The Rise of Rated Note Feeders: Structures and Subscription Facility Considerations

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As the traditional subscription facility market has matured, new liquidity and funding innovations have arisen. Enter the rated note feeder. This structural tool in the back pocket of GPs may ease the accessibility of private equity to investors that need to commit capital via a debt commitment and enhance investor returns through collateralized fund obligations. While the use of rated note feeders has gained significant traction over the last couple of years, implementing this structure in connection with a credit facility is fraught with questions. This article provides a background on rated note feeders against the backdrop of fund finance, discusses issues of enforceability in the event of a fund bankruptcy, and dissects the nuances of protective provisions you can use for a rated note feeder in your next fund finance deal.

We consulted with our industry-leading capital markets and bankruptcy experts to assess the adoption of rated note feeders in fund finance. This article first describes their basic structural elements and the two most common constructs: the application of rated note feeders for investors seeking debt commitments and collateralized fund obligations (also called CFOs). Next, this article details common concerns from fund finance lenders on the bankruptcy and insolvency risk that could prevent a lender from enforcing its collateral. Lastly is a robust toolkit with methods to mitigate such concerns through shared debt/equity capital commitments, by making a rated note feeder more bankruptcy remote and with specific credit facility safeguards.

Rated Note Feeder Structural Elements

Structurally, a rated note feeder is much like a typical feeder fund. There will be a master fund borrower in which the rated note feeder has a direct or indirect capital commitment. The feeder's partnership agreement and subscription agreement often will resemble ordinary fund documentation, though generally with provisions specifically tailored to address the bespoke structure. If the capital commitments are instead issued to investors under an indenture, the partnership agreement may be a short-form version.

The main difference is that rather than solely issuing equity to investors, a rated note feeder also issues debt. It does so through a note purchase agreement or an indenture. In either case, that agreement will include mechanisms for the issuance of notes to limited partners and corresponding capital contributions for the notes by the investors to the feeder. The aim is for the arrangement to be functionally equivalent to investor capital calls. Rather than periodic cash interest payments, interest on the notes is paid in kind until the investment manager elects to send distributions to the fund investors. Interest would also be paid in kind if underlying portfolio profits are insufficient to provide cash payments on the notes.

Frequently the rated note feeder is part of a larger fund structure with other fund entities that are traditionally structured for limited partnership interests. Sponsors can explore a separately managed account or parallel fund for ratings-sensitive investors to allow the fund to more easily manage and maintain the rating of the notes. That would often require additional time and cost compared to establishing the feeder in an existing or more encompassing fund, but if the investor carries a significant enough commitment, it could be worthwhile for the manager.

There are many underlying reasons why investors elect to structure a fund commitment through debt via a rated note feeder. While outside the scope of this article, we are well versed on, and would be happy to discuss, that structuring and its drivers. This article is aimed at risk mitigation for fund finance lenders and sponsors who intend to accommodate this popular investment tool.

Collateralized Fund Obligations

CFOs combine the technology of a traditional rated note feeder with securitization techniques. The feeder is set up as a special purpose vehicle that invests in a pool of limited partnership or similar interests in a fund. Those interests comprise the collateral for the rated notes that are issued by the feeder to its investors. The issuer establishes several tranches of notes. The most senior tranche will have the highest rating on its notes. Each successive tranche will be more junior to, and have notes that are lower rated than, the immediately prior tranche. The most subordinated tranche will be an equity tranche structured with either unrated notes or more traditional equity interests.

The tranche structure of a CFO gives its investors a diversified means of selecting their preferred risk and return criteria. Any losses will first be absorbed by the investors in the equity tranche, followed by the investors in the next higher tranche, followed by the investors in the next more senior tranche, and so on. The more junior the tranche, the higher the risk profile but also the higher the interest payments to the investors via their notes. Often the equity tranche would be held by the issuer or one of its affiliates, but that tranche can also can be issued to an investor with a higher risk appetite looking for significant yield.

A CFO will be a limited partner in one or more underlying funds. In that capacity, a subscription lender may view the CFO like any other investor. With a structure akin to the combination of a fund-of-funds investor and an investor aggregator vehicle, a subscription lender may seek to understand the credit quality of the CFO's investors. The rating agencies no longer permit the debt commitments to be called during an event of default under the CFO indenture, and so CFOs often are not included in the credit facility borrowing base. The protections discussed in the remainder of this article are considerations should a lender get comfortable with including a CFO in the borrowing base.

Bankruptcy and Insolvency Risk

There can be challenges including an investor in the borrowing base that commits through a rated note feeder if the fund structuring and the credit agreement are not properly documented to accommodate this arrangement. In the United States, there are questions about enforceability of an investor's obligations to purchase notes or contribute capital under a debt commitment if the feeder fund were to be insolvent or bankrupt. If a capital commitment is structured as both equity and debt, the investor may be a creditor to the fund with respect to the investor's debt commitment, and the fund may be a borrower in that respect. A creditor generally is not required to make loans to a borrower during a bankruptcy or insolvency of the borrower. In bankruptcy, an executory contract (*i.e.*, a contract that hasn't been fully performed by both parties) that includes a financial accommodation generally cannot be assumed, and may be unenforceable if not assumed.

A debt commitment may be viewed by a bankruptcy court as a financial accommodation to the rated note feeder. So if the fund were in a bankruptcy or insolvency proceeding, the limited partners may not be required to contribute capital to the fund under their debt commitments. When the debt commitments make up a large percentage of each investor's aggregate commitment, there may then be a risk whether the lenders in a subscription facility are able to be fully repaid.

Converting Debt and Shared Debt/Equity Commitments

Historically, one means thought to mitigate the risk of debt commitments in fund finance was to require a fund to convert the debt to instead be equity commitments, or to have the debt commitments satisfied by equity contributions, during a bankruptcy or insolvency event of the fund ? the rationale being that equity contributions may not be treated as a financial accommodation in bankruptcy to the same degree as debt commitments. The question is whether such conversion itself could be deemed unenforceable. A bankruptcy court may not enforce an agreement that modifies or terminates an executory contract if the modification or termination is triggered on the occurrence of a bankruptcy or insolvency event.

That question has not yet been tested in U.S. courts with respect to debt commitments to a fund. In Europe, legal practitioners seem more confident that a court there would assess the circumstances based on the underlying purpose of the transaction. The rated note feeder is clearly engineered to enable an investor to be able to commit capital to the fund through a structured vehicle. So the sense in Europe is that courts might treat the investor as being required to contribute capital if called on by a lender as if the limited partner's commitment were in equity, even though it is in fact through debt via the rated notes.

Converting debt to equity has also become a less certain solution because the rating agencies that rate a feeder's notes have raised concerns over this feature. If the conversion approach is not honored by the rating agencies, and the investors lose the benefit of obtaining a favorable rating on the notes, then this structuring mitigant becomes moot.

Because there is this question in the United States, a sponsor and the subscription lender might consider having the investors' capital commitments structured as a shared debt/equity commitment. Rather than a debt commitment and a separate equity commitment, the shared capital commitment can be called in the form of debt from the rated notes or via the equity interests with a typical capital call. Any capital that is contributed via the debt or the equity would reduce the entire shared unfunded capital commitment. While this issue has not been adjudicated in a bankruptcy court, a shared debt/equity commitment may not raise the same concerns as actually converting from debt to equity based on a bankruptcy filing.

This approach may also work for investors that need to commit capital via a rated note. To ensure the fund documentation works for such an investor, the investor would be permitted to contribute capital via the debt portion of its commitment in the ordinary course. The investor could be required under the fund's constituent documents to contribute via the equity sleeve only if the fund were to go into a bankruptcy or insolvency, if the investor did not or could not contribute capital pursuant to the debt portion of its commitment, or if there is an event of default under the credit facility. In addition, standard lender protections could be included in the rated note feeder's limited partnership agreement, note purchase agreement and/or indenture, such as providing for (1) assignability and the right of the fund and general partner to pledge the capital commitments, (2) a waiver by the investors of setoff, counterclaim and defenses, including a waiver of defenses under Section 365 of the U.S. Bankruptcy Code, and (3) the administrative agent and lenders under the credit facility being explicit third-party beneficiaries.

Once the feeder documents are properly arranged, the lender and the sponsor can include concomitant provisions in the credit agreement. There could be a covenant requiring the funding of capital contributions solely via the investor's equity commitment on a triggering event. The triggers would be tied directly to those in the fund documents. In addition, the lender and fund manager can make sure the administration of the notes, procedures for calling capital, timing of capital contributions, investor default remedies and practices for investor transfers all synch up between the underlying fund agreements and the loan documents. The lender needs to ensure that if it steps into the shoes of the general partner, the lender will be able to fully call capital despite the rated note feeder structure.

Bankruptcy Remoteness

Another way to protect a lender's interest with respect to a rated note feeder is to make the fund vehicle as bankruptcy remote as practicable. Two direct ways to enhance this are to have the fund appoint an independent director for the rated note feeder and include non-petition language in the rated notes. The independent director acts solely to vote on voluntary bankruptcies of the rated note feeder and related matters. The director is required to only take into account the interests of the feeder and its creditors. When using this approach, the fund's financing agreements should be drafted to clearly indicate the lender is a creditor to the feeder. The director would thus assess the lender's interest in not placing the rated note feeder into a bankruptcy or insolvency proceeding if it would impact the lender's ability to be repaid on the rated notes, along with assessing the interests of other stakeholders. Special purpose entity provisions would also confine the purposes and activities of the rated note feeder, thus limiting other liabilities and reducing the likelihood that the feeder would seek bankruptcy protection.

Non-petition language in the fund documents contains an agreement by all interested parties in the transaction to not file an involuntary bankruptcy against the rated note feeder without the consent of the lender. If investor letters are being used in connection with the subscription credit facility, non-petition language could also be included in them. Taken together, the independent director and non-petition provisions may help make the rated note feeder more bankruptcy remote.

There are other indirect ways to improve the bankruptcy remoteness for the capital call facility. If the borrowing base has enough investors with regular equity commitments to support the borrower's needs, a lender might choose to not include the shared debt/equity commitments in the borrowing base until certain hurdles are met. For example, set thresholds of limited partner capital would need to be funded (40%, 50%, 60%) to increase the advance rate against those limited partners under the credit facility. The credit agreement could include a NAV ratio to the Maximum Commitment (*e.g.*, 1-2x) for the shared debt/equity commitments to be included in the borrowing base. Once added to the borrowing base, the investors with shared debt/equity commitments could be removed if the rating on the notes decreases. A lender may also require additional reporting by the fund if its underlying investments start to underperform. By more closely monitoring those investments, the lender may know sooner whether the fund is at risk of a bankruptcy or insolvency. The lender and fund manager can negotiate how much the investments would need to be underperforming before the relevant investors are removed from the borrowing base and a mandatory prepayment is triggered. A lender could also ask for a clean-down provision in the credit agreement (perhaps ninety or one hundred twenty days) to lessen the likelihood that obligations are outstanding when a bankruptcy or insolvency event of the fund occurs. Each of those provisions in the credit agreement is meant to indirectly protect against the bankruptcy or insolvency risk of the rated note feeder.

Conclusion

While this article highlights some thoughts on rated note feeders at this time, this is an evolving landscape. We are increasingly receiving inquiries about adding rated note feeders to our deals and expect there to be continued innovation. A rated note feeder does lead to additional complexity. If a sponsor is expecting to create this structure in a fund, it would be good for the sponsor to communicate with its subscription credit lender early in the process to help ensure any rated note commitment may be counted in the borrowing base. Fortunately, it is relatively simple to document the appropriate provisions in the fund documents and the credit agreement once the rated note feeder structure is determined.

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