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Purchases of Bank Loans by a Borrower or its Sponsor

Can a borrower repurchase its own loan at a discount in today's volatile secondary market? Because many bank loans now trade below par, a borrower (or a borrower's equity sponsors) may be tempted to purchase the borrower's loans in the secondary market.

From the borrower's perspective, purchasing its loans at a discount avoids the more expensive alternative of making a voluntary prepayment at par, which in some cases may include a prepayment premium or "make-whole" payment. From the sponsor's perspective, purchasing the borrower's loans at a discount for investment purposes or retiring the debt to cure a financial covenant default or avoid an equity cure at par is an enticing proposition.

When determining if a credit agreement permits a borrower or its sponsor to purchase a borrower's loans in the secondary market, parties need to focus their review on a surprising number of unrelated sections of a credit agreement. These sections are highlighted in this memo.

Eligible Assignees

Most credit agreements provide that a lender is permitted to assign its loans only if the assignee is an "Eligible Assignee." Sometimes the definition of "Eligible Assignee" includes an express prohibition on the borrower, its parent company and its subsidiaries from being an Eligible Assignee. This prohibition may be broader to include affiliates of the borrower or specifically, the sponsor and its affiliates.

Administrative Agent Consent

The assignment section of the credit agreement may require the administrative agent's consent to assignments other than assignments to those lenders who are existing lenders, together with their affiliates and related funds. In these circumstances, the determination of whether or not the borrower or sponsor may purchase the borrower's loans is dependent on the judgment of the administrative agent. Some credit agreements are more permissive and permit loans (and in particular, term loans) to be assigned without the consent of the administrative agent.

Covenant Definitions

Credit agreements often place restrictions on a borrower's ability to make investments, acquisitions and restricted payments.¹ In most credit agreements, the definition of "Investments" often includes the purchase of loans. In addition, the purchase by the borrower of loans would be considered an acquisition, since the borrower is purchasing an asset owned by another person (the loan owned by the assignor). Restricted payments govern the ability of a borrower to make dividends and to repurchase or redeem indebtedness within its capital structure.²

Typically, the defined term "Investment" includes the purchase of loans *of another person*, which is intended to cover the loans of a third party, not the borrower itself. The "Permitted Acquisition" covenant usually applies to acquisitions of *all or substantially all* of the assets of a third party, which would not apply to the purchase by the borrower of a loan owned by a third party. In addition, prohibitions on restricted payments often apply only to other indebtedness within the borrower's capital structure (usually junior or subordinated debt) and not the loans made pursuant to the credit agreement. In order to determine whether or not a borrower can purchase its loans, parties should review these provisions carefully, and if these provisions are broad enough to cover the purchase by the borrower of its loans, then one must review the specific covenant to look for an exception.

Ratable Sharing

Credit agreements require a lender who receives a "benefit" from the borrower with respect to its loans to share that benefit ratably with the other lenders. This benefit includes any payment of the principal or interest on the loans or any act of set-off that a lender has taken. Most credit agreements are silent regarding whether the assignment or participation of a loan by a lender to the borrower constitutes a "benefit". Some credit agreements may expressly state that assignments and participations by lenders are not subject to the ratable sharing provisions, other than those assignments and participations made to the borrower. In these cases, a lender who assigned its loans to the borrower (the "Assigning Lender") would have to share the proceeds of that assignment with all the other lenders on a ratable basis, usually by requiring the Assigning Lender to purchase participations in the loans of the other lenders in an amount up to the Assigning Lender's ratable share of the assigned loan.

Voting

In cases where a credit agreement does not include a prohibition on the borrower or its sponsor from purchasing the borrower's loans in the secondary market, the amendment section of the credit agreement may exclude sponsors from being included in the determination of "Requisite Lenders" for voting purposes. Also an administrative agent may not consent to the assignment of loans to sponsors, in order to prevent interested parties from having a voting right.

¹ The covenants in credit agreements typically do not apply to the sponsor.

² Sometimes the restriction on repurchasing or redeeming indebtedness is not included in the "Restricted Payments" definition, but rather, handled in a separate covenant.

Participations

Credit agreements usually permit a lender to participate its loan to third parties without the consent of the administrative agent. In cases where a borrower and/or its sponsor is prohibited from being an Eligible Assignee, these same entities may be able to purchase a participation from a lender in the borrower's loans.

Tax Consequences

When a borrower purchases its loans at a discount from par, the borrower will generally recognize taxable income in an amount equal to the discount. This may also be the case if it is the borrower's sponsor, rather than the borrower itself, who makes the purchase. Accordingly, a tax advisor should be consulted prior to making any such purchase.

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This memo is not intended to be a full description of all material terms of repurchases of a borrower's loans. Parties interested in determining whether or not a borrower or sponsor may purchase the borrower's loans should review the terms and provisions of the particular credit agreement at issue as credit agreements vary with respect to these terms and provisions.