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The European Debt Crisis: Key Issues to Consider When Purchasing Distressed European Loan Portfolios

RENEE EUBANKS AND JEREMY CAPE

A number of funds are hoping to turn European bank woes into profitable endeavors. While there is certainly an opportunity to extract profits by purchasing distressed European loan portfolios, fund buyers of such portfolios should be mindful of the wide range of issues that can arise when closing on individual loans within the portfolio. This article raises some of the issues that can lurk within the loan portfolio and impact a buyer after the purchase. The authors caution that failure to anticipate these issues can significantly delay loan closings and can ratchet up transaction costs long after the bid to purchase the portfolio has been won.

As an increasing number of European banks look to move underperforming loans off their books, a number of funds are hoping to turn European bank woes into profitable endeavors. While there is certainly an opportunity to extract profits by purchasing distressed European loan portfolios, fund buyers of such portfolios should be mindful of the wide range of issues that can arise when closing on individual loans within the portfolio. Failure to anticipate these issues can significantly

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delay loan closings and can ratchet up transaction costs long after the bid to purchase the portfolio has been won.

DUE DILIGENCE: IDENTIFY OBSTACLES EARLY

A portfolio of loans offered for sale by the originating bank may include a diverse set of loan types. For example, a portfolio may include a combination of the selling bank's interests in large syndicated loans, bilateral loans or non syndicated loans limited to a few lenders. For certain loans, it may be that the selling bank played the role of administrative agent. Since it is unlikely that post sale the selling bank would continue with this role, a fund buyer must consider whether it is prepared to take over such duties or whether it will need to negotiate with the remaining lenders to find a new administrative agent. Also, for loans where collateral is securing the loan, to the extent that certain collateral issues were being handled by the selling bank rather than through a separate administrative agent, an additional step to the transfer process will be required, such that the buyer not only takes ownership of the loan, but also takes steps to insure that it has properly secured legal control over the collateral.

Before proceeding with the purchase of a distressed European loan portfolio, a review of the various borrowers' domiciles and the tax treaty coverage provided by the purchasing entity is essential. In the event a buyer needs to use alternate entities organized in favorable tax jurisdictions, loans within the portfolio may need to be allocated to different buyer entities. The feasibility of such allocations will depend on the investor structure of such entities and whether such entities can be easily used to take assignment of specific loans. Taking the time during the due diligence period to identify these and other settlement issues early in the process, will allow a buyer to formulate a cohesive approach on how such issues will be handled, which in turn should expedite the settlement process as the buyer closes on the individual loans within the portfolio.

TAX WITHHOLDING CONCERNS: CAYMAN NOT QUITE A HAVEN

Due to its popularity as a tax friendly jurisdiction, a significant number of funds are organized as Cayman Islands entities. When investing in U.S.

borrower loans, these Cayman based funds are able to avail themselves of the portfolio interest exemption to avoid tax withholding on interest payments made by U.S. borrowers to the funds. However, when purchasing loans of certain European based companies, the U.S.-Cayman advantage falls short. Most European company credit agreements will state that tax withholding avoidance, which is typically accomplished via a "gross-up" payment by the borrower of the withholding amount, is only available to "qualifying lenders" which are most often defined as:

(1) lenders domiciled in the same jurisdiction as the borrower;
(2) foreign lenders that are doing business via an office in the location where the borrower is domiciled; or
(3) foreign lenders that are organized in a jurisdiction that has a double taxation treaty in place with the country where the borrower is domiciled.[1]

At this time, and for the foreseeable future, the Cayman Islands lack significant double taxation treaties with European countries. Therefore, a Cayman organized fund seeking to become a direct lender to a European borrower may be subject to significant tax withholding consequences in the absence of an effective double taxation treaty or qualifying business activities conducted via an office located within the same domicile as the borrower.

In order for funds to avoid this problem, the buying entity used to take ownership of the loans can be organized in a country that provides the broadest tax treaty coverage based on the domiciles of the borrowers included in the portfolio. The country of organization should also be a country that has well established policies, procedures and services that are attractive to funds looking to organize in a particular jurisdiction. Luxembourg, Ireland and Malta are just a few of the countries that have favorable treaties with a large number of European countries that are also fund friendly for organization purposes. In the event the buying fund does not have an alternate entity that can step in to solve this problem, the fund will have to look to a fronting entity organized in a favorable jurisdiction. The fronting entity will take ownership of the loan and contemporaneously

with closing on the loan transfer, will enter into a participation agreement with the fund buyer so that the fund can reap the economic benefits of the loan as if it were a full lender. This structure allows payments to flow from the borrower to the fronting entity to the buyer/participant without withholding upon distribution.[2] When utilizing this solution care must also be taken to insure that the jurisdiction of the fronting entity and the buyer/ participant are tax compatible.

It is worth noting that a Cayman organized fund can be used when structuring a loan transfer using a fronting entity, in the case where the fronting entity is a U.K. bank. When a U.K. bank is acting as a grantor of a participation interest, a Cayman organized fund can avail itself of the U.K. bank exemption which allows U.K. banks to avoid withholding so long as the payments being made are in the ordinary course of its business. In a properly structured fronting transaction, payments by the U.K. bank to a participant organized in the Cayman Islands would typically be viewed as not subject to withholding tax. The use of fronting entities can be a viable solution to tax withholding issues, however since most fronting entities typically charge a fee to provide this service, the use of fronting entities will increase a buyer's overall transaction costs.

In the case of a bilateral loan where the borrower is cooperative, a buyer may be able to solve withholding issues by converting the loan into a bond. In jurisdictions where, for example, a Quoted Eurobond Exemption is in effect, withholding may be avoided by converting the existing loan into a bond and listing the bond on a recognized stock exchange. The bond may not need to be regularly traded. There are exchanges that satisfy the criteria where annual listing fees are approximately $2,000 per year.

TRANSFER METHOD: ASSIGNMENT VS. NOVATION

For certain credit agreements governed by English law, the issue of whether to transfer via novation or assignment may arise. Typically, syndicated loans are structured such that the selling lender sells all or part of its commitment by transferring both its rights and obligations to a buyer via novation. The novation effectively substitutes the buyer for the selling lender and brings the new lender into the syndicate on the same terms. As

a general matter, settlement by novation for bilateral loans can be more difficult. Under English law, novations require the consent of all parties to the loan. Syndicated loans are often structured such that the borrower's consent is given in advance in the original loan agreement. Since this mechanism is not generally part of the terms for bilateral loans, borrower consent is typically needed to complete a transfer via novation. Unfortunately, it is often the case that obtaining borrower's consent can be difficult and can significantly delay the closing process. For loan documents governed under English law, buyers should also take note that an assignment of a loan transfers the seller's rights *but not* its obligations under the loan, therefore is it a less than favorable method of transfer (whether the loan is bilateral or syndicated) unless it is clear that the selling lender has no further obligations under the loan agreements. Based on these nuances, buyers must carefully consider the terms and circumstances impacting a bilateral or similar loan when deciding whether to take ownership of the loan via assignment or novation.

COLLATERAL TRANSFERS: LOCAL RULES PREVAIL

In the case of syndicated loans where a separate administrative agent will remain in place after the sale of the loan, problems and delays related to the underlying collateral for a specific loan are unlikely, since there is no need to retake or transfer the collateral after a loan sale. However, in certain cases if a fund is taking ownership of a loan via novation, there will likely be additional steps that need to be taken with respect to securing collateral. In the case of bilateral loans or loans with few lenders that are transferred via assignment, buyers should make sure that the existing collateral is transferred at the same time the loan is transferred. With European credits, the local laws of each borrower's domicile will govern the manner in which various types of collateral should be transferred and perfected. Accordingly, a buyer may be faced with different procedures not only according to collateral type, but also according to location of the collateral and/or the borrower's domicile. It is imperative in these instances to have knowledgeable and reliable local counsel engaged to make sure the collateral transfer fully complies with all applicable local procedures

and laws. If the buyer's rights to the collateral are not properly secured, it is unlikely that the borrower will be of any assistance to a buyer trying to secure the collateral after there has been a defect in the collateral transfer process.

ASSIGNMENT ELIGIBILITY: WHEN ONLY FINANCIAL INSTITUTIONS AND BASEL BANKS NEED APPLY

While most European credit agreements contain language that make transfers from a selling bank to various buyer entity types fairly easy, on rare occasions a credit agreement will specify that the potential transferee must be a financial institution. Difficulty will often arise when the credit agreement terms include this requirement but do not specify a formal definition for the term financial institution. In other circumstances, the credit agreement may clearly define the term financial institution to include only commercial banks and entities providing banking services. Alternatively, some credit agreements may go even farther and require that a bank transferee be a Basel Bank.[3] Although it is clear that a fund would not qualify as a Basel Bank, whether a fund can be broadly viewed as a financial institution in the absence of a formal definition set forth in the credit agreement is less clear, except when such agreements are governed by English law. For such credits there is case law which supports the view that a "global emerging markets debt hedge fund" qualifies as a financial institution.[4] However, when dealing with loan agreements governed by jurisdictions where such jurisprudence is lacking, alternate settlement mechanisms may be required. When looking to avoid a possible violation of the credit agreement and a lengthy dispute with the borrower in these jurisdictions, fund buyers may wish to abstain from challenging this gray area and refrain from taking ownership of the loan directly. In order to solve issues related to the financial institution and Basel Bank requirements, a fund buyer will need to find a qualifying fronting bank to step in and take ownership of the loan. Once a formal financial institution or Basel Bank is selected as the fronting bank, the entity will step in to become a lender under the loan agreement and will enter into a participation agreement with the fund buyer in the same manner described in the tax withholding scenario above.

PHYSICAL NOTES: RETIRE, REISSUE, OR ENDORSE

Although the use of physical notes to evidence loans is no longer very common in the U.S. and the U.K., there may be an instance in which one or more loans in a portfolio travels with a physical note. In the event this situation arises, buyers will need to take steps to make sure that the note is properly transferred. Depending on the terms of the loan and the jurisdiction of the borrower, a note can be retired and reissued or retired without reissue so long as the borrower's obligation to pay and other rights are not harmed. In some cases, buyers may be able to simply endorse an existing note but must take care that all proper procedures for endorsement are followed. When physical notes are involved, having knowledgeable and reliable local counsel is highly desirable to make sure all transfer procedures involving the notes are handled properly.

SUMMARY

The issues discussed in this article are meant to be illustrative rather than exhaustive of the types of issues that can lurk within the loan portfolio and impact a buyer after the purchase. These types of issues are especially likely to arise when the portfolio contains diverse loan types and contains loans to borrowers located in varying jurisdictions. This matrix is in addition to the fact that credit agreements within the portfolio are likely to have some degree of variation with respect to terms governing transfers. For buyers of European distressed loan portfolios great profits may await, but the phrase, "Forewarned is forearmed," is certainly apropos.

NOTES

[1] Buyers should note that in many cases the borrower's withholding gross up may be limited to the borrower's gross-up obligation to the original lender.

[2] To insure that a fronting structure produces the desired effect, tax counsel should be consulted before entering into a transaction involving a fronting entity.

[3] A Basel Bank is a bank that is compliant with the Basel Accords, which

are recommendations on banking laws and regulations issue by the Basel Committee on Banking Supervision.

[4] *Essar Steel Ltd. v The Argo Fund Ltd*. [2006] EWCA Civ 241.