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Rated Note Feeder Issues Facing Subscription Line Lenders

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I. Overview:

In the United States, rated note feeder structures are used by private equity fund sponsors and insurance company investors to allow such investors to take advantage of favorable regulatory capital treatment for their investments in private equity funds. While not a new product, this favorable regulatory capital treatment has made rated note feeders increasingly popular in recent years and, coupled with the comparatively large capital commitments of insurance company investors, private equity sponsors want to leverage these capital commitments for their subscription lines of credit. However, rated note feeder structures are primarily or exclusively debt investments, rather than traditional equity investments, and this presents lenders with a unique set of challenges in structuring subscription lines of credit that include investors participating in rated note feeder structures in borrowing bases.

While the issues raised for such lenders are significant, proper governing documents and structuring of the rated note feeder that dovetails with a tailored subscription line structure can go a long way in giving lenders comfort that their collateral package is substantially similar to the collateral package for a traditional equity structure. In most instances careful structuring permits the capital commitments of investors in rated note feeder structures to be included in borrowing bases or other credit agreement covenant ratios. Most important to lenders among these structuring elements is the ability to call capital from investors in the rated note feeder as equity, rather than debt, when called to repay obligations under the subscription line credit facility.

II. Basic Rated Note Feeder Structure and Documentation:

At its most basic, a rated note feeder is simply another equity investor in a fund like any other investor or feeder fund that is managed or controlled by the same fund sponsor. The distinguishing factor is that a rated note feeder in turn calls capital from its investors, styled as note purchasers, primarily in the form of debt through the sale and purchase of rated notes. Rather than having the rights and obligations of the parties spelled out in the rated note feeder's limited partnership agreement or operating agreement and capital commitments contained in companion subscription agreements, these rights and obligations are often governed by an indenture and in those instances the investors' capital commitments are generally contained in a note purchase agreement. An indenture means the corresponding governing agreements are likely to be short-form agreements less relevant to the analysis. In some instances, the rated note elements are contained in the rated note feeder's governing agreements, especially situations where the rated note feeder may call a percentage of the capital as debt and a percentage as equity, a structure that is not uncommon in the market. In either case, the governing documents of the rated note feeder should also be diligently reviewed by lenders to ensure there are no problematic provisions for a subscription line credit facility.

In a typical scenario, the underlying main fund calls capital from its investors, including the rated note feeder. The rated note feeder then calls capital from the note purchase investors to fund its capital contribution to the main fund by borrowing funds from the note purchase investors in exchange for the rated note feeder issuing notes favorably rated by a rating agency. These notes are generally secured by a pledge of "*all assets*" of the rated note feeder, which is meant to provide the note purchase investors with a security interest in the corresponding interest of the rated note feeder in the underlying main fund and any account to which distributions from such underlying main fund are paid. Due to the broad nature of these security interests, subscription line lenders and their counsel need to ensure the collateral securing a subscription line credit facility is carved-out from the note purchase investors' security interest and, if needed, proper subordination provisions are included.

For insurance companies, at the date of this publication, holding rated notes issued by the rated note feeder instead of holding equity interests directly in the underlying fund is currently treated as having a lower risk classification, providing the insurance company investors favorable regulatory capital treatment, making investing in private equity funds through these structures more appealing. However, the increased popularity of the product has garnered regulatory attention from the National Association of Insurance Commissioners (the "***NAIC***"), the body used by state insurance regulators to coordinate regulatory oversight and promulgate related uniform rules and regulations. The NAIC is currently reviewing these structures and their treatment to determine required regulatory capital treatment going forward.

III. Issues for Subscription Line Lenders:

The rated note feeder structures described above present many significant challenges for subscription line lenders. One of the most fundamental aspects of traditional subscription line lending is the ability of lenders to issue and enforce capital calls upon investors to repay indebtedness under a subscription line directly into a collateral account pledged to the lenders. The distinction between investor obligations in the form of equity commitments and debt commitments significantly changes many of the underlying assumptions upon which subscription line lending is premised, particularly in the U.S. bankruptcy context. A lack of well-developed case law relating to rated note feeder structures means that the industry does not have guidance as clear or on point as it does for other types of collateral.

IV. Executory Contract Concerns:

The subscription line lending industry has long assumed, and for good reason, that the obligation of investors to fund capital commitments in the form of equity under a partnership agreement or operating agreement will be enforceable notwithstanding a bankruptcy of the fund.[1] However, the Bankruptcy Code is very clear that contracts to provide debt are not enforceable in a bankruptcy. Section 365(c)(2) of the Bankruptcy Code states

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[1] *See Chase Manhattan Bank v. Iridium Africa Corporation*, Civil Action No: 00-564 JJF, 2004 WL 323178 (D. Del. Feb. 13, 2004) (concluding that investors are not within the class of creditors Congress intended to protect under *Section 365(c)(2)* of the Bankruptcy code).

"*The trustee may not assume or assign any executory contract … of the debtor … if … such contract is a contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor, or to issue a security of the debtor.*" Given that U.S. bankruptcy courts are courts of equity able to apply equitable principles in their decision making, it may be that U.S. bankruptcy courts recognize the obligation to contribute capital to rated note feeders and receive rated notes in exchange is analogous to traditional equity commitments and should be treated in the same manner but, absent any case law or legislative guidance to the contrary, for now a lender would be prudent to assume the right to call capital in the form of debt will be unenforceable in a U.S. bankruptcy given the typical structure of rated note feeders and a plain reading of the Bankruptcy Code.

The preferred solution for this issue is for the rated note feeder to be permitted to call capital in the form of equity, at the very least to repay the subscription line credit facility. Ideally, lenders want the right to call capital as equity to repay the entire subscription line credit facility at any time, but the timing and conditions for when this right to call capital in the form of equity is triggered vary greatly and are relevant to whether the right will be available to lenders post-bankruptcy petition. Because bankruptcy courts are courts of equity and because there is a lack of relevant case law, lenders must apply an uncertain balancing test in these situations. Thus, it is in a lender's best interest to push for as many protections as can be negotiated to evidence that the equity component of the investors' capital commitments is a separate and independent obligation from the debt component. Each situation needs to be evaluated thoughtfully and independently, considering all factors specific to that situation. There are no magic words absolving lenders of all risk, but there are many provisions and protections that competent counsel can include when crafting language for indentures and related ancillary documents or governing agreements. This can be as simple as an acknowledgement that the right to call capital as equity is a now-existing "*separate and independent obligation*," but can also involve complex negotiations tailored to the specific structure of the fund and the structure of the subscription line, such as adding provisions related to bankruptcy remoteness of the rated note feeder. One constant, however, is that the sooner all relevant parties can review the relevant documents, discuss concerns, and create solutions, the better. If a lender is presented fully baked indenture and related documents or governing agreements already approved by investors (and therefore agreements not easily changed), rather than negotiating solutions on the front end that will work for all relevant parties, the lender is simply presented with a choice between accepting or rejecting the note purchase investors' capital commitments in the credit facility borrowing base.

V. Ipso Facto Rule Concerns:

An issue that has come to forefront recently is some sponsors structuring the right to call capital as equity in an indenture being triggered upon the occurrence of an event of default or even upon the commencement of bankruptcy proceeding. The Bankruptcy Code is clear in Section 365(e) that "*… any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on … the commencement of a case under this title[.]*"

This so-called *Ipso Facto* Rule then becomes crucial to evaluating the timing and triggers for the right to call capital as equity under an indenture. If the trigger to call capital in the form of equity is the commencement of a bankruptcy filing or other financial distress, then it would appear to be a blatant *Ipso Facto* Rule violation. On the other hand, being triggered by any event of default which may or not may not result from the commencement of a financial distress event or the commencement of a bankruptcy is a much less clear analysis and arguments exist that the *Ipso Facto* Rule is not violated. Currently, the market has not come to a full consensus as to what triggers do and do not violate the *Ipso Facto* Rule. Sponsors continue to push the limits of the balancing test by tipping the scales in favor of potentially violating the *Ipso Facto* Rule to appease rating agency and regulator concerns over the regulatory capital treatment of rated note feeders containing equity components considered crucial by lenders. Lenders continue to raise red flags while trying to balance providing some type of borrowing base credit for note purchase investors. There are no simple or market-approved solutions to resolve the issue but, when all parties cooperate upfront, a reasonable compromise can often be found.

VI. Indenture and Note Purchase Agreement Concerns:

As there is not a full market consensus on structuring subscription lines including investors in rated note feeders in borrowing bases, indentures and related documents vary greatly and it is not uncommon for these documents, or at least initial drafts, to omit standard "*bankable*" provisions lenders would expect to see. Often this is because, through shortsightedness, a fund's subscription line credit facility considerations take a backseat to a more immediate desire to secure capital commitments from insurance company investors. For this reason, it is important for all relevant parties to review indentures and related ancillary documents as early as possible and address any concerns. Some bankable provisions, such as waivers of defenses, are just as important in rated note feeder structures as they are in other subscription line contexts. Other provisions, such as requiring funding of capital contributions to collateral accounts and a lender's third-party beneficiary rights, take on particular significance in the context of a rated note feeder structure.

For instance, for the typical fund formed under the laws of the State of Delaware, *Section17-502(b)(1)* of the Delaware Revised Uniform Limited Partnership Act provides in relevant part "*a creditor of a limited partnership who extends credit, after the entering into of a partnership agreement or an amendment thereto which, in either case, reflects the obligation, and before the amendment thereof to reflect the compromise, may enforce the original obligation to the extent that, in extending credit, the creditor reasonably relied on the obligation of a partner to make a contribution or return.*" Lenders sometimes rely on this statutory protection (and others like it) to ensure that the bankable provisions in the governing agreements cannot be amended to the detriment of subscription line lenders, especially in the absence of additional contractual third-party beneficiary rights contained in governing agreements. Because *Section17-502(b)(1)* refers to "*partners*" of a limited partnership, the statutory protection afforded to subscription line lenders as creditors would not appear to apply to the obligations of note purchase investors of a rated note feeder. Further, the indenture and related documents are likely to be governed by laws of a jurisdiction other than Delaware. Lenders therefore need to be mindful that indentures contain language protecting against adverse amendments to the bankable provisions.

As another example, Section 9-406 of the Uniform Commercial Code provides that, if an "*account debtor*" has been notified of the assignment of its funding obligation to a secured party and been directed to pay amounts due to a collateral account, it will not have satisfied such funding obligation if it does not fund to such collateral account. The subscription line market generally assumes limited partners in a private equity fund are "*account* *debtors*" and has relied on the combination of governing document provisions requiring funding to collateral accounts combined with Section 9-406 of the Uniform Commercial Code to ensure that capital contributions must flow through collateral accounts subject to fully perfected liens in favor of lenders. The same arguments cannot be made for the obligations of note purchase investors funding debt obligations. Therefore, lenders will not have the same Uniform Commercial Code statutory protections and must rely solely on the enforceability of the contractual obligations contained in the indenture documents requiring funding to a collateral account.

VII. Capital Call Mechanics Concerns:

One of the first due diligence questions subscription line lenders must ask is which party has the right to call capital and how? In a rated note feeder structure governed by an indenture the answer can often be multitiered. A main fund will generally have a right to call capital from the feeder. The trick to properly structuring the liens on the collateral pledged by a rated note feeder governed by an indenture is in understanding how the feeder is in turn permitted to call capital from its note purchase investors.

In many indentures, the rated note feeder calls capital from note purchase investors but issues the capital call to an indenture trustee who in turn notifies the note purchase investors of the capital call and the corresponding obligations to fund their respective capital commitments. This adds indenture trustee bankruptcy risk to lenders' underwriting analysis and is also why many indentures provide, and lenders should always request, that the lenders have an unfettered right to call capital in an enforcement scenario directly from the note purchase investors bypassing the indenture trustee.

Whatever form an indenture takes, the technical capital call mechanisms need to be understood and the credit facility documentation needs to address the issues where appropriate and to the extent possible. For instance, a lender's right to issue capital call notices may need to address specific steps required by the indenture to cause the indenture trustee to notify the note purchase investors of a capital call.

VIII. Legal Opinion Concerns:

Legal opinions covering rated note feeder structures governed by an indenture can give rise to due diligence-related issues. Lenders almost universally seek a legal opinion that each borrower party is authorized under its constituent documents to execute the relevant loan documents and make the relevant pledges. Because in a traditional equity structure subscription line credit facility these constituent documents also create the right to call capital which is the primary collateral for a subscription line credit facility, it is best practice for lenders taking capital call rights as collateral to be comfortable the borrower parties are not violating the agreements giving rise to such collateral.

In a rated note feeder structure, the indenture is a debt document and not a constituent document traditionally implicated in an authority opinion. Further complicating the issue is the fact that it is often the case the rated note feeder's constituent documents are governed by the laws of one jurisdiction (commonly Delaware) and the indenture is governed by another (most frequently New York). Thus, unless inclusion is expressly negotiated, the indenture is not subject to opinion coverage.

There are several options for addressing these due diligence opinion concerns but one of the most common is for the law firm giving the opinion for the laws of the jurisdiction that governs the indenture to give an opinion that the execution, delivery, and performance of the borrower party's obligations under the subscription line credit facility do not contravene the indenture. It is worth noting that some firms representing borrowers have taken the position that they will not opine on non-contravention of debt instruments. However, in these instances, it should be brought to such firm's attention that the indentures are often meticulously negotiated to include the equity components discussed above specifically designed to be treated as something other than a debt instrument and declining to give the opinion on such basis is the fund's counsel putting the lender on notice that it does not believe the structure in fact works as intended. Unlike conventional debt instruments, the customary bankable provisions required by lenders in the constituent documents will be contained in the indenture and, because the indenture is the document creating the collateral, a conflict could be catastrophic for the lender.

An additional consideration for legal opinions is the fact legal opinions delivered to lenders with respect to a subscription line are universally qualified with respect to or subject to the effects of bankruptcy, insolvency proceedings, liquidation, receivership, fraudulent conveyance, reorganization or similar laws affecting the rights, remedies or recourse of creditors generally. This undercuts the value of opposing counsel's opinions on rated note feeder structures and means, practically, that there is greater reliance upon the analysis of the lender's own counsel to provide comfort when including borrowing base credit for note purchase investors.

IX. Potential Regulatory Change Concerns and Alternative Structures:

While lenders have conditioned borrowing base credit for note purchase investors on having the equity obligation to repay subscription line indebtedness, as well as the debt obligation, this feature has garnered scrutiny from the NAIC. Some have argued that including the equity obligation undercuts the arguments supporting better regulatory capital treatment for rated note feeder structures. The NAIC announced in 2021 that it will propose rule amendments related to rated note feeder structures not to take effect before January of 2024. It is important to note no grandfathering of existing rated note structures has been proposed.

If the NAIC determines rated note feeder structures should not enjoy the regulatory capital treatment currently afforded, the need for rated note feeder structures, and the assumption of the related risks for lenders, will no longer be necessary going forward. The effect on any then-existing rated note feeder structures will need to be evaluated at the time and lenders will be well served to revisit indenture documents (including side letters to the extent applicable) and feeder governing agreements to ensure a change in regulatory capital treatment doesn't change a note purchase investor's obligation to fund capital to repay subscription line indebtedness.

We would not expect insurance companies to stop investing in private equity funds altogether as a result of any such rule change adopted by the NAIC. It would likely mean insurance company investors would return to investing directly as typical equity investors do or develop other strategies to derive similar regulatory capital advantages. For instance, managed account structures where insurance company investors invest directly in underlying assets alongside the fund may address many of the NAIC concerns. Other potential structures that are yet to receive market acceptance, such as insurance company investor-issued letters of credit or analogous guaranty obligations backing the funding of debt obligations, may work as well. These structures also create unique and complex issues for lenders, but as mentioned above, reasonable compromise solutions can often be found when all parties cooperate. It is also possible the NAIC will propose rules permitting regulators to look-through the fund to the creditworthiness of the underlying assets as is the case currently in Europe.

X. Conclusion:

Including the capital commitments of note purchase investors in rated note feeder structures in subscription line credit facility borrowing bases poses significant issues for lenders but, although evolving, the market recognizes solutions and mitigation strategies that have allowed and, we hope, will continue to allow this practice. If lenders and their private equity fund borrowers start working towards this common goal together early in the process, rated note feeder structures and the related loan documents can be tailored to unlock more borrowing base availability for private equity funds and sufficient collateral support needed by subscription line lenders. Our Haynes and Boone Fund Finance and Bankruptcy attorneys have experience with these issues and are happy to help.