LevFin Quarterly

Weil

Editors' Welcome

Welcome to the latest edition of LevFin Quarterly. In this issue, we look at the implications of President Trump's tax reform plan and the House Republican plan on Private Equity acquisitions of U.S. targets. We also discuss the Second Circuit's highly anticipated recent decision in Marblegate, and we discuss liability management transactions, focusing on key issues in debt exchanges. We look forward to continuing to provide you with insightful commentary on current topics in leveraged finance. As always, we would be happy to discuss the topics in this issue and other developments in leveraged finance with you.

Best regards,

Heather L. Emmel
Danek A. Freeman
Allison R. Liff

In This Issue

1. Editors' Welcome
1. Comprehensive Tax Reform: What Does It Mean for Private Equity Deals?
3. The Second Circuit's Decision in Marblegate
3. Liability Management: Key Issues in Debt Exchanges
5. Weil's U.S., U.K. and Hong Kong Finance Practices and Partners Recognized in 2017 Edition of *IFLR1000*

Comprehensive Tax Reform: What Does It Mean for Private Equity Deals?

An important element of President Donald J. Trump's campaign platform was tax reform. Although the available information on the President's tax reform plan (the "Trump Plan") is somewhat limited, some important elements are known.

In any case, the President will need to work with the Congress if he wishes to accomplish comprehensive tax reform. This may well entail some compromise between, or melding of, the Trump Plan and the House Republican plan released in 2016 entitled "A Better Way: Our Vision for a Confident America" (the "House GOP Plan"). *See table on page 2*

Comparing and Contrasting the Trump Plan and the House GOP Plan

While it is inherently difficult and risky to predict the outcome of the multiparty negotiations that would be involved in comprehensive tax reform, involving both political parties, both houses of Congress and of course the Trump Administration, there are some lessons for Private Equity that can be learned by comparing and contrasting the Trump Plan and the House GOP Plan. Accordingly, the table below sets forth some of the key provisions of the two plans that relate to acquisitions of U.S.-based targets by Private Equity, although it is not meant to summarize all of the proposals in the two plans.

High-level impact on Private Equity acquisitions of U.S.-based targets

The biggest impact of the House GOP Plan on private equity is that interest expense would no longer be deductible (other than against interest income). Although the impact may be mitigated by the lower maximum corporate income tax rate (20%), this limitation would make it more expensive to do leveraged acquisitions of freestanding subchapter C corporations, in which no asset-level tax basis step up is obtained.

In contrast, the ability to expense completely tangible and intangible assets in the year of acquisition is a substantial benefit to acquisitions of assets, disregarded entities (e.g., single member limited liability companies that have not elected to be taxed as corporations), and subchapter S corporations and subsidiaries in consolidated groups that agree to a Section 338(h)(10) or Section 336(e) election, all of which can provide an asset-level tax basis step up for the buyer. (Note that it is unclear as yet whether this proposal is intended to apply to a purchase of an interest in a partnership that has a Section 754 election in place, such that the

Issue	Trump Plan	House GOP Plan
Maximum corporate tax rate	15%	20%
Cost recovery	U.S. manufacturers would get to elect to expense their capital investments and acquisitions, but would have to give up the ability to deduct interest expense (after 3 years, the election becomes irrevocable)	Immediate expensing of tangible and intangible assets (excluding land)
Business interest deductibility	A "reasonable cap" on business interest deductions will be phased in	Interest deductible *only* against interest income, but excess interest deductions carried forward indefinitely
Net operating losses (NOLs)	No express provision	• NOLs may only be used against 90% of taxable income (similar to current limitation under the alternative minimum tax rules) • NOLs can be carried forward indefinitely (and will be increased by an interest factor) • No carryback of NOLs allowed
Earnings of foreign subsidiaries of U.S. corporations	• Previously accumulated foreign earnings deemed repatriated and taxed at a special one-time reduced rate of 10% • Going forward, foreign income is treated as pass-through, even if earned by a corporate subsidiary	• Previously accumulated earnings in foreign subsidiaries deemed repatriated and subject to tax at a special one-time rate (8.75% to the extent held in cash or cash and cash equivalents and 3.5% otherwise), with companies having 8 years to pay the resulting tax • 100% exemption for dividends from foreign subsidiaries
"Border adjustability"	No provision	Introduces border adjustability: broadly speaking, exports not taxed and import costs not deductible
Carried interest	"No more carried interest" – unclear what this means in practice	No provision
Delta between maximum ordinary income and long-term capital gain/ qualified dividend rates	5% (25% vs 20%)	16.5% (33% vs 16.5%)
Taxation of pass-through business income	"Business income" from flow-through entities to individuals taxed at 15% corporate rate	"Business income" from flow-through entities to individuals taxed at 25% rate

buyer's share of the partnership's basis in its assets is adjusted under Section 743(b). This structure is common in purchases of flow-through businesses with a substantial rollover component.)

Moreover, NOLs resulting from this expensing of assets can be carried forward indefinitely and increased by an interest factor, although they can only shelter 90% of net taxable income in the carryforward year. The combination of capital investment expensing and indefinite NOL carryforwards with an interest factor should at least partially offset the negative impact of interest disallowance (and may fully or more than fully offset that negative impact). In short, it seems likely that the existing tax advantage of step up deals over non-step up deals would be increased under the House GOP Plan.

In contrast, because the Trump Plan limits expensing to U.S. manufacturing businesses that elect to give up interest deductions, and interest deductions for others are not eliminated but subject to a phase in of as yet undefined "reasonable caps," it is more difficult to predict the impact of the plan on Private Equity deals.

The Trump Plan would result in a substantially smaller rate differential between ordinary income and long-term capital gains/qualified dividend income (5%), compared to both current law and the House GOP Plan, and relative to the benefit of corporate deductions under the Trump Plan itself (15%). The likely impact of this on Private Equity transactions would be to (1) make deductible compensation (e.g., nonqualified stock options) more favored relative to non-deductible incentives (e.g., profits interests or incentive stock

options) and (2) reduce the cost of making sellers whole for the difference between capital gains and ordinary income (e.g., depreciation recapture) arising from an actual or deemed asset sale.

Both plans may make it easier for Private Equity sponsors to access the target's offshore cash to do "bootstrap" acquisitions, because they both attempt to eliminate the concept of "trapped cash" in foreign subsidiaries.

Also, the inability to carry back NOLs under the House GOP Plan may make it more challenging commercially for Private Equity sellers to capture the benefit of transaction tax deductions (e.g., option cash-out payments at closing) in negotiations with buyers because current law allows NOLs generated by these deductions in the year of the closing to be carried back to the two immediately preceding taxable years, potentially creating refunds that can be claimed by the target company.

The Second Circuit's Decision in Marblegate

After the controversial district court decision in *Marblegate Asset Management v. Education Management Corp.* (S.D.N.Y.) which found a violation of Section 316(b) of the Trust Indenture Act (TIA) in an out of court restructuring, on January 17, 2017, the Second Circuit issued its much anticipated decision, holding that "Section 316(b) prohibits only non-consensual amendments to an indenture's core payment terms." At issue is whether the phrase "right . . . to receive payment" forecloses "more than formal amendments to payment terms that eliminate the right to sue for payment." The Second Circuit held that it does not.

Since the inception of the TIA in 1939, most practitioners and courts have interpreted §316(b) as providing only limited protection to noteholders by prohibiting formal modifications of the payment terms or the right to sue. The traditional view, which remained largely unchanged for more than seven decades, is that §316(b) protects only a noteholder's legal right to receive payment when due rather than any practical ability to receive it. By contrast, the Marblegate District Court decisions and the BOKF NA v. Caesars Entertainment Corp. decision interpreted §316(b) as prohibiting amendments that impair noteholders' practical ability to receive payment.

The Second Circuit decision restores the status quo and reinstates the traditional view that §316(b) provides only limited protection to noteholders by prohibiting formal modifications of the payment terms or the right to sue. While the decision does not mention Federated Strategic Income Fund v. Mechala Grp. Jamaica Ltd., 1999 WL 993648 (S.D.N.Y. Nov. 2, 1999) – the only pre-Marblegate case to hold that §316(b) protects the practical ability to be repaid – it effectively overrules this long-criticized decision. Noteholders like Marblegate are not without recourse: they will continue to have whatever contractual protections exist in their indentures as well as protections under fraudulent conveyance, foreclosure and other state laws protecting creditors and, in the case of insolvent issuers, potential claims against officers and directors for breach of fiduciary duty. Noteholders can also seek to protect against the type of out-of-court restructuring that occurred in Marblegate by requiring the inclusion of specific protective convents in the indenture.

On February 7, 2017, Marblegate filed a petition with the Second Circuit to rehear the case *en banc*, arguing that the panel's split decision presents a question of significant importance. It is unlikely that the Second Circuit will grant the petition.

Liability Management: Key Issues in Debt Exchanges

With periods of weakness in the leveraged finance markets, and an increase in the number of stressed and distressed leveraged issuers has led to an uptick in exchange offer transactions in recent months. A well-structured exchange offer can facilitate liability management transactions, allow debt and equity holders to recapitalize a company, and provide restructuring opportunities for strategic issuers and funds.

Types of Exchange Offers

A debt exchange can take a number of different forms and serve a variety of purposes. Debt securities can be exchanged for equity securities, convertible securities or other debt securities. Exchange offers can eliminate a class of securities to avoid a potential default, extend an upcoming maturity date, de-lever a balance sheet, or reduce cash interest payments, in some cases, with holders agreeing to exchange into a full or partial "paid-in-kind" security. Some debt exchanges even have a capital raising component; an issuer with unsecured bonds may be able to raise new first lien debt by elevating to second lien status the bonds of noteholders who agree to provide commitments to the new first lien facility. The types of permissible transactions will,

of course, be heavily dependent on limitations under existing credit documentation.

While this article primarily addresses exchanges of securities, issuances of new refinancing loans or loan exchanges may be possible through some combination of a credit facility's accordion, availability under debt and/or lien covenants and permitted refinancing refinancing provisions. Transactions involving exchanges of loans for securities or securities for loans are an option, though some bondholders and credit agreement lenders, due to restrictions in their charter documents or investment mandate, may be unable or unwilling to accept a loan in exchange for a debt security (or vice versa). In addition, elements of an exchange offer (notably the incurrence of new debt or liens) may require issuers with bank debt in their capital structure to seek consent from credit agreement lenders to permit the applicable transaction. Many of the commercial and legal considerations described below will also apply to exchanges involving loans in addition to exchanges of and for securities.

To Register or Not to Register

Exchanging one security for another security requires either registration with the SEC or an exemption under the securities laws. The registration process is expensive and time consuming, and not typically practical for distressed issuers. The most common exemptions from registration are under §3(a)(9), §3(a)(10), §4(a)(2), Regulation D and Regulation S of the Securities Act, each of which include requirements which may limit the scope of the exchange, including the number and type of investors approached to participate, the payment of fees and the identity of the issuer. However, if a particular debt security is widely held – and especially to the extent held by retail/non-accredited investors - the only option may be a registered exchange offer.

The Holdout Problem

Outside of a bankruptcy proceeding, issuers are bound by contractual restrictions in debt instruments and generally cannot force upon non-consenting holders amendments or modifications that reduce the principal amount of their debt, lower or postpone interest payments or extend the maturity date of a security. However, issuers have a number of "carrots" and "sticks" at their disposal to encourage (or coerce, depending on your perspective) holders to participate in an exchange offer:

- A high minimum tender threshold (e.g., 90%) as a condition to effectiveness, providing comfort to tendering holders that there will be a minimal number of free riders and that holders who remain in the old security will have drastically reduced liquidity.
- "Exit consents" from exchanging holders to strip an existing indenture of covenants, guarantees and other protections for holders to the extent permitted by the amendment provisions.
  - Although this approach is quite common for high yield bonds, credit agreement lenders and agents have historically been unwilling to utilize these tactics, perhaps as a result of concerns about reputational risk and liability claims.
- The expense and uncertainty of a bankruptcy proceeding and the possibility of a cram down or substantially reduced recovery.
- Threatening the permitted exercise of rights under an existing debt instrument, such as asset sales, restricted payments or the designation of, or transfer of assets to, unrestricted subsidiaries outside the purview of indenture covenants.
- Many indentures contain a "payment for consent" covenant which requires that all holders (and not a handpicked majority or supermajority) receive the same offer of consideration for the exchange. Note that the offer to exchange in and of itself may trigger this provision even if no cash payment is provided. This can make an exchange considerably more expensive and more complex from an execution perspective.
- An improved position in the capital structure, including through new liens or guarantees or a higher payment priority. The ability to provide such additional benefits will typically be limited by restrictions in other debt instruments, including lien baskets in secured credit agreements and "equal and ratable" clauses in indentures.
  - Note also that certain modifications to a debt instrument or a capital structure generally, may create risks for lenders under applicable insolvency laws where the issuer files for bankruptcy protection following an exchange, such as fraudulent conveyances, voidable preferences, debt recharacterization or equitable subordination.

Weil's U.S., U.K. and Hong Kong Finance Practices and Partners Recognized in 2017 Edition of *IFLR1000*

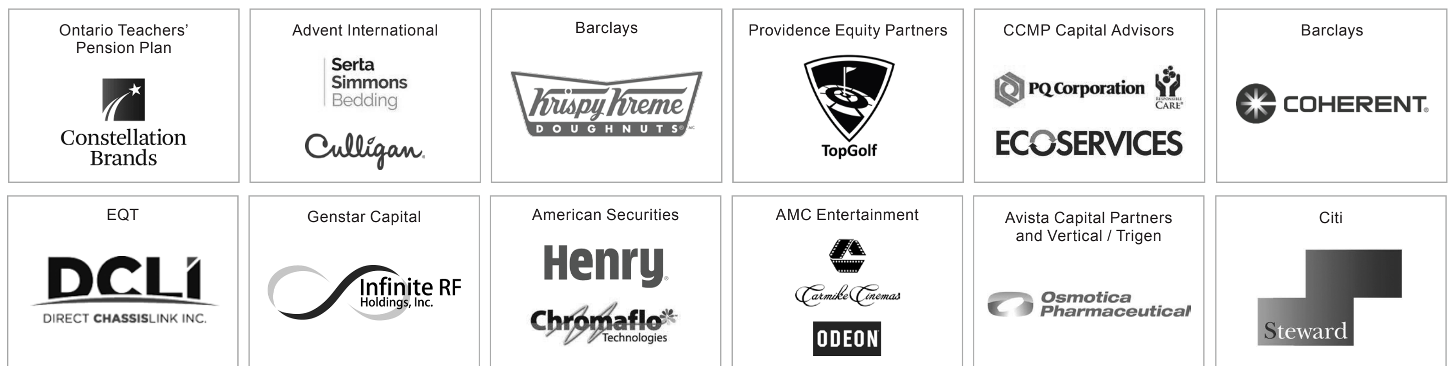
IFLR1000, an annual guide to the world's leading financial and corporate law firms, recently released its 2017 United States, United Kingdom and Asia-Pacific rankings. Weil's Banking and Capital Markets practices and its partners received numerous recommendations in the United States, United Kingdom and Hong Kong.

In the U.S., over 50 lawyers were recognized by the publication, and Weil's Finance practice included nine lawyers named "Leading Lawyers" and seven named "Rising Stars."

Leading Lawyers: Frank Adams, Morgan Bale, Jennifer Bensch, Todd Chandler, Corey Chivers, Andrew Colao, Daniel Dokos, Alex Lynch and Douglas Urquhart

Rising Stars: Barbra Broudy, Heather Emmel, Danek Freeman, Gabriel Gregson, Allison Liff, Courtney Marcus and Andrew Yoon

Recent Weil Representations



LevFin Quarterly provides updates on current topics and trends in leveraged finance and is published by the Finance practice of Weil, Gotshal & Manges LLP, 767 Fifth Avenue, New York, NY 10153, +1 212 310 8000. www.weil.com.

If you would like more information about the contents of this issue, or about Weil's leveraged finance practice, please speak to your regular contact at Weil, or to any of the editors or authors:

Editors:

Heather L. Emmel (Capital Markets)	heather.emmel@weil.com	+1 212 310 8849
Danek A. Freeman (Banking & Finance)	danek.freeman@weil.com	+1 212 310 8646
Allison R. Liff (Banking & Finance)	allison.liff@weil.com	+1 212 310 8118

Contributing Authors:

Jared M. Rusman (Tax)	jared.rusman@weil.com	+1 214 746 8193
Miranda S. Schiller (Securities Litigation)	miranda.schiller@weil.com	+1 212 310 8491
Philip Ratner (Banking & Finance)	philip.ratner@weil.com	+1 212 310 8369
Agustina Berro (Securities Litigation)	agustina.berro@weil.com	+1 212 310 8937

© 2017 Weil, Gotshal & Manges LLP. All rights reserved. Quotation with attribution is permitted. This publication provides general information and should not be used or taken as legal advice for specific situations that depends on the evaluation of precise factual circumstances. The views expressed in these articles reflect those of the authors and not necessarily the views of Weil, Gotshal & Manges LLP.