out market have led private equity firms to search for new investment opportunities. Not surprisingly, the economic forces that precipitated the downturn may generate some of these new opportunities. New credit is hard to obtain, but seasoned debt investors and, increasingly, private equity investors who have traditionally focused on equity investments, are actively considering investments in the debt of companies in a variety of sectors. These investment opportunities involve (i) buying debt of highly leveraged companies owned by others, with an eye toward helping the companies delever, and ultimately gaining an equity interest in or gaining control of them, and (ii) delevering their own portfolio companies by buying their debt. As an advance word of caution, however, even experienced private equity investors need to take adequate precautions and pay heed to the special legal and practical challenges of playing in this new arena.

With banks constrained, some hedge funds facing mounting margin calls and redemption requests and CLOs scrambling to delever, even performing senior loans in today's environment often trade well below their face value and first lien loans perceived to be at risk trade at much greater discounts to their face amounts. These current pricing conditions present opportunities for intrepid investors with capital to deploy. Buying substantially discounted debt that may end up paying close to par over its remaining term, or converting such debt to equity at a discounted value, is an avenue for private equity firms to obtain their target rates of return in what is otherwise a difficult private equity environment.

Loan To Own

Some investors in the current market are taking a page out of the playbook used by Leon Black and Steve Feinberg, founders of Apollo Management and Cerberus Capital Management, respectively, by purchasing distressed debt in a so-called "loan-to-own" strategy. Specifically, sponsors such as Goldman, Blackstone, Carlyle and others have recently raised substantial funds to take advantage of these opportunities and compete with the established players such as Apollo, Cerberus, Oaktree Capital and others. While this is not a new business model, its consideration by more traditional private equity firms is a potentially significant development in response to unprecedented economic conditions.

Essentially, a loan-to-own strategy involves purchasing outstanding debt of a company at a discount (usually pursuant to a standard LSTA (Loan Syndication and Trading Association) Purchase and Sale Agreement for Distressed Debt) and then

negotiating with the issuer to restructure and convert the debt to equity. This can be done consensually, through foreclosure or litigation, or through a bankruptcy proceeding.

A recent example of a completed loan-to-own transaction was the acquisition of Portola Packaging by Wayzata Investment Partners, which was effected by the purchase of the company's \$180 million senior notes on the secondary market. The noteholder's claims were converted to equity in a Chapter 11 proceeding. The pre-packaged bankruptcy restructuring plan was financed with the proceeds of a \$79 million DIP facility of which \$10 million was a bridge loan from Wayzata itself. Wayzata also refinanced \$30 million of the existing second lien debt upon exit and obtained \$66 million in first lien senior debt exit financing as well. In discharging the note obligation of \$180 million in funded debt through bankruptcy and satisfying all trade claims and other debt obligations, Wayzata completed a successful acquisition at discounted value with a recast capital structure.

Implementing a loan-to-own strategy is not for the faint of heart. New entrants should consider the following issues:

Do the Fund Documents Authorize the Loan-to-Own Transaction? Sponsors will need to determine whether their existing fund documents authorize the use of committed capital to invest in debt, particularly the debt of distressed companies. In addition, a sponsor needs to consider whether such investments are consistent with the investment strategy described to limited partners in its fund's PPM. If a fund has foreign investors, it may be restricted in its ability to earn certain types of interest income. Sponsors may need to raise special opportunity funds or obtain waivers to pursue the strategy.

Is the Fund a Permitted Transferee Under the Loan Documents? Frequently the loan documents in syndicated bank loans restrict transfers of interests in the loans to "entities which extend credit or buy loans as one of their businesses." A private equity investor venturing into the debt markets may not easily fit within this category.

Understand the Cash Flow. The loan-to-own business often involves a long gestation period before the purchased debt can be converted to equity. Unless the debt is paying current interest, there may be a long workout period in which there are no incoming revenues or management fees and quite likely substantial out-going expenses for restructuring counsel and possibly litigation costs, debtor financing or tax costs from phantom interest income inclusion. The ability of the fund to fund loans quickly could be required. Successfully capturing the equity may require a fresh capital infusion into the restructured company. If the investor does not successfully convert the acquired debt into control of the company, there may be other stakeholders such as junior debt holders and former equity holders with residual interests in the company who will want a say in the sponsor's ability to take management fees and other current payments until it exits. Even in a successful conversion of debt to equity, issues with these constituents will need to be addressed.

Recognize the Information Gap. Success in the loan-to-own market requires the willingness to make an investment without the benefit of the thorough due diligence to which private equity investors are accustomed. The issuer often is in default and may not be issuing current financial statements to its current investors. Old data is stale, the market is changing and the issuer is likely to be under duress and changing its business model in an effort to cope with adverse economic conditions. Accordingly, the investor's investment decision usually must be based upon industry expertise, anecdotal data obtained from conflicted sources and instinct. With public companies, and in many instances even with private companies, the investor must be careful about 10b-5 exposure or common law fraud risk, which limit the investor's ability to pre-arrange a solution with insiders while accumulating a debt position in the market.

Remain Nimble. Typically, loan-to-own situations involve stakeholders at different levels of the capital structure competing to preserve value for themselves and often to depress value for others. Business prospects and performance and the general economy can swing dramatically during the pendency of the restructuring, resulting in swiftly changing expectations and leverage of the various parties. Even more ominous is the prospect that the weaker party's position can be bought out at a substantial discount by an industry veteran at any point of the process, entirely changing the dynamics of the restructuring.

Sharpen Your Elbows. The loan-to-own business is rough and tumble. The stakes are high in a zero sum game where one party's loss is another's gain. A private equity investor in this arena has to be prepared to substantially dilute or eliminate the incumbent equity sponsor in the transaction. This orientation may be foreign to and uncomfortable for private equity investors who are used to friendly, negotiated deals with companies and members of "club" syndicates. Investors who are used to the club deal mentality that typified investments in the recent boom may find the dynamic loan-to-own context an alien environment. To be successful in this context, an investor must be prepared to litigate and the other participants in the process must understand and respect that fact. Also, the ability and stomach to strike a deal on the courtroom steps with minutes to decide is also required.

Retain an Expert. A loan-to-own strategy involves much art and a bit less science than the typical private equity investment. It is therefore prudent for an investor who is new to this strategy to consider partnering with an investor who is either an experienced fund or is experienced in the art of distressed debt trading. This might mean finding a talented refugee from an imploding hedge fund who would thrive in the relative stability of an established private equity fund.

Tax Concerns. Although a loan-to-own strategy does not generally give rise to cancellation of indebtedness ("COD") income to the portfolio company (as discussed below with respect to "own-your-own" strategies), tax issues can arise for the fund, such as current inclusions of ordinary income from discount from the original face amount of the acquired debt or the application of ordinary income tax rates rather than capital gain rates to a portion of gain from sale of the acquired debt.

Portfolio Company Roll-up Opportunity. If the foregoing challenges are not too daunting, the loan-to-own strategy can be employed at the portfolio company level by funding a portfolio company's acquisition of the discounted debt of weak competitors. This can be a cost effective way to consolidate an industry. Investors pursuing this strategy should be aware that many loan agreements provide that "direct competitors" are not "permitted transferees" of debt.

Buy Your Own

In addition to the traditional loan-to-own strategy, the current debt market dislocations present opportunities for private equity investors to generate gains by repurchasing the debt of their own portfolio companies. The debt may be available at a discount due to the many current pressures that are affecting the banks, hedge funds and CLOs that hold this debt. By buying this debt, either directly through the portfolio company itself or through an affiliate, a private equity fund can effectively delever its portfolio companies, creating operational flexibility, while profiting directly on the debt purchase.

A buy-your-own strategy avoids some of the pitfalls of the loan-to-own approach because there is no knowledge gap. This strategy generally can be executed with healthy debtors, and, therefore, may avoid many of the challenges that are inherent in a full blown restructuring. On the other hand, limitations imposed by investors' fund documents apply equally to the buy-your-own strategy if the fund rather than the portfolio company is the acquirer.

Be Aware of Fiduciary Obligations. The sponsor may confront fiduciary issues, particularly when it acquires the debt of a portfolio company with a different fund than that which holds the equity. This situation gives rise to potential conflicts between the interests of the limited partners in the fund that holds that equity and the limited partners in the fund that holds the debt when the company runs into trouble. The situation could also lead to lender liability claims by third parties. Even if the debt is owned by the same fund as the equity, third-party claims could arise such as equitable subordination attacks. It is important to remember which hat you are wearing, debt or equity, when you make decisions. Care should be taken to anticipate these issues and establish and maintain control over authority for the debt and equity positions and information flow.

Additional Permitted Transferee Challenges. In addition to the limits described above, loan documents often also prohibit transfers to "affiliates of the portfolio company or sponsor." When confronted with this restriction, the potential acquirer may be able to use a related but unaffiliated entity as the acquisition vehicle if it can fit within the definitional restrictions. It is also possible to get a waiver from the requisite holders of the debt, but such a waiver will often be conditioned upon agreements limiting the acquirer's ability to exercise its voting and other rights with respect to the purchased debt. Keep in mind that lenders may not be happy with debt being bought at a discount rather than being paid at the contract rate, that waivers may be expensive or not be granted, and that relationships may be strained.

Buy Your Own Has Tax Consequences. When a portfolio company's debt is repurchased at a discount, or when a party "related" to the portfolio company

purchases debt of the portfolio company, it generally results in COD income to the portfolio company in an amount equal to the difference between the adjusted issue price of the debt and the amount paid for the debt. Subject to certain exceptions for bankruptcy or insolvency that may apply, this COD income can create a tax liability for the portfolio company or reduce available net operating losses. Depending on the circumstances, it may be worthwhile to consider triggering COD if the tax consequences reduce but don't eliminate the economic advantage of repurchasing the debt.

For purposes of determining whether COD income is triggered, very generally, parties are related if they are at least 50% owned or controlled by the same persons. Complex attribution rules apply in making the related party determination. When a debt instrument is acquired by a party related to the portfolio company at a discount, the debt is generally treated as repurchased by the portfolio company and reissued to the related party for the discounted amount. Therefore, the debt may be treated as reissued with original issue discount ("OID"). If debt treated as reissued with OID constitutes an applicable high yield debt obligation ("AHYDO"), then interest deductions on the debt may be deferred or disallowed.

COD income is not triggered if debt is purchased by a person that is not a related party. So, the acquisition of debt by an entity sufficiently independent to avoid the related party characterization will avoid triggering COD income. In this case, however, the debt will generally be purchased with "market discount" (subject to certain exceptions), which can cause the purchaser to accrue that market discount over time or, alternatively, will convert a portion of any gain on the sale of the debt from capital gain to ordinary interest income.

Tax Law Changes Makes Buy Your Own More Attractive. The recently enacted American Recovery and Reinvestment Act of 2009 ("Act") may dramatically change the landscape for certain portfolio companies that may recognize COD income in connection with a debt repurchase. The Act allows business taxpayers to elect to defer COD income from debt instruments reacquired in 2009 and 2010. With the election, a portfolio company may defer the inclusion of COD income until 2014, at which time the COD income will be includable in income ratably over five years.

If a portfolio company elects to use this new deferral rule, then the other COD exceptions generally will not apply (bankruptcy, insolvency, etc.) and if the portfolio company sells substantially all of its assets or no longer continues its trade or business, any deferred items of income or deduction will be accelerated. Special rules also apply in the case of a portfolio company that is a tax partnership.

If, as part of a debt acquisition by a related party, a debt instrument is treated as reissued with OID to the related party, deductions to the portfolio company with respect to the OID will generally be deferred. Under an anti-abuse provision, if any debt instrument is issued and the proceeds of such issuance are used directly or indirectly to reacquire a debt instrument of the portfolio company, the debt that is issued may be treated as issued in exchange for the debt that is reacquired.

Lastly, under the Act, the limitation on AHYDO interest deductions to a portfolio company will not apply to any AHYDO issued from September 1, 2008 to December 31, 2009 in exchange (including an exchange resulting from a modification of the debt) for debt that is not an AHYDO, provided the portfolio company or obligor remains the same. However, because this exception does not apply to a debt that is issued (or treated as issued) to a related person, this exception does not currently appear to be of much use to a portfolio company, the debt of which is purchased by a related party and treated as reissued by the portfolio company at a discount. The AHYDO exception also does not apply to an instrument that provides for certain contingent interest.

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Dramatic changes in market conditions inevitably generate prompt and entrepreneurial responses by the professionals who populate the private equity industry. The recent focus by some on delevering their own portfolio companies and/or acquiring debt of other companies reflects such a response. Whether investors will embrace the conflicts and costs these strategies can entail, whether investors will ultimately be able to realize target return rates by utilizing them and whether these investment strategies will become prevalent are questions still to be answered in the early days of the brave new post-freeze world. But the savviest investors know that the opportunities are too interesting not to explore, and the exploration is active and ongoing.

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