

CLIENT ALERT

Managing Information Issues in Borrower or Sponsor Buybacks

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When commercial loans trade at a discount, borrowers (and their affiliated sponsors) are rationally motivated to buy back their loans at the discount, retire them at par and improve their balance sheets by reducing long-term debt. In recent years these buybacks are often explicitly contemplated in credit agreements, even with detailed procedures designed to ensure the existing syndicate of lenders is not prejudiced by the buyback.

For borrowers or sponsors that have sufficient liquidity, the current market environment may provide an extraordinary opportunity. Here we suggest ways in which parties to a borrower or sponsor buyback transaction should approach legal issues arising from what is presumably an uneven information playing field.

The secondary loan market operates on the assumption that market participants have access to material information about a borrower that is made available to lenders but not the general public. Borrowers and sponsors, however, also possess information which is not required to be shared with lenders under credit agreements. In the purchase and sale of loans, borrowers and sponsors and their counterparties should focus on the information disparity inherent in the transactions. Potential legal issues to consider include the following:

1. Can a borrower or sponsor protect itself from a selling lender's claim that it was at an informational disadvantage?

The usual loan market approach to information disparity consists of two parts: (a) disclosing to the counterparty that one may possess material information that the counterparty may not have, and (b) demanding a waiver from the counterparty of any claim arising from that information disparity. In a borrower or sponsor buyback, that approach may be both unnecessary and ineffectual. It is self-evident that the borrower would, and the sponsor is highly likely to, have more information about the borrower than a lender. The waiver, even if obtained from a selling lender, may not be enforceable when the buyer is the borrower or sponsor with highly material information.

Without an effective waiver, borrowers and sponsors may need to disclose the information to the selling lender or to the public generally. If disclosure to the seller is preferable, an undertaking from the seller to keep the information confidential would be prudent. This serves a commercial purpose and, for a borrower with outstanding securities, also helps to avoid triggering public disclosure duties under Regulation FD.

In the absence of disclosure, some techniques analogous to a trading plan under the safe harbor provided by Rule 10b5-1 promulgated under the Securities Exchange Act of 1934 may be available. That is if, at a time when it has disclosed all material information, the borrower or sponsor is able to put in place the material terms necessary irrevocably to authorize a buyback plan.

2. How does a selling lender protect itself from unwanted information?

A selling lender should think twice before agreeing to accept information from the borrower. Such information may not be available to other lenders and could prevent the seller from trading in loans in the future. If the seller does agree to acquire the information, the terms of the non-disclosure agreement under which it does so should be negotiated to provide the seller with flexibility in future loan trading activities. Moreover, it is important to evaluate the restriction, and the duration of such restriction, that the information may impose on securities trading.

For some sellers, acquiring the information from the borrower is not possible because they wish to maintain “public” status in order to trade securities of the borrower. These sellers should also consider with their counsel the impact of the knowledge of the existence or terms of the borrower or sponsor buyback.

3. How does a dealer or other intermediary protect itself when facilitating a borrower or sponsor buyback?

An intermediary has it particularly hard in this situation. On the one hand, just like any seller to a borrower or sponsor, it should consider what information, if any, it is willing to accept and negotiate for permissive terms of non-disclosure agreements. More importantly, an intermediary should be thoughtful about what information to provide to its seller. It is also possible that the mere fact that the borrower or sponsor is the ultimate buyer of the loans is material to the trade in which the seller is selling the loans to the intermediary. If so, the intermediary should seek to disclose that fact to the seller, with the consent of the borrower, if necessary.

Borrower buybacks are far from ordinary events in the loan market. In today’s market they are becoming more common. Parties on all sides of those transactions should diligently evaluate and resolve legal issues arising from any information disparity presented in this type of transactions.

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