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Liability Management Series Part 2: Tax Issues, LIBOR Phase-Out and the CMS Rate Problem

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Agenda

- LIBOR Phase-Out
- Adjustable Interest Rate (LIBOR) Act and Regulation ZZ
- Liability Management: Considerations for Issuers in light of LIBOR Act
- The CMS Rate Problem and Possible Approaches
- The Tax Angle:
  - Debt repurchases
  - Debt modifications or debt-for-debt exchanges
  - Debt-equity exchanges
  - Bankruptcy restructurings

LIBOR Phase-out

- On March 5, 2021, the UK Financial Conduct Authority, which regulates the administrator of the London Interbank Offered Rate (“LIBOR”), announced that all remaining tenors of USD LIBOR will cease to be published immediately after June 30, 2023.
- Problem of “tough legacy” USD LIBOR notes, the terms of which would cause them to freeze at the last USD LIBOR reading, effectively turning them into fixed rate notes.
- Legislative Solution: Adjustable Interest Rate (LIBOR) Act (“AIRLA” or “Libor Act”) provides a federal solution for replacing references to USD LIBOR in existing “LIBOR contracts” that either lack, or contain insufficient, LIBOR fallback provisions

LIBOR Act and Regulation ZZ

- AIRLA: On "LIBOR Replacement Date," the "Board-Selected Benchmark Replacement" shall, by operation of law, be the Benchmark Replacement for any LIBOR contract with no or insufficient LIBOR fallback provisions:
  - Polling provisions in tough legacy USD LIBOR contracts (e.g. floating rate notes) will be disregarded
  - USD LIBOR will be replaced by "Board-Selected Benchmark Rate", plus a spread adjustment
- 12 C.F.R. Part 253, "Regulation Implementing the Adjustable Interest Rate (LIBOR) Act (Regulation ZZ)": Fed identifies SOFR-based benchmark rates that will replace USD LIBOR in certain financial contracts after June 30, 2023
  - e.g. For floating rate notes, CME Term SOFR of same tenor, plus spread adjustment

Navigating the LIBOR Act – Issuer Considerations

- Situation: Issuer with outstanding USD LIBOR Floating Rate Notes maturing after June 30, 2023 -- Rely on Libor Act and Reg ZZ?
- What Options are available? What issues should you watch out for?
- Question 1: Is it a LIBOR Contract?

LIBOR Contract	Not a LIBOR Contract
Governed by US law (or US state)	Non-US law governed e.g. UK
Matures after June 30, 2023	Matures on or before June 30, 2023
LIBOR = overnight, 1-, 3-, 6- and 12-month USD Libor tenors	1-week or 2-month USD Libor tenors, non-USD Libor

- "Contract" includes any agreement, indenture, organizational document, security (debt or equity), instrument, obligation or asset

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Navigating the LIBOR Act – Issuer Considerations

- Question 2: Is it a LIBOR Contract subject to the Libor Act and Reg ZZ?

Subject to Libor Act	Not subject to Libor Act
Has no fallback provisions	Parties agree in writing not to be subject
Has fallback provisions that do not identify a specific benchmark replacement or a determining person	Has fallback provisions that identify a benchmark not based on Libor (e.g. prime rate or effective Fed funds rate)
Has fallback provisions that identify a determining person who, however, does not select a benchmark replacement by the earlier of: LIBOR Replacement Date and latest date for selection under contract	Determining person selects a benchmark other than Board-selected benchmark replacement (after disregarding LIBOR value and poll-based fallback provisions)

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Navigating the LIBOR Act – Issuer Considerations

- In looking at fallback provisions, disregard as null and void: (a) benchmark replacement based on any LIBOR value and (b) requirement to conduct a poll, survey, inquiries for quotes or interbank lending or deposit rates.
  - Example: Interest rate is 3-Month USD LIBOR plus 1% spread. 3-Month USD LIBOR is defined in Libor Contract as: (1) the London interbank offered rate for deposits in U.S. dollars having an index maturity of 3 months as it appears on "Reuters Page LIBOR01" at 11:00 a.m., London time, (2) if no rate appears, calculation agent will request principal London offices of 4 major reference banks in London interbank market, to provide offered a quotation representative of a single transaction in U.S. dollars in market (3) if at least two quotes obtained, then use arithmetic mean of quotations, (4) if no quotes obtained, then the last published 3-Month USD LIBOR value will be used.
- This is a LIBOR Contract with no fallback provisions. Also, no Determining Person (person with authority to determine Benchmark Replacement)
- On LIBOR Replacement Date, interest rate will be replaced with CME Term SOFR plus 1.26161% (i.e. the 0.26161% spread adjustment under Libor Act plus 1% spread in contract)

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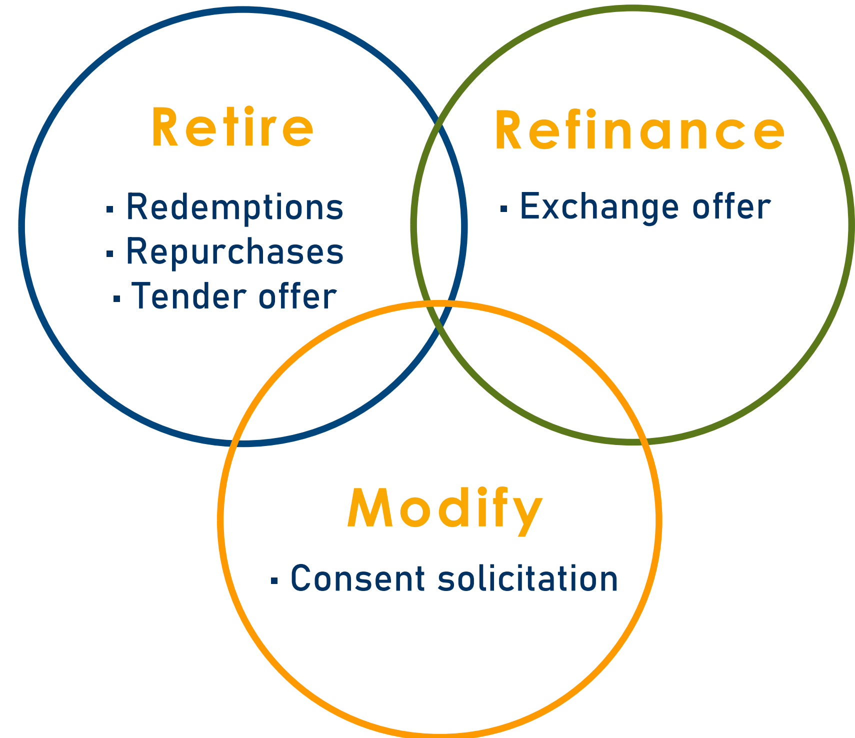
Liability Management: Options and Considerations for Issuers

- If LIBOR Contract subject to Libor Act:
  - Issuer can rely on legislative solution
  - Determining person can timely select other benchmark replacement
  - Agree in writing not to be subject (if possible under contract)
- If not subject to Libor Act, then:
  - Follow fallback provisions in contract
  - Can explore and consider different liability management transactions with the aim of retiring, refinancing and/or modifying existing debt instruments



Repurchases for cash

- **Redemptions** – Purchase of outstanding debt securities for cash in accordance with their terms
  - Look at indenture/ terms of indenture to see if redemption is allowed
  - Comply with required minimum notice periods
  - Pay redemption price and any make-whole premium
- **Repurchases** – Open market or privately negotiated purchases of outstanding debt for cash
  - Can negotiate the purchase price directly or engage a financial intermediary to negotiate and effect open market repurchases
  - Structure so that offers to repurchase are made: for a limited amount of securities; to a limited number of holders (preferably sophisticated investors); with no pressure for holders to sell and over an extended period of time; at prices privately and individually negotiated; and with offers and acceptances independent of one another.

Repurchases for cash

- **Tender offers** – An offer made to holders of a series to repurchase outstanding debt securities for cash
  - The offer may be for "any and all" of the outstanding securities of one or more series or may be for a maximum principal or purchase amount
  - Must generally be held open for 20 business days
  - Exception: 5-day Abbreviated Tender offer Process under conditions the SEC Staff issued in its January 2015 no-action letter guidance for non-convertible debt

Exchange Offers and Consent Solicitations

- **Exchange Offer** – Issuer offers investors to exchange a new series of securities for its outstanding securities
  - Can be conducted pursuant to Section 4(a)(2) and made to sophisticated investors usually QIBS
  - Can also do under Section 3(a)(9): "any securities exchanged by the issuer with its existing securityholders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange."
- **Consent Solicitation** – Issuer solicits consent to amend the terms of the indenture governing outstanding securities
  - Issuer seeks consent of a specified threshold/number of holders of the notes, which consent would allow the issuer to amend the notes to change the interest rate
  - Usually, 100% consent of the holders is required to change an interest rate

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Non-Impairment of right to payment, TIA Issues

- **Why 100% consent?**
  - Section 316(b) of the Trust Indenture Act (TIA): Right of holder to receive payment of principal and interest shall not be impaired.
  - Payment of principal and interest: "Core" terms that require consent of holder
  - So for contracts not subject to Libor Act: to amend interest rate provisions e.g. replacing LIBOR rate with another benchmark replacement rate, will usually trigger 100% consent threshold requirement
  - This makes consent solicitations difficult

Non-Impairment of right to payment, TIA Issues

- **Not an Issue for LIBOR Contracts under the Libor Act and Reg ZZ**
  - The selection or use of Board-Selected Benchmark Replacement pursuant to Libor Act:
    - Shall not be deemed to impair or affect the right of any person to receive payment
    - Does not discharge or excuse performance under the contract
    - Does not constitute a breach of nor void or nullify, any Libor contract
    - Shall not be deemed to prejudice, impair or affect any person's rights or obligations thereunder
  - Section 316(b) of the TIA was amended to state that the right of a holder of any indenture security to receive payment of principal and interest shall not be deemed to be impaired or affected by any change arising from the application of section 104 of the Libor Act.

LIBOR and CMS – Some Open Issues

Synthetic USD LIBOR – does it work?

- Depends on how the note is drafted
- Rate may be limited to a screen display for "interbank offered rates"
- Synthetic USD LIBOR is not an interbank offered rate
- Synthetic USD LIBOR is not representative of USD LIBOR

LIBOR and CMS – Open Issues: CMS Rate Problem

ICE Benchmark Administration Limited announced on November 14, 2022 that the ICE Swap Rate (the CMS rate) will no longer be published immediately after June 30, 2023.

Neither AIRLA nor Rule 253 apply to a floating rate note linked to the CMS rate, as that floating rate note is not a "LIBOR contract." Although the floating rate leg of the CMS rate is based on 3-month USD LIBOR, a floating rate note linked to the CMS rate does not use LIBOR as a benchmark.

The Tax Angle

Debt repurchases

Debt repurchase for cash

- Repurchase at discount
  - Issuer: generally cancellation of indebtedness (COD) income equal to adjusted issue price over repurchase price
  - Holder: capital gain, subject to market discount rules, (or loss) to the extent repurchase price is greater (or less) than adjusted basis
- Repurchase at premium
  - Issuer: repurchase premium may be deductible by the issuer as interest expense (Treas. Reg. section 1.163-7(c))
    - Amount in excess of adjusted issue price
    - Section 249: deduction only for a reasonable premium in the case of convertible bonds
  - Holder: capital gain, subject to market discount bond rules

Debt repurchase for cash (con't)

- Related party (50% by value) debt repurchase - COD still realized by debtor
  - Direct purchase by related party
  - "Indirect" purchase where purchaser becomes related
- Exception for debt to be retired within a year
- Deemed issuance to related holder
  - Can create OID – issue price is deemed to be amount paid by related party for the debt
  - No gain or loss to related holder for deemed issuance, but potential for OID

Debt repurchase for cash (con’t)

- Repurchases of “contingent payment debt instruments”
  - Issuer:
    - Price more than projected contingent payment (a “net positive adjustment”)--interest deduction
    - Price less than projected contingent payment (a “net negative adjustment”)--ordinary income
  - Holder:
    - Net positive adjustments--interest income
    - Net negative adjustments--ordinary loss to the extent of current and prior year income inclusions, then capital loss

Debt modifications or exchanges

Exchanges and modifications: overview

- "Significant modification" rules
- Consequences to parties
  - In general
  - Publicly traded?
  - Issuer
  - Holder
  - Consent fees

“Significant modification” rules

- A modification of existing debt will be treated as an exchange of such debt for new debt if the modification is “significant”
  - A modification is significant only if the legal rights or obligations that are altered and the degree to which they are altered are economically significant
  - Generally, modifications are “significant” if, among other things:
    - The yield changes by the greater of 25 basis points and 5% of the existing yield
    - Scheduled payments are materially deferred
      - Safe harbor equal to the lesser of 5 years or 50% of the original term
    - Modified credit enhancements change payment expectations
    - The nature of the security changes (*e.g.*, from debt to equity (without regard to decline in credit quality) or from recourse to nonrecourse)
  - Consent solicitations that seek to change “customary accounting or financial covenants” would not, in themselves, be significant modifications

Consequences to parties: in general

- Rules apply the same whether there is debt-for-debt exchange or an amendment of terms
- Where an amendment of terms, deemed exchange of the “old” note for a “new” note

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Consequences to parties: publicly traded?

- A debt instrument will be publicly traded if, within 15 days before or after the deemed exchange, there is:
  - A sales price
  - One or more firm quotes
  - One or more indicative quotes
- Exception—A debt instrument will not be treated as publicly traded if the principal amount for the issue (generally the class) is $100MM or less at the time of determination
- Anti-abuse rule

Consequences to parties: issuer

- Potential for COD and OID
  - Exception for issuers in bankruptcy or that are insolvent
- Corporations that issue obligations with OID as part of their restructuring need to be mindful of potential limitations on the deductibility of this discount
- Repurchase premium may be deductible by the issuer as interest expense

Consequences to parties: issuer (con’t)

- For corporations that issue certain high yield obligations with significant OID (“AHYDO”), a portion of the discount is treated as a non-deductible dividend, with the remaining discount not deductible until actually paid
- Section 163(e)(5): OID deductions on "applicable high yield discount obligation“ (“AHYDO”) issued by a corporation (in excess of “disqualified portion”) deferred until OID paid.
- Section 163(i): AHYDO means any debt instrument if:
  - The maturity date of such instrument is more than 5 years from the issue date,
  - The yield to maturity on such instrument equals or exceeds the sum of – (i) the AFR for the calendar month in which the obligation is issued, plus (ii) 5 percentage points, and
  - Such instrument has “significant OID.”
    - An instrument has significant OID if at the end of any accrual period ending more than 5 years after issue date, the aggregate amount of accrued but unpaid OID > (issue price * YTM).
- If AHYDO, then the “disqualified portion” of OID deductions is permanently disallowed, and the remainder is deferred until OID paid.

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Consequences to parties: issuer (con’t)

- Suppose a note is issued with the following terms:
  - Principal Amount = $1,000
  - Issue Price = $800
  - Maturity = 8 years
  - Coupon = 10%, paid semi-annually
  - Thus, YTM = 14.27%

- AHYDO Analysis:
  - Maturity > 5 years? Yes
  - YTM ≥ AFR + 5%? Yes - 14.27% > AFR (4%) + 5%
  - Significant OID? Yes
    - Sometime after the 5th anniversary of the issue date, the aggregate amount of accrued OID would exceed (issue price * YTM = $800 * 14.27% = $114.2).
    - Specifically, on the 6th anniversary of the issue date, the aggregate accrued OID would be $128.

Consequences to parties: holder

- Tax consequences for holders depend on whether the restructuring constitutes a "recapitalization" under the Code
  - Generally debt exchanges of securities with terms longer than 10 years will qualify as recapitalizations
  - Gray area: 5-10 years
  - More uncertainty with respect to securities with shorter terms

Consequences to parties: holders (con't)

- If an exchange or modification of debt constituted a recapitalization, the holder should generally not recognize gain or loss
  - However, depending on the terms of the new debt relative to the old, there may be tax consequences
  - If the principal amount of the new debt exceeds that of the old, the holder could recognize gain equal to the fair market value of the excess
    - Gain also recognized to the extent of "boot"
  - Exchanges and modifications also can create OID, or conversely, an amortizable premium, due to differences in the issue price of the new debt and the stated redemption price at maturity

Consequences to parties: holders (con’t)

- If an exchange or modification of debt is not a recap, holder will generally have gain or loss equal to the difference between the issue price of the new debt and the holder’s basis in the debt instrument, which will usually be a capital gain or loss (except for accrued market discount)
  - If the holder acquired the debt with market discount (as secondary market purchaser), a portion of any gain may be characterized as ordinary income

Consequences to parties: holders (con’t)

- Non-US investors careful not to overdo it
- Non-U.S. persons are subject to U.S. net basis income tax on income that is “effectively connected” with the conduct of a “trade or business within the United States.”
- *Securities Trading Safe Harbor*. No U.S. trade or business results from merely trading in stocks and securities within the United States by a non-dealer.

Consequences to parties: consent fees

- Tax treatment of consent fees is unclear
  - Tax treatment to holders?
  - Subject to withholding tax if paid to non-US holders?
  - PLR 201105016

Debt-equity exchanges

Debt-equity exchanges

- Tax treatment of debt with an option component
  - Investment unit versus convertible debt
- Debt-equity exchange
  - Issuer: recognizes ordinary COD income to the extent the adjusted issue price of the outstanding debt exceeds the fair market value of the equity issued
    - Compare vs. contribution of debt to capital
  - Holder: If a debt-equity exchange constitutes a recapitalization, it should not result in gain or loss to the holder
    - Market discount accrued on the exchanged debt will carryover to the equity
  - Special entity considerations – REITs and non-US lenders may not want equity

Bankruptcy restructurings

Bankruptcy restructurings

- COD excluded from gross income if taxpayer bankrupt or insolvent
- Tax attributes reduced to the extent of COD excluded:
  - NOLs
  - Credits
  - Minimum tax credits
  - Capital loss carryovers
  - Basis reduction

Bankruptcy restructurings (con't)

- Generally, NOLs subject to reduction under section 382 where there is an ownership change
- Section 382(l)(5): section 382 does not apply to NOLs that survive the attribute reduction for COD
  - Shareholders and "old and cold" creditors of old loss corporation own at least 50% of emerging corporation
  - No ownership change for two years after emerging from bankruptcy
  - Losses reduced for interest payments to creditors-turned-shareholders in 3 previous years
- Section 382(l)(6): if taxpayer elects out or does not qualify for (l)(5), (l)(6) may be available. Section 382 limitation, but takes into account increase in value from COD

Additional resources

IFLR PUBLICATION

Structuring Liability Management Transactions

Mayer Brown's summary of US legal framework, including guidance in numerous no-action letters applicable to debt repurchases, tender offers and exchange offers. Also presented are some main regulatory and tax considerations.

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