crowell moring

CLIENT ALERT

Leveraging Portfolios of Illiquid Financial Assets

May.08.2020

Investment funds often need additional liquidity, particularly in a volatile market. If permitted under governing documents, they naturally try to leverage their investment portfolio. Finance providers, for their part, may hesitate when the portfolios consist of distressed loans, insolvency claims, high yield bonds and other illiquid financial assets. This note outlines structuring considerations and techniques for both sides in this situation.

Structuring the Transaction

Insofar as the commercial outcome is concerned, different transaction structures can achieve the same result and may be functional equivalents. Their legal treatments, however, may be quite different and often drive the structuring decision. Here is a short list of a few alternatives:

Secured credit facility. A financing transaction is traditionally structured as a secured credit facility. The borrower grants a first priority security interest in the underlying assets to the lender. Upon the borrower's default, the lender is entitled to exercise its rights as a secured creditor under the Uniform Commercial Code and other applicable law. This should enable the lender to foreclose on the collateral and dispose of it in a commercially reasonable manner, subject to some limitations. When the borrower is in a chapter 11 proceeding, for example, a creditor's exercise of remedies is usually subject to an automatic stay, from which relief needs to be granted by the court before the collateral may be liquidated.

Total return swap. A total return swap enjoys "safe harbor" status from the automatic stay provisions under the U.S. bankruptcy code. The swap can be terminated and liquidated if the counterparty is in bankruptcy in the U.S., and similarly closed out in the event of a counterparty insolvency in many other jurisdictions. Used to leverage an existing portfolio of assets, the transaction typically involves a transfer of the portfolio of assets to the finance provider, and a total return swap referencing the portfolio with the finance provider as the total return payer. Additional protective measures should be taken to give finance providers assurance that its interest in the underlying assets is unlikely to be challenged by other creditors of the investment fund in the event of the fund's default.

Repurchase Agreement. If the underlying assets are securities, a repurchase agreement may be another structuring alternative that qualifies as a "safe harbor" transaction. Under a repurchase agreement, the securities are sold to the finance provider at an initial purchase price and repurchased from the finance provider, at the initial purchase price plus a spread, at the end of an agreed term. From an accounting perspective, the securities are likely not recognized on the balance sheet of the finance provider, even if it initially "purchased" them.

Choosing Among Alternative Structures

The primary concern for a finance provider is usually its ability to exercise remedies upon a counterparty default. With illiquid assets, the ability to take and liquidate the underlying collateral without delay is key, and the potential benefit of "safe harbor" status in the counterparty's bankruptcy should be considered by finance providers when weighing alternative structures. A swap transaction, or a repurchase agreement on securities, usually fits the bill for this purpose. Sometimes, however, the finance provider has other structural constraints, possibly regulatory issues, that disfavor a swap transaction.

Investment funds also have constraints on the structure of financing transactions. Some funds, for example, have self-imposed prohibitions on borrowing money or guaranteeing the borrowing of money under their governing documents. Occasionally funds may prefer not to engage in swap transactions because of increased regulatory and compliance obligations.

Other considerations may be party-neutral. For instance, tax and regulatory issues may dictate specific holding structure of the underlying assets, making outright transfer of interest in the assets more cumbersome or costly. In these circumstances pledging the assets under a secured credit facility may be the only feasible structuring option.

Conclusion

Finance providers and investment funds have an array of options when considering how to efficiently leverage portfolios of illiquid financial assets. With careful evaluation of internal governance restrictions as well as tax, regulatory, bankruptcy and accounting issues, finance providers and investment funds can optimize the transaction structure to balance the needs of all parties when leveraging a portfolio of illiquid financial assets.

For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.

Julia Lu
Partner – New York
Phone: +1 212.530.1892
Email: jlu@crowell.com

Kevin Rubinstein
Partner – New York
Phone: +1 212.530.1818
Email: krubinstein@crowell.com