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Utilizing Repurchase Facilities and Related Protected Contracts as an Alternative Source for Fund Liquidity

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I. Introduction

Subscription-backed credit facilities (also known as "capital call" or "capital commitment" facilities, and each a "Subscription Facility") have served as the cornerstone of the fund finance market for the past 20 years. Loan availability under a Subscription Facility is subject to a borrowing base, which is typically tied to the remaining amount of the pledged uncalled capital commitments of investors satisfying certain eligibility requirements, multiplied by an advance rate. However, in connection with the ongoing evolution of the fund finance market, we have seen a growing interest among real estate and other private credit funds (each, a "Fund") for additional fund financing tools to leverage the value of their portfolio assets and optimize investment returns.

In order to meet the financing needs of these Funds, a growing number of banks and other credit institutions (each, a "Buyer") are entering into financing arrangements, commonly known as repurchase agreements or securities contracts, with subsidiaries of these Funds (each, a "Seller") whereby the Buyer provides liquidity by "purchasing" certain portfolio assets with an obligation of the Seller to "repurchase" these same assets on a specified date in the future (each a "Repurchase Facility"). In contrast to Subscription Facilities (which look "up" to capital commitments of investors to determine loan availability), Repurchase Facilities look "down" to assets beneath the Fund level. Repurchase Facilities can also be used effectively in tandem with Subscription Facilities.

Repurchase Facilities are often used to provide temporary financing of an asset until an exit strategy (like pooling into a securitization) can be pursued. In addition to Repurchase Facilities, there are other tools available to Funds for purposes of obtaining liquidity from portfolio assets, including "note on note" financings (whereby a lender provides an advance against a loan asset and in turn takes an assignment of the underlying loan documentation as collateral for repayment) and "CLO light" structures (whereby a lender provides a temporary warehouse line of credit for loan assets meeting certain specified eligibility criteria). Repurchase Facilities, however, include distinct structural elements resulting in an increased appetite from market participants for this type of financing arrangement. In light of this trend, this article will discuss some common features of Repurchase Facilities and certain other related "protected contracts" and the benefits of this alternative source of liquidity associated with Fund assets.

II. Benefits of Protected Contracts

Protected contracts are specific types of contracts designated under Title 11 of the United States Code, as amended (the "Bankruptcy Code") to receive "safe harbor" protections that allow the qualifying party to liquidate and close out the protected contract when its counterparty becomes the subject of a bankruptcy case, and to do so free from the automatic stay and certain other significant restrictions of the Bankruptcy Code.

In most lending arrangements, if a counterparty files for bankruptcy, an automatic stay of actions is imposed which prevents a lender from (i) foreclosing on the property of the debtor, (ii) commencing or continuing certain enforcement actions against the debtor or its property and/or (iii) setting off amounts owed under such arrangements (in each case unless a motion seeking relief from the stay is filed and granted in the related bankruptcy case). In addition, provisions in these lending contracts that allow for the termination or modification of a contract based on the debtor's bankruptcy or financial condition (also known as "ipso facto clauses") are prohibited from being enforced.

In contrast, if a contract is a "protected contract" and the party seeking enforcement is a "protected party" (e.g., in the case of securities contracts, a financial institution or a financial participant as defined within the Bankruptcy Code), then ipso facto clauses that would not otherwise be enforceable can be enforced and the actions taken by the protected party to enforce the protected contract are not subject to the automatic stay. The safe harbor provisions, therefore, enable counterparties to protected contracts to terminate their financial contracts and exercise contractually agreed upon rights of liquidation, termination and acceleration (e.g., enforcement through the netting and setoff of then outstanding obligations) promptly upon the bankruptcy of the debtor. Additionally, each of the Bankruptcy Code's protected contract provisions makes clear that a protected party can freely exercise its rights under any security agreements, guarantees, reimbursement agreements or other credit enhancements that relate to the primary protected contract and that those related contracts are each eligible, in their own right, for treatment as protected contracts. As a result, enforcement actions by the protected parties of these related protected contracts are exempt from the automatic stay and can be undertaken without prior approval of the bankruptcy court.

The Bankruptcy Code also shields protected parties from a variety of avoidance powers that are generally available to a bankruptcy trustee (or debtor-in-possession) with respect to transactions engaged in by the debtor prior to commencement of the bankruptcy case. Most importantly, under Section 546(e) of the Bankruptcy Code, certain payments and other transfers received by the protected party from the debtor in connection with a Repurchase Facility, prior to commencement of the case, may be retained by the protected party. Likewise, because the Bankruptcy Code permits the close-out of the Repurchase Facility, those post-bankruptcy actions also cannot be "avoided" by the trustee (or the debtor-in-possession).

As a consequence, because a counterparty to a protected contract has more certainty in contract enforcement upon a debtor bankruptcy, the counterparty is able to undertake a different calculus in determining the necessary resources to recover on a claim against the bankrupt debtor, the amount recoverable, the timeframe in which the recovery can be achieved and, equally important, the ability to retain the recovery once achieved. As a result of these changes to the protected counterparty's "calculus," the Seller under a Repurchase Facility or a

securities contract (described below) may obtain better pricing as compared to a typical asset-level lending arrangement.

III. Common Characteristics of Repurchase Facilities and Securities Contracts

Protected contracts entitled to safe harbor treatment under the Bankruptcy Code include commodity contracts, forward contracts, master netting agreements, swaps, repurchase agreements and securities contracts. Repurchase Facilities are the most similar to a typical secured lending arrangement and can be used as an alternative to a secured lending arrangement if certain characteristics are met.

A Repurchase Facility is similar to a secured lending facility in that the Buyer (or lender) provides financing to the Seller (or borrower) for a period of time and expects to receive a rate of return on the amount provided to the Seller. The rate of return is typically described as the "price differential" and, similar to interest on a loan, is payable periodically prior to or upon repurchase of the applicable asset(s) by the Seller. In addition, Repurchase Facilities are usually treated by Sellers and Buyers as loans for accounting and tax purposes.

Unlike most other secured lending arrangements, Repurchase Facilities are treated as protected contracts under the Bankruptcy Code and are afforded the safe harbor protections described above. Not every lending contract can be a repurchase agreement. In fact, to fit into the "repurchase agreement" definition under the Bankruptcy Code, an agreement must:

> [provide] for the transfer of one or more certificates of deposit, mortgage related securities . . . mortgage loans, interests in mortgage related securities or mortgage loans, eligible bankers' acceptances, qualified foreign government securities (defined as a security that is a direct obligation of, or that is fully guaranteed by, the central government of a member of the Organization for Economic Cooperation and Development), or securities that are direct obligations of, or that are fully guaranteed by, the United States or any agency of the United States against the transfer of funds by the transferee of such certificates of deposit, eligible bankers' acceptances, securities, mortgage loans, or interests, with a simultaneous agreement by such transferee to transfer to the transferor thereof certificates of deposit, eligible bankers' acceptance, securities, mortgage loans, or interests of the kind described in this clause, at a date certain not later than 1 year after such transfer or on demand, against the transfer of funds . . . .[2]

In sum, the underlying asset subject to a Repurchase Facility must be (a) a security, mortgage loan or an interest therein and (b) sold with an automatic obligation to resell such asset within one (1) year.

In addition, there are other protected contracts that can be utilized in a manner similar to secured lending arrangements. "Securities contracts" under the Bankruptcy Code are similar to repurchase agreements, with the notable exception that there is no requirement to transfer the asset back to the counterparty. However, the Buyer in connection with a "securities contract" must be a stockbroker, securities clearing agency, financial institution or financial participant. In other words, such entity must be:

> an entity that, at the time it enters into a securities contract, commodity contract, swap agreement, repurchase agreement, or forward contract, or at the time of the date of

> the filing of the petition, has one or more [securities contracts, commodity contracts, repos, swaps or master netting agreements] with …any entity (other than an affiliate) of a total gross dollar value of not less than $1,000,000,000 in notional or actual principal amount outstanding (aggregated across counterparties) at such time or on any day during the 15-month period preceding the date of the filing of the petition, or has gross mark-to-market positions of not less than $100,000,000 (aggregated across counterparties) in one or more such agreements or transactions with the debtor or any other entity (other than an affiliate) at such time or on any day during the 15-month period preceding the date of the filing of the petition…" or is a clearing organization (as defined in section 402 of the Federal Deposit Insurance Corporation Improvement Act of 1991).[3]

While under the Bankruptcy Code a "securities contract" is more broadly defined than a "repurchase agreement", the universe of potential "Buyer" counterparties to a securities contracts may be limited. Regardless, structuring asset-level financing as a "protected contract" (whether as a repurchase agreement or securities contract under the Bankruptcy Code) should benefit both parties by providing the Buyer with safe harbor protections for the enforcement of remedies in connection with a bankruptcy of the Seller, and likely providing the Seller with more favorable economic terms.

IV. Conclusion

As the fund finance market continues to mature, both Funds and financial institutions will continue to explore new and innovative ways to generate liquidity from existing pools of assets. In addition to the rise in Net Asset Value Facilities, Hybrid Facilities and Unencumbered Asset Pool Facilities (looking beyond just the capital commitments of a Fund under a Subscription Facility to the underlying assets of a Fund as a source of liquidity), we have seen an increase in the number of Funds entering into Repurchase Facilities to obtain asset-level leverage (particularly for mortgage loans). Since Repurchase Facilities provide Funds with another cost-effective method for satisfying their liquidity needs and optimizing returns for Fund investors, we expect to see continued growth of these financing arrangements in the coming years.

Endnotes

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[2] 11 U.S.C. § 101(47).

[3] 11 U.S.C. §101(22A).

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