Proskauer

Private Credit: Considerations for Debt Portfolio Acquisitions in Times of Uncertainty

April 27, 2020

Many markets, including the private credit markets, are facing market declines, disruptions and dislocations stemming from the policies enacted to combat the ongoing spread of COVID-19. The private credit industry has seen rapid growth in the years following the financial crisis of 2008 as banks pulled back from issuing loans to certain borrowers and private credit funds built up record levels of assets under management in recent years. Asset managers are now facing a potential decline in the value of their debt portfolios due to the short term and long term effects of the global pandemic. While certain credit providers may be positioned to weather the storm, many others may find it necessary to sell off portions of their debt portfolios. Prospective buyers and sellers of these portfolios need to be aware of several important considerations during this time of uncertainty and rapidly changing economic conditions.

Pricing. Debt instruments have always presented unique valuation challenges as readily available market prices do not always exist, particularly in the direct lending market. This has become even more difficult in the current economic backdrop as valuations may be based on rapidly changing underlying assumptions. Furthermore the underlying assumptions that drive cash flow projections, such as default rates and recovery rates, may not be correlated with historical data. All of this may make it harder for the parties to a debt trade to determine and agree on the fair value of the loan portfolio. The parties also need to consider appropriate true-up mechanisms to address pricing changes during any interim period as a result of certain events such as voluntary and mandatory prepayments or redemptions (e.g. in connection with a typical excess cash flow sweep made during the interim period) or any increase in the funded portion of an assigned loan (e.g. if a borrower sends a funding notice with respect to a delayed draw term loan).

Restrictions on Transfer. One of the first steps the parties must take is determining whether there are any restrictions on the ability of the seller to assign its individual loans or debt securities to the buyer. These restrictions typically work differently depending on the type of debt interest that is being assigned. Whereas issuers of high yield debt securities do not typically maintain any consent rights regarding the trading of their securities, borrowers in both the syndicated and direct leveraged lending markets do. Absent the continuance of an event of default under the credit facility governing such debt (and, more typically, absent only a payment or bankruptcy-related event of default), assignments of loans require approval from the borrower. Moreover, disqualified lender lists or lender "blacklists" prohibiting in all circumstances the assignment to a specific subset of lenders and competitors of the borrower have become prevalent and must be examined when considering the purchase of a portfolio. If a required consent cannot be obtained, or cannot be obtained in a timely manner, the parties may structure the transaction such that the economics of the underlying debt interest pass from seller to buyer in the form of a participation or similar instrument. Consideration will need to be given to the expected rights of the participant in such scenario as participant rights are often far more limited than the rights of a true assignee. If the parties also contemplate the transfer of equity tags as part of the transaction, the parties will need to consider transfer restrictions applicable to the equity interests, which may be different than the transfer restrictions applicable to the debt.

Due Diligence. Due diligence of each underlying loan in a portfolio will become increasingly important to transactions during this time. As described above, the results of the due diligence will inform many of the assumptions that the buyer will consider in pricing out the debt portfolio. Doing a deep dive on due diligence of each underlying borrower or debt issuer may be even more important if the purchase agreement does not include robust representations and warranties from the seller as to the history and attributes of the underlying loans or debt securities. The seller will also need to consider the confidentiality restrictions in the underlying debt agreements before sharing any information about the borrower or issuer to a prospective lender or purchaser of the debt. The parties must also take into account tax considerations, including tax issues that arise specifically in the purchase and sale of distressed debt.

Covenants. Purchase agreements for the sale of debt portfolios often have limited covenants as compared to the purchase and sale of other assets. However, some of the typical covenants present some potentially novel issues during this period. For example, the purchase agreement may contain covenants with respect to the loan or debt portfolio that restrict the seller's ability to amend or modify the applicable loans or to waive any right or cancel any liability with respect to the applicable loans. This may put undue restrictions on the lender in an environment when the credit profile of many borrowers may be impaired, and both lender and borrower may require creative temporary or longer term solutions. The parties should attempt to devise a mechanism to address these potential amendments and waivers and develop a clear understanding as to the type of actions that require the buyer's consent.

Closing Conditions. If a transaction is not structured as a simultaneous sign and close, the parties should very clearly define the required closing conditions in the purchase agreement. If the parties agree on a purchase price on a loan-by-loan basis, they can structure the transaction to close the sale of the debt securities on a rolling basis, or they may agree to close on the sale of the entire debt portfolio only once all required closing conditions are obtained. Given the current environment there may be external events that occur between the signing and closing that may have a material impact on the value of a loan or debt security (e.g. borrower default, government intervention, etc.) and the parties will want to agree up front on risk allocation and what events should give a party a termination right.

* * *

Proskauer's market-leading Private Credit Group and Private Equity/Mergers & Acquisitions Group are both among the most sophisticated in the market. We craft solutions for our clients by taking full advantage of our formidable finance, securities, tax and private equity experience. Please feel free to contact any of the team members listed with any questions.

Proskauer's cross-disciplinary, cross-jurisdictional Coronavirus Response Team is focused on supporting and addressing client concerns. Visit our Coronavirus Resource Center for guidance on risk management measures, practical steps businesses can take and resources to help manage ongoing operations.

Related Professionals

- **Justin Breen**

  Partner

- **Gary J. Creem**

  Partner