Certain Important Tax Consequences of Amending Debt Instruments

In considering any proposal to amend a bank loan or other debt instrument, it is important to recognize that, if the proposed modifications are considered "significant" for U.S. federal income tax purposes, the amendment may in certain circumstances (1) cause the borrower to recognize cancellation of debt income ("COD Income") and (2) affect the fungibility of interests in the debt instrument. This may be the case even if the amendment does not reduce the stated principal amount of the debt instrument, and even if there is no actual exchange of the debt instrument for a new debt instrument. While the potential for COD Income and fungibility concerns has existed in this context since the 1990's (when certain statutory and regulatory changes took effect), these issues are of particular concern in the current market environment because these adverse tax-related consequences generally result only where a debt instrument trades at a discount after the amendment occurs. On January 6, 2009, Senator John Ensign (the "Ensign Bill") introduced a bill that would, if enacted, provide borrowers with some relief from COD Income arising in 2009 or 2010.

This memorandum describes the COD Income and fungibility issues in more detail and the circumstances under which these issues may arise. For simplicity, the discussion in Sections A through C below generally refers only to bank loans but the issues discussed herein are applicable to proposed amendments of all debt instruments, including bonds proposed to be amended through a consent solicitation.

This memorandum is intended to provide a general overview of the issues addressed herein and should not be construed as legal advice with respect to any particular transaction. A tax advisor should be consulted before pursuing any particular amendment. The following discussion is limited to U.S. federal income tax considerations with respect to the COD Income and fungibility issues, does not address other potential tax consequences and, except for the discussion of the Ensign Bill, is based on current law that is subject to change (possibly with retroactive effect).

A. COD Income.

If proposed modifications to a loan are "significant" for U.S. federal income tax purposes, the federal income tax law will treat the amendment as resulting in a deemed exchange of a new modified loan for the existing loan. If the "issue price" of the deemed new loan is less than the "adjusted issue price" of the existing loan, the shortfall will constitute COD Income. The issue price of a deemed new loan will depend on whether either the deemed new loan or the existing loan is considered "publicly traded" at any time during the 60 day period beginning 30 days before the amendment date. If either loan is considered publicly traded, the issue price of the deemed new loan will generally equal the fair market value ("FMV") of the deemed new loan immediately after the amendment occurs and COD Income may result. If neither loan is considered publicly traded at any time during the relevant 60 day period, the issue price of the deemed new loan generally should equal the stated principal amount of the new loan and COD Income generally should not result.[1]

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[1] This discussion assumes that the deemed new loan would be treated as debt for U.S. federal income tax purposes. As a technical matter, the Internal Revenue Service (the "IRS") might successfully argue that a deemed new loan should be characterized as equity for tax purposes where the loan is trading at a significant discount after the amendment. While the technical merits of such an argument are uncertain, we believe that the practical risk of the IRS asserting such an argument should be low in this context where the commercial terms of the deemed new loan support debt treatment (and the only factor arguing in favor of equity treatment is the low issue price/high yield of the loan), except possibly in extreme cases such as where a deemed new loan is trading at distressed levels and it appears likely that the lenders will

COD Income will be taxable as ordinary income to a U.S. borrower (or a foreign borrower that is a U.S. taxpayer) in the taxable year in which the modification occurs unless one of the limited exceptions applies (such as where the borrower is a debtor in a Title 11 bankruptcy proceeding[2] or is insolvent). Where COD Income arises and the stated principal amount of the loan has not been reduced, the deemed new loan generally should be treated as having been issued with original issue discount ("OID") approximately equal to the amount of COD Income recognized. This OID generally should be deductible over the term of the deemed new loan except to the extent that such deductions are limited by the "AHYDO" rules.[3] Nevertheless, unless a U.S. borrower has sufficient net operating loss carryovers ("NOLs") or current year tax losses to offset the upfront COD Income,[4] the COD Income will result in a potentially significant cash tax impact in the current taxable year that, at best, will be offset over time by subsequent OID deductions.[5]

COD Income should not be an impediment to a foreign borrower that is not a U.S. taxpayer unless the tax law of the relevant foreign jurisdiction(s) views the amendment as resulting in COD Income.

The Ensign Bill proposes a new exclusion for COD Income arising from certain cancellations of "applicable financial indebtedness" in 2009 or 2010 (including COD Income arising from a significant modification of such indebtedness). Applicable financial indebtedness generally would include any debt originally issued by a corporation, or a partnership engaged in a trade or business (other than the trading of stocks or securities for the partnership's own account), if such debt (i) is publicly traded for tax purposes, (ii) was originally issued or syndicated by certain financial institutions or (iii) is a security for purposes of the Securities Act of 1933 and was issued pursuant to an effective registration statement or exempt from the registration requirement. The Ensign Bill, if enacted in its current form, should provide relief in most situations in which taxable COD Income would otherwise result from an amendment of a debt instrument.

B. Fungibility.

A fungibility issue may arise where there is a significant modification of a loan that affects some but not all of the lenders. A common example is where an amendment fee large enough to result in a significant modification is payable only to consenting lenders but other proposed modifications that are insignificant (*e.g.*, covenant changes for which the amendment fee was paid) apply to all lenders. In such event, the consenting lenders will be deemed to have exchanged their interests in the existing loan for interests in a deemed new loan

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become stockholders in the near future. If a deemed new loan were treated as equity for U.S. federal income tax purposes, COD Income generally would result to the extent that the adjusted issue price of the existing loan exceeded the FMV of the deemed new loan (regardless of whether either loan is considered publicly traded), and interest payments on the deemed new loan would not be deductible.

2 The bankruptcy exception may in some instances make it advisable to effect a modification through a pre-packaged bankruptcy proceeding.

3 Sections 163(e)(5) and 163(i) of the Internal Revenue Code.

4 A U.S. borrower with NOLs may nevertheless incur some alternative minimum tax ("AMT") because of limitations on deducting NOLs for AMT purposes.

5 In certain instances, there is some risk that a borrower whose deemed new loan trades at a significant discount may undergo an "ownership change" for purposes of Section 382 of the Internal Revenue Code as a result of the deemed issuance of such loan. Section 382 limits a corporation that undergoes an ownership change in using its pre-change NOLs and certain other tax attributes to offset the corporation's taxable income in post-change taxable years. In determining whether an ownership change has occurred, a Treasury Regulation issued under Section 382 provides that certain non-stock instruments will be treated as stock (for purposes of Section 382) if such instruments offer "a potential significant participation in the growth of the corporation" and certain other conditions are met. It is unclear whether this provision would apply to a deemed new loan trading at a significant discount.

(the "Consenting Portion"), whereas the nonconsenting holders will be viewed as continuing to hold interests in the existing loan (the "Nonconsenting Portion").

If the deemed new loan has OID and the existing loan does not (which could often be the case if either the deemed new loan or existing loan is considered publicly traded), the Consenting Portion of the amended tranche generally will no longer be fungible for U.S. federal income tax purposes with the Nonconsenting Portion.

C. When Is a Modification "Significant?"

The applicable Treasury Regulations provide a number of specific rules for determining whether certain modifications are "significant," and a general rule that applies to all modifications not covered by the specific rules. As noted above in the fungibility discussion, significance is tested on a lender-by-lender basis (e.g., a loan held by a consenting lender that receives an amendment fee may undergo a significant modification, whereas the same loan held by a nonconsenting lender that does not receive the fee may not be so treated).

1. Change in Yield: For most loans,[6] a change in yield will be deemed significant if the change exceeds the greater of (x) 25 basis points and (y) 5% of the yield before the amendment.[7] It should be noted that (1) any change in determining the interest rate, such as the addition of a LIBOR floor or Base Rate floor or a change in the definition of Base Rate that has the impact of potentially increasing or decreasing the interest rate, will generally be viewed as a change in yield and (2) amendment fees are specifically included in calculating the change in yield. For floating rate loans, the yield generally is calculated as of the date of the modification.

2. Change in Timing of Payments: Any change in the payment schedule that results in a material deferral of scheduled payments is a significant modification.[8] A deferral of one or more payments will be deemed insignificant under a safe harbor if the deferred payments are payable no later than the end of a safe harbor period (that begins on the original due date of the first scheduled payment and extends for a period equal to the lesser of (A) five years or (B) 50 percent of the original term of the loan (determined without regard to any option to extend the original maturity)).

3. Change in Obligor or Security: Subject to certain exceptions, a change in obligor is a significant modification. The addition or deletion of a co-obligor, or a change in collateral, guarantees, other credit enhancements or priority, generally should be treated as significant only if it results in a "change in payment expectations." A change in payment expectations occurs if, as a result of the modifications, (A) there is a substantial enhancement of the obligor's capacity to meet its payment obligations and that capacity was primarily speculative prior to the modification and adequate after the modification or (B) there is a

6 This specific rule (which is more objective than the general rule of significance discussed below) applies only to fixed rate debt instruments and variable rate debt instruments. It does not apply to contingent payment debt instruments ("CPDIs"), which are tested exclusively under the general rule of significance. In some cases, a loan with an excess cash flow ("ECF") sweep might be treated as a CPDI and, thus, ineligible for the specific rule. Moreover, even if a particular loan with an ECF sweep is not a CPDI, it is unclear how the specific rule should be applied to such a loan.

7 The baseline for determining change in yield is generally the unmodified yield of the loan based on the adjusted issue price of the loan immediately prior to the modification (as opposed to the trading price or the stated principal amount).

8 If the adjusted issue price of a loan differs from its stated principal amount, a deferral of payments may cause (or contribute to) a significant change in yield. See footnote 7 above.

substantial impairment of the obligor's capacity to meet its payment obligations and that capacity was adequate prior to the modification and is primarily speculative after the modification.

4. Change in Nature of Debt: A modification that results in a loan no longer being treated as debt for U.S. federal income tax purposes, or that changes the loan from recourse to non-recourse or from non-recourse to recourse, generally is a significant modification.

5. Covenants: A modification that adds, deletes or changes customary accounting or financial covenants is not a significant modification. However, any change in yield arising in connection with a covenant modification (e.g., a covenant modification accompanied by amendment fees or an increase in interest rate) may result in a significant modification under the change in yield rule (as described above). Because there is no definition of "customary financial or accounting covenants," it is often unclear whether a proposed modification to one or more covenants will qualify under this specific rule (or instead must be tested under the general rule).

6. The General Rule: A modification not covered by any of the specific rules will be deemed to be significant only if, based on all facts and circumstances, the legal rights and obligations that are altered and the degree to which they are altered are economically significant. All modifications (other than any modifications covered by the specific rules) are considered collectively -- thus, a series of modifications may be significant in the aggregate even if each modification, standing alone, would not be significant.

7. Cumulative Effect: Two or more modifications of a loan occurring separately over a period of time will result in a significant modification when the cumulative effect becomes significant if, had the modifications occurred together, the change would have been significant (except that any change in yield occurring more than five years before the date of the current modification will be disregarded). Thus, the limitation on changing the yield should be viewed not only in the context of an amendment at hand, but also taking into consideration any possible cushion that may be necessary for amendments within the next five years.

D. When Is Debt "Publicly Traded" for Tax Purposes?

A debt instrument will be treated as publicly traded for U.S. federal income tax purposes if the debt instrument is listed on a national securities exchange, an interdealer quotation system sponsored by a national securities association or a specified foreign securities exchange, or traded on a board of trade designated as a contract market by the Commodities Futures Trading Commission or on an interbank market. Debt instruments that do not meet the foregoing (such as a typical bank loan) should be considered publicly traded only if either of the following two tests is satisfied:

1. The debt instrument appears on a "quotation medium." A quotation medium is a system of general circulation (including a computer listing disseminated to subscribing brokers, dealers or traders) that provides a reasonable basis to determine fair market value by disseminating either (i) recent price quotations (including rates, yield or other pricing information) of one or more identified brokers, dealers or traders or (ii) actual prices (including rates, yields or other pricing information) of recent sales transactions. A quotation medium does not include a directory or listing of brokers, dealers or traders for

specific securities, such as yellow sheets, that provides neither price quotations nor actual prices of recent sales transactions. Based on the language of the applicable Treasury Regulations described above, a position can be taken that, even if an information service provides actual recent sales prices or recent quotes of one or more identified brokers, dealers or traders, the information service should not be viewed as quotation medium with respect to a particular debt instrument that trades infrequently (because such sales prices or quotes do not "provid[e] a reasonable basis to determine fair market value"); however, because there is no guidance for applying this regulatory language, there is uncertainty about whether such a position would prevail in any particular case. The quotation medium test should be considered carefully each time a modification is proposed (given the frequent changes in the information being provided by particular information services and in the marketplace generally, and the different packages that may be available to subscribers from time to time).

(a) <u>Markit Loan Pricing</u>: Markit provides a subscription-based service for the syndicated loan market. Currently, Markit does not provide any prices of actual recent sales transactions for loans. If a loan is quoted by three or more market participants, all such quotes are reported in one column, and all of the dealers are reported in another column (without attribution of a particular quote to a particular party). If a loan is quoted by only one or two market participants, only the quote or average of the two quotes is reported, without attribution of the quote to any identified party. This would suggest that Markit should not be considered a quotation medium with respect to a loan for which there are only one or two market makers. However, a representative of Markit indicated in a phone conversation that no attribution is typically necessary where there are fewer than three market makers with respect to a particular loan because it is relatively easy for investors to determine the identity of the market makers. The representative of Markit also noted that an investor using the Markit service may obtain attribution of all quotes provided by a particular market maker if the market maker provides its consent in advance, and some market makers have generally been willing to provide such consent. Thus, it appears that Markit may be considered a quotation medium with respect to a particular loan (even if there are fewer than three market makers with respect to such loan) unless trading in such loan is so infrequent that one can persuasively argue that Markit does not provide a reasonable basis for determining the fair market value of such loan (as discussed above).

(b) <u>TRACE</u>: The Trade Reporting and Compliance Engine of FINRA ("TRACE") reports actual prices of recent sales transactions of bonds that have been registered with the Securities and Exchange Commission. Although brokers/dealers who are FINRA member firms are obligated to report transactions in all corporate bonds to TRACE, TRACE currently does not disseminate this information for bonds that were sold in Rule 144A offerings and have not been registered with the SEC. Trading data with respect to unregistered bonds other than those sold pursuant to Rule 144A (*e.g.*, bonds issued under Section 3(a)(9) of the Securities Act of 1933 or bonds trading pursuant to Rule 144 under the Securities Act) may or may not be disseminated through TRACE, and should be checked on a case-by-case basis. Thus, subject to the infrequent trading argument discussed above, it appears that TRACE should be considered a quotation medium for registered bonds (and possibly some unregistered bonds other than those sold pursuant to Rule 144A), but should not be viewed as a quotation medium for unregistered bonds sold pursuant to Rule 144A for which trading data is not disseminated.

(c) Other Information Services: The arrangers or solicitation agent of the amendment should determine whether there are any other information services that may qualify as a quotation medium for the debt.

2. Price quotations for the debt are readily available from dealers, brokers or traders (the "Market Maker Test"). We understand that the arrangers of many syndicated loans will act as market makers and provide price quotations with respect to such loans. However, unlike the quotation medium test (which has no exceptions), the Market Maker Test will not apply if any of the following safe harbors applies:

   (a) No other debt of the issuer (or of any person that guarantees the debt in question) is publicly traded under any of the more robust forms of public trading described above such as the quotation medium test (*i.e.*, there is no "other traded debt");

   (b) The original principal amount of the tranche being modified does not exceed $25 million;

   (c) The conditions and covenants relating to the issuer's performance with respect to the modified debt are materially less restrictive than the conditions and covenants included in all of the issuer's other traded debt (*e.g.*, the modified debt is subject to an economically significant subordination provision whereas the issuer's other traded debt is senior); or

   (d) The maturity date of the modified debt is more than 3 years after the latest maturity date of the issuer's other traded debt.

3. Anti-Abuse Rule: An anti-abuse rule provides that any temporary restriction on trading a purpose of which is to cause a debt instrument not to be treated as publicly traded will be disregarded. The rule explicitly provides that a temporary restriction need not be imposed by the issuer to violate the rule — thus, an agreement among market makers to suspend trading will likely pose a concern.

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If you have any questions about the issues addressed in this memorandum, please do not hesitate to contact the authors or your regular Cahill contacts.