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Insight and Opportunities for Clients

Rated-Debt Feeder Funds: Structural Issues and Legal Considerations

Investor interest in rated-debt feeder funds has grown since we first issued our Action Item concerning such funds in March 2019. We expect this interest to continue as the private credit market expands through the COVID-19 crisis. Throughout 2019 and 2020, credit fund managers used the rated-debt feeder structure to raise capital to invest in a wide range of debt strategies, including secured senior, second lien, mezzanine, unitranche, bridge, and DIP financings, as well as sale leaseback financings and preferred equity strategies. In 2021, investors will likely find more managers using the rated-debt feeder strategy to raise capital for funds with an investment strategy expected to generate consistent cash flows.

As discussed in our 2019 Action Item, a significant portion of the capital of a rated-debt feeder fund comes from debt that is rated by an NRSRO (Nationally Recognized Statistical Rating Organization). When an insurance company purchases a rated note from a credit fund's rated-debt feeder, it may be entitled to a lower risk-based capital charge than if it had made an equity investment directly into the credit fund.

While investing in a credit fund through its rated-debt feeder may provide an insurance company with some regulatory capital relief, insurance companies need to take into account a number of structural business issues and legal considerations that are unique to the rated-debt feeder structure.

Structural Issues

Ratio of debt to equity. Since rated-debt feeder funds are capitalized by both debt and equity, the fund manager's determination of the ratio of debt to equity (in consultation with the NRSRO) is critical to the rating of the feeder fund debt. While a debt/equity ratio of 85/15 appears to be quite common, the ratio may range from 90/10 to 55/45.

Interest on the debt. The rate of interest typically falls between 3% and 8% on senior debt, and between 5% and 12% on junior debt. Most rated-debt feeders mandate that interest only be paid if and when the feeder fund has sufficient cash flow for such debt service, utilizing "PIK" and "make-whole" features to avoid defaults on feeder fund debt.

Priority of payments. While such "pay if you can" terms may impact an NRSRO's rating, the priority of payments on the debt and equity and the relative size and subordination of the "cushion" below the "senior" debt are also integral to the rating determination.

Use of a leverage covenant. Some rated-debt feeders permit certain payments or distributions on the junior debt or the equity after senior debt interest is paid, but before the payment of any senior debt principal. If that is the case, such payments or distributions may need to be limited by a debt coverage covenant to preserve a higher rating on the senior debt. For example, prohibiting payments of junior interest or equity distributions if senior debt is greater than 80% of the net asset value of the fund.

Rating the junior debt. If a rated-debt feeder fund uses junior debt to provide some of the "cushion" to the senior debt, the junior debt may also qualify for a rating (depending on the amount of equity below the junior debt). While that junior debt's rating may be substantially lower than the senior debt's rating, it may still provide an insurance company with further regulatory capital relief.

Expenses of the feeder fund. Feeder fund investors (or alternatively all of the investors in the main fund, including the feeder fund) might bear the expenses associated with the rated-debt feeder fund (including the cost of the initial and annual NRSRO ratings).

Legal Considerations

Documentation. Consider how the feeder fund debt tranche(s) will be documented. Will all investors be party to one debt agreement or will multiple debt agreements be used? If multiple agreements are used, how will feeder fund investors ensure that all debtholders receive consistent treatment? What is the scope of the representations, warranties, and covenants provided to the feeder fund investors through the debt documents? Are they sufficient for the obligations to qualify as debt?

Coordination of capital calls. Consider if the feeder fund debt and equity documents appropriately reflect how and in what priority capital will be called for each debt and equity tranche.

Coordination of cash flow from the main fund. Consider if the feeder fund debt and equity documents appropriately

allocate, distribute, and account for all cash flows from the main fund in terms of payments of principal and interest (on both the senior and junior debt) and limited partner distributions.

Coordination of returns of capital to the main fund. Because distributions received by a feeder fund from a main fund are distributed to feeder fund debt and equity holders, consider if the feeder fund debt and equity documents appropriately address from which holders and in what priority funds must be returned by feeder fund debt and equity holders when the main fund either (i) recalls distributions from the feeder fund for recycling purposes or (ii) requires the feeder fund to disgorge distributions to support the main fund's payment of indemnification obligations. For example, consider how interest payments to a debtholder would be returned, since interest payments cannot typically be "reborrowed".

Pass-through voting and notices. Consider if the main fund equity documents and the feeder fund debt and equity documents are coordinated so as to provide the feeder fund debt and equity holders with (i) notices and reports given to investors in the main fund and (ii) the ability to consent to and vote on main fund matters as if they were limited partners in the main fund.

Remedies. Consider what remedy, if any, is appropriate if a feeder fund debtholder experiences a material default under the debt documents or a material change in the rating occurs.

Coordination with the main fund. Consider how a removal of the main fund general partner impacts the feeder fund general partner and how the dissolution of the main fund impacts the feeder fund.

Conclusion

Given the range of structural issues and legal considerations that are unique to an insurance company's investment in a credit fund through a rated-debt feeder, insurance companies should hire counsel that is experienced in such investment transactions. Chapman attorneys have significant experience in rated-debt feeder investment transactions. That experience, combined with Chapman's experience representing insurance companies in more than 100 private investment transactions, makes Chapman highly suited to represent insurance companies investing in credit funds through rated-debt feeder structures and to represent credit fund managers considering a rated-debt feeder structure to raise capital.

We welcome the opportunity to discuss any questions that you may have about rated-debt feeder fund transactions.

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