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CLIENT MEMORANDUM

Private Equity Investments in Portfolio Company Debt: An Overview of Legal Issues

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INTRODUCTION

Due to the current state of U.S. bank and bond markets, many private equity investors are considering investments in portfolio companies either to provide additional liquidity or to opportunistically take advantage of distressed trading levels of debt instruments. This memorandum briefly summarizes the issues and legal risks that may arise in connection with a private equity fund's investment in one of its portfolio companies through the purchase of existing debt or by making a new cash investment in the form of debt. These risks apply to investments in debt of any entity that becomes the subject of a case under the U.S. Bankruptcy Code.

CONTRACT AND TAX LAW ISSUES

The primary issues to be considered when a private equity fund contemplates purchasing existing debt of a portfolio company at a price below par include the ability to do so under the underlying financing documents, as well as important tax ramifications of doing so.

- A key threshold issue to consider is whether the underlying credit agreement permits affiliates of the portfolio company borrower to be assignees of the loans, and if it does, whether it restricts voting of any loans held by the affiliate. A credit agreement that permits such assignments would typically condition that assignment on consent of the administrative agent (usually not to be unreasonably withheld). Agents may object or be within their rights to condition their consent to assignments to private equity fund affiliates.
- A straight purchase of portfolio company bank debt by a private equity fund owner with its own cash will not trigger the typical problems under the pro rata payments or sharing provisions of a portfolio company credit agreement associated with a borrower buyback of its own loans, nor would it raise any problems under a typical credit agreement

covenant restricting repurchases of junior debt. To the extent any such purchase is made by the fund with cash coming from the portfolio company (including through a permitted dividend), there is a possible equitable argument that this is a constructive and impermissible non-pro rata payment or breach of the junior debt buyback covenant, as the case may be, particularly if the debt is contributed back to the portfolio company for cancellation. In general, if the purchased debt is contributed back to the portfolio company in exchange for cash or other consideration (other than common equity) many take the view that the company has made a non-pro rata payment or breached the junior debt buyback covenant. There have been a number of amendments to credit agreements completed in the market that seek to address these issues, often in the context of amendments to also permit the portfolio company itself to buy back its loans.

- Indentures do not contain "pro rata" payment provisions and therefore do not typically preclude a company, or its affiliates, from acquiring the issuer's debt. However, high yield senior note covenants typically include restricted payment provisions that limit redemptions or prepayments of subordinated debt which may preclude an issuer from buying-in higher cost subordinated notes. Also, indentures typically exclude the vote of affiliates in determining whether noteholders have taken action under an indenture. The Trust Indenture Act of 1939 similarly limits the effectiveness of votes cast by affiliates if a default has occurred. Unlike lending arrangements, federal and state securities laws apply to purchases of outstanding notes by the issuer and its affiliates. As a result, it is advisable that issuers and their affiliates refrain from the acquisition of notes during periods in which they possess material non-public information. We generally advise issuers to state their possible intention to acquire notes through open market purchases, tenders or privately negotiated transactions in advance of such purchases in their '34 Act reports.
- If a private equity fund purchases debt of a portfolio company at a discount, the portfolio company may be required to report cancellation of indebtedness ("COD") income in the amount of the difference between the par or accreted value of the debt and the purchase price of the debt, even if the indebtedness remains outstanding. In general, such consequences would depend on whether the portfolio company and the private equity fund are considered related for U.S. federal income tax purposes and whether certain exceptions apply (such as insolvency or bankruptcy of the debtor). In general, a private equity fund partnership would be considered related to the debtor if the partnership owns or is treated as owning more than 50% of the portfolio company or the same persons own or are treated as owning more than 50% of the debtor and the partnership.[1] In addition to the COD income, the private equity fund purchaser would have to accrue the discount into income as original issue discount ("OID") over the remaining life of the debt whether or not it

[1] Complex and broad constructive ownership rules apply in determining whether two persons are related for these purposes, which can result in unexpected relationships between parties. For example, as a result of overlapping limited partner ownership, a private equity fund purchaser of debt may be treated as related to the debtor as a result of ownership of the debtor by a different private equity fund.

receives cash (i.e. phantom income). The portfolio company may be able to deduct the OID as interest expense subject to certain disallowance rules.

Under the American Recovery and Reinvestment Tax Act of 2009 (the "Act"), which was approved by the House of Representatives on February 13, 2009, however, a portfolio company that is a corporation or otherwise engaged in a trade or business may elect to defer the COD income generated by the purchase of its debt by a related private equity fund if the purchase occurs in 2009 or 2010. The Act is expected to be signed by President Obama once approved by the Senate. If the purchase of the debt occurs in 2009, an electing debtor recognizes the resulting COD income ratably over the five taxable years beginning with the fifth taxable year following the taxable year in which the purchase occurs. If the reacquisition occurs in 2010, an electing debtor recognizes the resulting COD income ratably over the five taxable years beginning with the fourth taxable year following the taxable year in which the purchase occurs. The Act would not change the required OID inclusions by the private equity fund, as described above. Although the Act temporarily suspends limitations on a borrower's ability to deduct OID resulting from certain debt-for-debt exchanges involving applicable high yield debt obligations ("AHDYOs"), this provision of the Act does not apply to OID resulting from debt issued (or deemed issued) to a related person).

In addition, the portfolio company may have net operating loss carryforwards which can be used to offset, in whole or in part, the COD income. As a result of the deemed discount described above, there may also be additional interest deductions for the portfolio company to use to offset future operating income.

BANKRUPTCY AND CORPORATE LAW CONSIDERATIONS

The primary risks under U.S. law that a private equity fund may face as a creditor of a portfolio company in bankruptcy are (1) reduction of its claim to the amount paid for the debt, (2) allegations of breach of fiduciary duty under the "corporate opportunity" doctrine, (3) equitable subordination of its claim, (4) recharacterization of the investment as equity and (5) unwinding of debt repayments as preferential or fraudulent transfers. The first two risks apply mainly to debt purchased in the secondary market and the last three risks apply to purchased debt and new money loans as well. Set forth below is a discussion of these five risks as well as practical steps that can be taken to mitigate them.

- If an insider[2] of a company acquires the debt of that company at a discount when that company is in financial difficulty, the insider's claim can be reduced to the value paid for the claim. Courts have indicated that this result may be avoided if the affiliate discloses its intention to acquire debt to the portfolio company, obtains approval from disinterested members of the board, makes disclosure to all court-appointed committees (if a bankruptcy has commenced) and discloses its identity to the seller.
- The "corporate opportunity" doctrine prohibits one who occupies a fiduciary relationship to a corporation from acquiring, in opposition to the corporation, property in which the corporation has an interest or tangible expectancy or which is essential to its existence. This may apply to the

[2] The Bankruptcy Code defines "insider" of a corporate debtor as including a "(i) director of the debtor; (ii) officer of the debtor; (iii) person in control of the debtor" or an "affiliate [of the debtor], or insider of an affiliate as if such affiliate were the debtor." 11 U.S.C. § 101(31). Affiliate is in turn defined as an entity that "directly or indirectly owns, controls or holds with power to vote, 20 percent or more of the outstanding voting securities of the debtor . . ." 11 U.S.C. § 101(2).

opportunity of a corporation to repurchase its debt at a discount. It is prudent for an affiliate to disclose its intention to buy debt to the portfolio company so that the portfolio company can determine whether or not it wants to buy the debt instead. In a distressed situation, the company will not be able to afford to buy the debt, so as a practical matter, it generally would not be precluded from any opportunity.

- While courts recognize that insiders are frequently the constituency most incented to improve the financial condition of a distressed entity and so often protect legitimate efforts to do so, a court can subordinate a creditor's claim if that creditor engages in inequitable conduct[3] that results in injury to another creditor. An insider making a loan to an undercapitalized business is not in itself inequitable conduct, but insiders will bear the burden of proving that the loan transaction was a good faith transaction and inherently fair. As a condition to a finding of inequitable conduct, courts generally require a finding that the insider/creditor actually used its position to advantage its position as a creditor to the detriment of other creditors.
- Bankruptcy courts can look through the form of a transaction and to its essential substance and recharacterize a debt investment as equity. Unlike equitable subordination, recharacterization as equity does not require inequitable conduct. Rather, the focus of the court's inquiry will be the intent of the parties at the time of the transaction, and whether the economic reality of the "loan" is instead an equity investment. A debt investment in an affiliate is most at risk of being recharacterized as equity if the business is not sufficiently capitalized and if an outsider would not have made a similar extension of credit on similar terms. Courts are reluctant to recharacterize a debt given the public policy desires to incentivize insiders to support their affiliates.
- To the extent that a private equity fund receives payment on any unsecured debt it purchases or any new money it lends to the portfolio company on an unsecured basis, it will be subject to a one year preference risk, not the more common 90-day exposure. If the portfolio company files for bankruptcy within one year of any such payment, there is the risk of an unwinding of debt repayments as preferential or fraudulent transfers.

This memorandum was not intended or written to be used, and cannot be used, for the purpose of avoiding tax-related penalties under federal, state, or local tax law.

[3] Inequitable conduct includes fraud, illegality, breach of fiduciary duties, mismanagement or "faithless stewardship" and is best understood by the notion that an insider must not breach "rules of fair play and good conscience."

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