International
Comparative
Legal Guides

Practical cross-border insights into lending and secured finance

Lending & Secured Finance 2022

10th Edition

Contributing Editor:
Thomas Mellor
Morgan, Lewis & Bockius LLP

LSTA
LMA Loan Market Association
APLMA Asia Pacific Loan Market Association
ICLG.com

Editorial Chapters

Expert Analysis Chapters

Expert Analysis Chapters Continued

Q&A Chapters

Financing Your Private Debt Platform

Dechert's Global Finance Group

Over the last several years, financing options for private debt platforms have become increasingly diverse. There is now a broad range of products available to managers seeking to leverage their investment portfolios. These products serve different purposes and are provided by different investor groups. In this chapter, we explore some of the different financing options that private debt fund managers have utilized in recent years. Such products include senior secured facilities, unsecured notes and structured credit products. Common senior secured facilities include asset-based loans (ABLs), loans-to-SPVs (special purpose vehicles), hybrid subscription and ABL lines, collateralized loan obligations (CLOs) and hybrid variants. Unsecured notes include rated notes, baby bonds and convertible notes. Available structured credit products include repurchase agreements, total return swaps and forward contracts.

I Senior Secured Facilities

A. Asset-Based Loans

What is an asset-based loan facility?

ABLs at the fund level are one method of obtaining platform-wide financing. ABLs advance against a borrower's portfolio of investments based on the value and classification of each eligible investment held. ABLs are generally provided by banks and other financial institutions and, depending on total commitments, may take the form of club or syndicated deals. ABLs are also one of the most flexible types of secured financing – a borrower's ability to purchase assets is generally only limited by its own investment policies and compliance with applicable law. Portfolio managers may otherwise distribute cash throughout the system with relative ease, subject in some circumstances to certain borrowing base cushions and other specified conditions, and may purchase and sell assets and otherwise conduct day-to-day business with little involvement of the lenders.

What are the common features that distinguish ABLs?

- **Tenor**. ABLs generally provide for a three- to four-year revolving credit line, with some recent funds opting for a small term loan piece to optimize pricing. During the availability period, there are generally no prepayment penalties or make-whole premiums, and mandatory prepayments are limited to those needed to cure borrowing base deficiencies. Following the availability period, there is often a one- to two-year term out period during which the outstanding loans amortize, most commonly either evenly on a monthly basis through the scheduled maturity date or contingent upon the receipt of net cash proceeds in connection with the occurrence of certain events (for example, sales not in the ordinary course, returns on investments, incurrence of debt, issuance of equity and receipt of insurance proceeds).
- **Cash Flow**. Loan proceeds may be used for general corporate purposes, including purchases of assets that do not receive credit in the borrowing base. Furthermore, cash generated from the business is not required to be sent to a lockbox or to be paid subject to a payment waterfall. Instead, a borrower retains its rights to direct use of cash from its various accounts until a default occurs, at which time the secured parties may exercise authority over any cash or securities held in accounts governed by a control agreement. Cash may also be freely moved up and down the capital structure, in some cases subject to no default and a borrowing base cushion, including to make distributions and prepay other debt. ABLs for registered investment companies (RICs) also frequently permit certain distributions notwithstanding the existence of a default, typically in an amount equal to the higher of the net investment income or the amount of required tax distributions estimated by a borrower, in each case subject to a cushion.
- **Borrowing Base**. Borrowing bases for ABLs comprise the following primary components:
  - **Eligibility Criteria**. Although eligibility criteria vary borrower to borrower and, in some cases, provider to provider, a consistent feature is that they are predetermined and not subject to subsequent agent or lender review or consent. In addition, although eligibility criteria determine whether any given asset may contribute to the borrowing base, they do not limit whether an asset may be purchased in the first instance (unlike many loan-to-SPV facilities discussed below that require lender consent to purchase an asset).
  - **Advance Rates**. ABLs give credit to a wide variety of assets, including first-lien loans (which may be subject to prior working capital liens), second-lien loans (which may include first-lien loans in excess of certain leverage ratio thresholds), high yield securities, mezzanine loans, last out loans, covenant-lite loans, loans that permit interest to be paid in kind (PIK loans), and debtor-in-possession (DIP) loans. Some facilities will require minimum EBITDA thresholds for certain assets to be deemed eligible, but recent trends have provided managers with the added flexibility for portions of the borrowing base to be based on assets whose performance is measured by metrics other than EBITDA, including, for example, recurring revenue, loan-to-value and late stage lending loans. Credit may also be given to preferred and common equity investments, both

performing and non-performing assets and investments in foreign portfolio companies. Advance rates given to quoted, first-lien loans may be as high as 85%, and vary depending on factors such as credit quality, seniority, tenor of a specific type of asset, overall fund performance (for example, stepping up as the most recently calculated asset coverage ratio increases above 1.50×) and a manager's track record.

- **Concentration Limitations**. Counterbalancing the flexibility granted to a borrower in its acquisition strategy, secured parties enforce diversity and cap non-core assets through concentration limitations. Common concentration limitations include issuer and industry concentrations, minimum percentages of first-lien and/or second-lien loans, and maximum percentages of non-performing assets, PIK loans, DIP loans, equity investments and/or foreign assets. However, a borrower does still maintain control over the application of such concentration limitations – to the extent more than one concentration limitation may apply, a borrower may choose which assets to move in and out of the borrowing base in order to satisfy the concentration limitations, and thereby optimize its borrowing base availability.
- **Value**. The value of assets in an ABL are marked to market on a periodic basis, typically requiring both a level of internal and external review. Internal valuations may be required as frequently as weekly, though some managers seek to limit to quarterly, and a negotiated percentage of the assets are to be valued externally at least on a quarterly or in some cases, biannual, basis. Secured parties also reserve the ability to perform supplemental valuations at any time, though borrower reimbursement obligations are often capped to the extent no default exists. Valuation dispute mechanics are negotiated, including the value that controls while any dispute is ongoing.

- **Structuring Considerations**. ABLs are secured by substantially all assets of the fund and its subsidiaries. Such grant is subject to certain exceptions, which may vary based on a given fund's investment strategy and profile, but assets are typically included in the security package irrespective of whether such assets are included in the borrowing base. Representations, warranties, covenants and defaults may extend to all subsidiaries as well. For a manager considering a combination of the financing options described in this chapter, of particular importance to note is the extent to which the ABL agreement will apply to "subsidiary" investment vehicles controlled by the fund, including SPVs, CLOs, small business investment companies (SBICs) and their related assets. Generally speaking, there are two principal challenges a manager faces in this regard. First, there may be limitations on moving investments held by the fund and its other subsidiaries into these vehicles, including the absence of a default and a borrowing base cushion. Second, ABLs commonly cross-default, or at a minimum cross-accelerate, to the third-party debt facilities incurred or expected to be incurred by such vehicles.
- **Other Notable Features**. It is also common for ABLs to be available to provide borrowings in foreign currencies and to issue letters of credit on behalf of a credit party or an underlying portfolio investment company.

Recent developments

- **Consolidation**. The business development company (BDC) segment of the permanent capital space, in particular, has seen an increase in the rate of consolidation in the past few years. ABLs have accommodated by not only permitting an existing borrower to acquire third parties, but even providing for limited representations and conditionality in certain circumstances – for example, in connection with acquiring another BDC sharing a common advisor. A related permutation has been the availability of "umbrella" facilities, which provide for uniform borrowing mechanics and other terms for multiple BDC co-borrowers under one shared facility, subject only to several (and not joint) liability. Such facilities simultaneously ease loan administration and prebake in merger mechanics and the ability to port over commitments from the non-surviving borrower to the surviving borrower, allowing for more seamless streamlining and scaling.
- **Access to Other Capital**. Historically, various forms of debt have been permitted, including uncapped (other than by statutory and, in some cases, more stringent contractual asset coverage ratio compliance) unsecured debt maturing outside a preference period, baskets for unsecured shorter-term debt, and secured *pari passu* debt. Finance providers at the fund level are recognizing the potential benefits of greater flexibility in fundraising, and are working with funds to allow easier access to other capital when opportunities arise. There has been greater flexibility to incur shorter-term debt maturing earlier than the ABL, as well as to structure bankruptcy-remote vehicles to leverage pools of assets and securitizations via SPVs and CLOs highlighted later in this chapter. Increased flexibility in this area has been important in allowing funds to react in real-time to developing trends.

On balance, what are the pros and cons for managers of ABLs?

Pros

- Flexibility: ABLs are versatile and flexible, providing for liquidity at all levels of the capital structure and strategic leveraging of a diverse range of assets. Such flexibility also extends to concurrent access to other capital – ABLs are frequently set up in contemplation of and providing for easy-to-exercise mechanics for assuming or issuing many of the other types of financings discussed herein.

Cons

- Overcollateralization: All assets coverage and financial covenants can be restrictive, making lenders overcollateralized, and if breached can put real stress on the "fund" structure and ability to support other facilities.

B. Loan-to-SPVs

What is a loan-to-SPV facility?

A loan-to-SPV facility is a financing to a bankruptcy-remote special purpose vehicle (SPV) that is secured by and with recourse only to a portfolio of assets held by the SPV. The bankruptcy-remote nature of the vehicle is a key feature of this type of financing – although the SPV is typically a wholly owned subsidiary of the parent fund, these facilities by nature are expressly non-recourse to the fund, and credit underwriting is instead based on the portfolio of assets owned by the SPV. As a result, there are often meaningful limitations on the nature of the assets that may be held at the SPV level, and managers will have comparatively less flexibility with respect to the portfolio in comparison to fund-level revolvers and other asset-based financing products (including on their ability to purchase and sell assets and make distributions). However, these facilities are often priced attractively in comparison to other products, and can be a valuable resource for managers both as a long-term leverage solution and as short-term warehouse financing in advance of a CLO.

In contrast to securitizations backed by different tranches of notes issued to investors, or the broad syndications seen in certain fund-level financings, many loan-to-SPV facilities are structured as single-tranche, bilateral loan facilities between a single bank (or a small syndicate of banks) lending directly to the SPV. Although the SPV is often a wholly owned subsidiary of a parent BDC or other investment vehicle, the parent fund typically does not provide direct credit support beyond a limited indemnity for bad acts and other limited exceptions. The parent fund is also often party to the transaction documents as the "Collateral Manager" responsible for the management of the portfolio held by the SPV (this is often true even if the parent fund is managed by an external adviser, meaning that the adviser is not required to be party to the transaction documents).

What are the common features that distinguish loan-to-SPV facilities?

The composition of the portfolio in a loan-to-SPV facility is often tightly restricted. It is not uncommon for lenders to have an up-or-down right to approve the inclusion of any asset in the portfolio, whether or not funded with advances under the facility. Eligibility criteria and concentration limits for inclusion of assets in the borrowing base tend to be narrower than those governing fund-level revolvers, and are often curated to a pre-determined strategy (e.g. a portfolio exclusive to broadly syndicated loans (BSL)). Advance rates for different asset categories also tend to be lower than at the fund level (for example, a liquid, performing first-lien loan, which might receive an advance rate of 75–85% in an ABL revolver, might receive an advance rate of only 65–75% in an SPV facility). It is rare for equity to receive any credit in the borrowing base. Many facilities require a standing equity cushion to the borrowing base as well.

Asset valuation is a critical component for managers to evaluate when considering a loan-to-SPV facility. Certain facilities, particularly those backed by a liquid portfolio, permit the lender to mark any or all of the assets in the portfolio to market at their discretion at any time. Another common approach is for assets to be valued at their initial purchase price (with near-par trades or loans issued with original issue discount treated as being acquired at par), and with the lender having the right to mark down the asset only after the occurrence of one or more specified "value adjustment events" (often including a wide range of triggers such as payment defaults, increases in leverage, declines in EBITDA, and "material modifications" of the underlying loan documents). In many cases, a manager may dispute a lender's valuation, either by obtaining firm bids for liquid assets or by retaining an approved independent valuation firm to value an illiquid asset. However, it is often the case that the lender's valuation will apply during the pendency of a dispute, which can result in the need to cure a borrowing base deficiency in the short-term before the dispute is resolved (this is especially true in an economy-wide crisis like the COVID-19 pandemic in which lenders may mark down assets across the portfolio simultaneously).

Another typical feature in loan-to-SPV facilities is that the borrower's access to cash collections on the portfolio is restricted, with cash proceeds flowing into a controlled collection account and distributed through a periodic (often quarterly) waterfall. Payments to the equity are generally last in the waterfall, subject to re-direction during the reinvestment period to acquire additional assets, or as may be required to cure a borrowing base deficiency (though there is often a scrape at the top of the waterfall to permit collateral management fees to be distributed to the parent fund). SPV facilities sitting below a BDC or other registered fund generally include less flexibility than at the fund level to permit cash to be used for distributions by the parent fund to maintain treatment as a RIC, with distributions to the parent fund for this purpose often subordinated in the waterfall and/or subject to a payment block during an event of default. To avoid cash being trapped at the SPV level between quarterly distribution dates, managers often push for flexibility to elect to run the waterfall on an interim basis, and/or to make interim distributions to the parent fund subject to certain criteria (including *pro forma* borrowing base compliance and sufficient cash to cover the next upcoming waterfall distribution).

What are the implications of the bankruptcy-remote structure?

Structuring a facility as a bankruptcy-remote financing requires a two-pronged analysis: one, that the sales and contributions of assets from the parent fund into the SPV portfolio are "true sales," meaning that if the parent fund were to file for bankruptcy, a court would not recharacterize the sale of the assets as a secured financing from the SPV in which the assets remain part of the parent fund's bankruptcy estate; and two, that a bankruptcy court would not use its equitable powers to "substantively consolidate" the SPV and its assets into the bankruptcy estate of the parent. It is customary for borrower counsel to deliver legal opinions on a reasoned basis that these bankruptcy-remote aspects of the transactions would be respected in a bankruptcy court in the event of a bankruptcy of the parent fund.

While both the true sale and substantive consolidation analyses are detailed and fact-specific, they have structuring implications for bankruptcy-remote financing facilities. For example, the existence of recourse to the parent fund for the performance of the underlying portfolio is a bad fact for the true sale analysis, which operates as a significant limitation on the ability of the parent fund to guarantee or backstop the obligations of the SPV. In addition, true sale considerations limit the ability of the parent fund to repurchase assets that have been contributed to the SPV, though market participants have got comfortable with some flexibility for such trades within a modest cap. From a substantive consolidation perspective, key considerations include ensuring that the parent fund and the SPV conduct their operations separately, with no commingling of cash and with clear records demonstrating ownership of assets available to satisfy respective creditors' claims. Additionally, bankruptcy-remote SPVs are expected to have at least one independent director whose consent is required for the SPV to file for bankruptcy or take certain other actions including dissolution and liquidation of the portfolio.

What are some other basic terms that can be expected in a loan-to-SPV facility?

Certain other core terms of SPV facilities are driven by the purpose of the facility, including whether it is a short-term facility for a CLO warehouse or a longer-term leverage facility. In the CLO warehouse context, the expectation is typically that the facility will be outstanding on a shorter-term basis (six to 18 months), and the economics may reflect the expectation that an affiliate of the warehouse provider will place the CLO (for example, the facility may include a margin step-up to incentivize CLO execution, and there may not be an unused fee or a make-whole unless the CLO fails to occur and no placement agency fee is paid). By contrast, a longer-term facility often includes a reinvestment period of between two and four years, with a term-out period of one to three years, often with an unused fee and/or a minimum utilization fee during the reinvestment period (sometimes after a short ramp-up period). It is not uncommon for longer-term facilities to include a make-whole or other call protection in the first 12 to 24 months of the facility.

On balance, what are the pros and cons for managers for loan-to-SPV facilities?

Pros

- Specificity: Facilities can be structured as bespoke vehicles for different strategies (BSL portfolio, CLO warehouse, etc.).
- Economics: Bankruptcy-remote structure and extensive lender control rights lead to more attractive pricing than other comparable products (though make-wholes are more prevalent than at the fund level).
- Insulation: A problem at a bankruptcy-remote portfolio will not necessarily cross-default to the rest of the fund structure, and the fund often retains the ability to step in and cure a default or a borrowing base deficiency before foreclosure or liquidation of the portfolio.

Cons

- Lender Discretion: Lenders often have significant rights (in their "sole and absolute discretion") with respect to the portfolio, including whether to lend against individual assets and how those assets should be valued, meaning relationships between lenders and borrowers and the "trust factor" is an important consideration.
- Call Protection: Make-wholes are prevalent in longer-term facilities, which can complicate efforts to refinance facilities that are not working as intended (e.g., a lender that is no longer approving asset acquisitions or who is aggressive on marking down asset values).
- Trapping of Assets: As a result of the waterfall construct and the limitation on sales to affiliates from a bankruptcy-remoteness perspective, there can be significant limitations on getting cash and assets out of the SPV and up to the parent fund.

C. Hybrid Subscription and ABL Lines

Another common type of fund-level facility not discussed in detail in this chapter is a subscription facility, which leverages the capital commitments of investors in a fund. Subscription facilities are often used in the early stage of funds as they begin to ramp up in order to bridge the period of time necessary to call capital for investments. In order to maximize leverage and terms, one alternative used by managers is a hybrid facility that includes both investor capital commitments and portfolio investments of the fund in the borrowing base. A hybrid facility may take a myriad of forms. Some hybrid facilities have separate interest rates for each borrowing base, while others have blended interest rates that may adjust depending on which portion of the borrowing base is being more heavily utilized. Certain hybrid facilities may be used when there is a weaker investor base or if the investor base lacks the necessary diversity. Other hybrid facilities start off as subscription lines, providing for varying advances linked to the strength of the investors supporting the fund, and set forth a series of benchmarks that, as met, will ease the primary source of credit support toward a more traditional all-assets ABL. Under this latter type of financing, as the capital commitments are called and the fund matures, the hybrid facility evolves into an ABL – investor restrictions and reporting obligations loosen and the collateral focus shifts to the robustness of the asset portfolio. Including all phases and growth mechanics in one facility guarantees consistent access to liquidity, eliminates timing and refinancing uncertainty, and thereby minimizes potential business interruptions (at the risk of leaving all financing options in the hands of one lender or a group of lenders).

D. Collateralized Loan Obligations

What is a CLO?

Collateralized loan obligations (CLOs) are private funds that raise money by issuing varying classes of investment-grade and slightly below investment-grade secured notes and subordinated notes (unrated), preferred equity or other first loss positions. Managers apply the money raised by CLOs to invest in a pool of non-investment grade corporate loans, including loans in connection with leveraged buyouts and recapitalizations. CLOs are structured to provide protections and credit ratings that debt investors find appealing, while maintaining the ability to provide attractive risk adjusted returns to equity investors. Most, but not all, CLOs are actively managed vehicles. The manager (typically called a Collateral Manager) receives a fee for managing the CLO. A Collateral Manager's duties include asset selection, disposition and acting on behalf of the CLO issuer in its day-to-day functioning. Overall CLO issuance decreased in 2020 due to uncertainty around the global COVID-19 pandemic, but volumes surged to record levels in 2021. Although we expect a bit of a pause in the pace of CLO issuance in early 2022 as the leveraged loan and CLO markets adjust to the transition from LIBOR to SOFR as the underlying reference rate for floating rate debt, CLO issuance is largely expected to remain brisk once the markets recalibrate pricing based on SOFR.

What are the different types of CLOs?

The two most common types of CLOs are balance sheet CLOs and arbitrage CLOs. Specialty finance/lending firms tend to use balance sheet CLOs as a means of financing the origination of middle-market loans (Middle Market CLOs). Comparatively, arbitrage CLOs are managed with the goal of producing returns in excess of the borrowing costs of the notes issued by such CLOs. Arbitrage CLOs are generally collateralized by pools of BSL acquired in the secondary market by CLO issuers (BSL CLOs). BSL CLOs make up the vast majority of CLOs, but the last several years have seen significant growth in the issuance of Middle Market CLOs.

What is the typical lifecycle of a CLO?

The typical lifecycle of a CLO includes a warehouse period prior to launching the CLO, a three- to six-month ramp-up period after the CLO closes and a three- to four-year reinvestment period followed by amortization to maturity or call. During the warehouse period, one or more banks will provide financing in the form of a credit facility (such as a loan-to-SPV facility described above) or total return swap (as described below) so as to allow the Collateral Manager the ability to build the initial pool of assets that will back the CLO. Generally, asset accumulation is not complete at the time a CLO closes, and after the CLO closes, the CLO will continue to build its collateral portfolio until an effective date. During this ramp-up period, the CLO will have some relaxed testing standards so as to provide the manager with greater flexibility to finalize the portfolio. CLOs generally allow for reinvestment of principal collections in additional loans during the first three or four years. Reinvestment is subject to compliance with certain transaction tests, as described below. After the reinvestment period, the CLO will enter into amortization, during which the manager has less ability to actively manage the portfolio as the deal winds down. BSL CLOs generally offer more flexibility for managers to invest during the post-reinvestment period than do Middle Market CLOs.

What are the common features that distinguish CLOs?
One attractive feature of CLOs is that the cash flows on the underlying loans of the CLO are the source of payment for the CLO's liabilities, and thus repayment is only required to the extent such cash flows are available to make such payments. This makes CLOs advantageous as compared to funds with market value-based repayment triggers, as such triggers can be extremely punitive in periods of high volatility, particularly when the pricing of underlying loans is declining.

As noted previously, CLOs include key protections that make them attractive to debt investors seeking to invest in a structured finance product. These protections include overcollateralization and interest coverage requirements, which if not satisfied, result in the diversion of excess interest on junior classes of notes to pay down the principal of senior classes of notes. CLOs also provide for collateral quality tests to ensure the underlying loan portfolio meets certain quality standards. If these standards are not generally satisfied, the manager's ability to trade assets on behalf of the CLO during the reinvestment period could be restricted. Finally, the underlying loans in a CLO are required to meet various eligibility and concentration criteria. Such eligibility criteria, protections and other key terms are highly negotiated with both equity and debt investors. Further, the rating agencies providing the ratings to the rated debt issued in a CLO all have their own specific methodology and requirements that are stipulated prior to closing a CLO.

Who invests in CLOs?
CLOs largely attract a wide array of institutional investors. Insurance companies, domestic and foreign banks (including U.S. regional banks), pension funds and the investment arms of large companies typically invest in AAA-rated and other senior CLO note classes. Hedge funds, credit arms of private equity firms, insurance companies and other credit opportunity funds typically invest in mezzanine and junior CLO notes, as well as in the equity issued by CLOs. Subject to applicable regulatory laws, foreign investment is generally permitted in CLOs, with much of such foreign investment deriving from Europe, Japan and South Korea in recent years.

On balance, what are the pros and cons for managers of CLOs?
Pros

- Fees and Returns: Managers can use BSL CLOs to generate management fee revenue and to provide investors in other funds managed by it with returns on equity in its CLOs (to the extent its managed funds invest in CLO equity).
- Cost Effective Financing: For firms with middle market lending operations, Middle Market CLOs are attractive financing vehicles for such lending operations because the cost of borrowing through CLO vehicles is generally lower than through other forms of financing and Middle Market CLOs create opportunities for their managers to form long-term relationships with debt investors that invest in the manager's CLOs.
- Investor Protections: CLOs provide protections and credit ratings that debt investors find appealing.
- Ramp-Up Flexibility: Ramp-up periods allow managers to continue to build the underlying portfolio as they take advantage of CLO financing.
- Reinvestment: CLOs allow for reinvestment so that experienced managers can trade loans and generate higher returns for equity investors.
- Cash Flow: Cash flows on the underlying loans of the CLO are the source of payment on CLO notes and therefore repayment is only required to the extent of available cash flows.
- Interest Rates: As most of the liabilities issued by a CLO are floating rate-based (as are the underlying assets), CLO liabilities are not as sensitive to rising interest rates. Alternatively, in a low interest rate environment, the coupons offered on CLO liabilities are traditionally more attractive than the return in many asset classes.

Cons

- Limitations in Workouts: Although CLO reinvestment criteria are intended to provide a certain amount of flexibility for the Collateral Manager, they do have their limits. In particular, such criteria have historically limited the ability of CLO managers to maximize value when underlying loans undergo workouts, restructurings or other distressed scenarios. In fact, recently, distressed debt investors have utilized these inherent restrictions against CLOs so as to intentionally structure workout transactions in a manner largely benefiting the non-CLO lenders in the lending group. However, the CLO market in 2020 began to coalesce around certain strategies to level the playing field in the workout/restructuring context and continued to refine these strategies in 2021. Further, Collateral Managers have been able to negotiate better flexibility (by historical standards) in regard to this issue in their recent vintage CLOs.
- Rating Agency Requirements: Because CLOs are rated, Collateral Managers have to structure CLOs to satisfy rating agency requirements in addition to investor stipulations, which places additional limitations on flexibility to manage the portfolio.
- Ratings Volatility: The underlying collateral of CLOs is required to have ratings or credit estimates, which subjects CLOs to potential ratings volatility. As we saw in the second quarter of 2020, sharp downgrades in ratings on underlying loans can cause haircuts to the valuation of these assets (which can in turn make the valuation of the asset more sensitive to its market value at a given time). Thus, even though CLOs are cash flow-based, in a period of high volatility in the leveraged loan markets, the various tests and triggers imbedded within a CLO expose it to broader market and credit risks.

In sum, the unique structure of CLOs coupled with debt investor protections make CLOs a useful and cost-effective tool for asset managers. Even taking into account the turbulence of 2020 and 2021, CLOs in aggregate remain the largest lender to the leveraged loan market and this is likely to be the case for the foreseeable future.

E. CLO/ABS Hybrid Transactions

What are Hybrid Structures?
A relatively niche product in the securitization space that we are seeing employed more routinely is the hybrid CLO/ABS structure (Hybrid Structures). Based on more traditional asset-backed securitizations (ABS) that initially emerged after the credit crisis, these transactions offer attractive yields to debt investors while at the same time offering sponsors in the middle market space better flexibility to finance loans that are viewed as niche products relative to regular-way middle market corporate loans. In particular, these Hybrid Structures have been utilized to finance loans to venture-backed obligors in the technology, software and healthcare sectors, which are seen as carrying a higher risk profile than traditional middle market loans backing private equity-sponsored buyouts. More recently, the Hybrid Structures have become a preferred method of financing recurring revenue loans and late stage lending loans.

How are Hybrid Structures structured?
From a structural and legal documentation perspective, Hybrid Structures are relatively straightforward. Typically, one or more funds managed by the sponsor will sell assets down to a special purpose entity issuer. The issuer finances the acquisition through the issuance of debt and the equity is retained by one or more of the selling funds. Although older transactions in this space utilized a Delaware statutory trust for the issuer, more recent deals have used Cayman domiciled entities (again, similar to a CLO). Importantly, Hybrid Structures are cash flow-based and utilize a borrowing base approach versus the coverage test features typically seen in CLOs.

What are the common features that distinguish Hybrid Structures?
One looking at the older vintage of these transactions might be surprised at their recent growth. The portfolios were often static with some limited availability for substitution, so the sponsor/manager was relatively constrained in its options regarding management of the portfolio. Further, certain triggers based on the amount of delinquent and/or defaulted assets in the portfolio would trigger early amortization of the portfolio. Generally speaking, although a securitization, they looked more akin to a traditional loan-to-SPV financing. However, recent incorporation of traditional CLO mechanics (such as reinvestment periods and greater flexibility for the acquisition and disposition of assets), have provided attractive flexibility for middle market sponsors of various stripes. Further, the assets securitized in these transactions are not required to have a rating or credit estimate, which, when combined with a borrowing base approach that does not utilize haircuts to the assets such as what one sees in the overcollateralization tests in a CLO, helps to safeguard the transaction from market price risk. Finally, these Hybrid Structures have often employed a revolving loan tranche (something relatively rare in post-credit crisis CLOs). This revolving tranche provides the issuer greater flexibility to manage unfunded commitments and/or the acquisition of additional assets into the portfolio.

Who invests in Hybrid Structures?
Historically, investors in this space were largely insurance companies, pension funds and banking institutions. Although that largely remains the case, more recent transactions have seen an increase in primarily traditional CLO investors (hedge funds, credit funds and other non-bank credit investors).

What is the outlook for Hybrid Structures?
As credit platforms targeting all spectrums of the middle market continue to grow, we expect to see further growth in the Hybrid Structure space. Many traditional Middle Market CLOs are not designed to hold the assets that are primarily financed in Hybrid Structures for one or more reasons. Various lenders will provide financing for such assets, but the Hybrid Structures provide an overall better cost of funding and flexibility. It would not be surprising to see regular issuance of Hybrid Structures from many of the current leading Middle Market CLO managers in the years to come. Further, we expect this particular product will continue to be attractive amongst large investors seeking higher yield opportunities in this current low interest rate environment.

On balance, what are the pros and cons for managers of Hybrid Structures?
Pros

- Attractive Yields: Hybrid Structures provide attractive yields to debt investors and offer middle market sponsors flexibility to finance niche finance loans.
- Ease: Straightforward from a structural and legal documentation perspective.
- Flexibility: Recent incorporation of traditional CLO mechanics have provided Hybrid Structures with attractive flexibility.
- No Asset Ratings or Borrowing Base Haircuts: Underlying assets are not required to have a rating or credit estimate and the borrowing base is not haircut, all of which help to insulate the transaction from market and credit risk.

Cons

- Niche: Application is limited to niche assets such as loans to venture-backed technology and healthcare sectors, recurring revenue loans and late lending stage loans. These types of loans are generally considered to have a higher risk profile and are fairly illiquid.

II Unsecured Notes

A. Rated Note Structures

What is a rated note?
A rated note is a type of security issued by investment funds that allows insurance companies to invest in those funds on a more capital-efficient basis. Managers offering interests in their private funds to domestic and foreign insurance companies will often structure these offerings as rated note issuances. Insurance companies are typically required to hold regulatory capital against investments in debt and equity securities. When investing into a fund as a limited partner, shareholder or other equity investor, insurance companies are required to hold higher amounts of regulatory capital against that investment than they would against debt issued by the same fund. A rated note may allow an insurance company to characterize a portion of its investment as a debt investment, and incur a lower regulatory capital charge, while obtaining a return that is linked in part to the performance of the underlying fund by also holding the equity in the fund.

How are rated notes structured?
The terms of a rated note offering will usually reflect the terms and structure of the underlying fund. For example, investors in rated notes typically are required to fund the principal amount of the note over time, *pro rata* with capital called from the equity investors. Investors in rated notes may also have the ability to reduce the outstanding principal amount of the notes in the same manner in which equity investors may be able to redeem from the underlying fund.

A rated note structure will typically have at least two tranches, a senior or debt tranche that will be rated and a junior or equity tranche that provides the subordination required to support the senior tranche rating. In some structures, depending on the type of assets in the underlying fund portfolio, the note may include a mezzanine tranche. While the mezzanine tranche will have a lower rating than the senior tranche, it may still allow the insurance company to treat this tranche as debt rather than equity. Usually, but not always, the debt, mezzanine and equity tranches will be "stapled" – that is, issued together as a single investment unit that will not allow for the separate sale or transfer of any individual tranche.

A rated note structure allows for a significant amount of flexibility for both managers and insurance companies. The senior tranche, like other debt securities, will have a fixed maturity and interest rate. However, the senior tranche may pay a supplemental distribution that captures additional investment returns of the fund during a particular interest period. Alternatively,

particularly in stapled structures, the excess returns may go to the related equity. To address potential underperformance by the fund, the interest payable on the senior tranche typically allows for PIK interest. Rated notes are usually not secured, although in some structures the feeder fund issuer may pledge to noteholders its investment in the master fund.

What type of vehicles issue rated notes?
A rated note can be issued by a dedicated feeder fund, established for the sole purpose of issuing the notes. This feeder fund would be established as another feeder fund to invest alongside traditional domestic and offshore feeder funds into a master fund. This approach allows managers to offer a rated note structure if, for example, demand for this type of investment arose after the underlying fund's initial close. In other cases, managers may establish a single feeder fund as part of the initial launch of the underlying fund to issue both limited partnership interests and rated notes. This approach can reduce the cost and expense associated with administering and operating a separate dedicated feeder fund. Other managers use a parallel rated notes fund that invests *pro rata* with the other parallel fund(s).

How does the NAIC view rated note offerings?
The National Association of Insurance Commissioners (NAIC) is currently reviewing these types of structures, including collateralized fund obligations (CFOs), which are similar to rated notes but include collateral support for the principal and interest payments on the debt tranches. The NAIC is concerned that certain types of CFOs, rated notes and other similar structured securities may be repackaging an equity investment into a debt security that attracts a lower capital charge. The NAIC has been in extensive dialogue with industry participants on the matter and a formal NAIC response to address these concerns is expected in the first quarter of 2022.

On balance, what are the pros and cons for managers of rated note offerings?
Pros

- Potential for Optimized Capital Treatment: Rated notes may allow insurance companies to invest in private funds in a manner more efficient than investing directly as a limited partner or other equity investor.
- Ease of Execution: Rated notes can be issued from a feeder fund that has been established for this purpose without interfering with the operations of existing feeder funds.
- Flexibility: Rated note structures allow insurance companies to invest substantial amounts in securities with a fixed return, with the potential for upside from the notes themselves or the related equity. In addition, the required interest payments on the senior and mezzanine tranches may be PIK.

Cons

- Regulatory Review: The NAIC is currently reviewing rated notes, CFOs and other similar types of structured securities. The outcome of this review could result in the elimination in whole or part of the regulatory capital benefits available to insurance companies investing in rated notes.
- Formal Securities Offering: An issuance of rated notes is substantially similar to other issuances of debt securities, which will require a private placement memorandum, indenture and other customary documentation.
- Negotiation: Because rated notes can be structured in a variety of different ways depending on the investment objectives of the prospective purchasers, additional time may be required to negotiate and structure each separate rated note offering.

B. Baby Bonds

In contrast to private placement notes under the American College of Investment Counsel's Model Note Purchase Agreement (the Model NPA)[1] and rated note issuances discussed above, which are marketed and sold to insurance companies and other institutional purchasers, registered funds such as BDCs may seek to issue debt instruments that may be marketed and sold to both institutional and retail investors. "Baby bonds" are designed to access this pool of potential debt investors.

Baby bonds – key terms

- **Small minimum denomination**. Unlike conventional or institutional bonds, which are typically sold in minimum denominations of $1,000 or more, baby bonds are sold in small denominations such as $25. This smaller minimum investment in notes facilitates public trading and broadens the pool of potential purchasers, such as retail investors, who may not be comfortable buying and selling securities in $1,000 increments.
- **Senior unsecured notes**. Baby bonds are typically structured as senior unsecured notes, ranking *pari passu* with other unsecured and unsubordinated debt of the fund. As with the other fund-level unsecured debt, baby bonds are effectively subordinated to any secured debt (for instance, senior secured revolver or term loan debt) and structurally subordinated (with respect to assets below the fund level) to any subsidiary debt.
- **Fixed interest rate**. Baby bonds are issued with a fixed interest rate, which may be higher than the rate on other debt available to the fund such as senior secured credit facilities or convertible notes discussed below. In recent years, it has been common for BDC baby bonds to be issued with a coupon between 5% and 7%.
- **Quarterly interest**. Baby bonds are often structured to pay interest quarterly, unlike the typical semi-annual interest payments in higher-denomination institutional bonds.
- **Relatively long maturity**. Baby bonds provide a relatively long-term source of debt capital, with maturity extending out five to 10 years, and in some cases longer.
- **Issuer right to call**. The relatively long maturity may be unattractive to the issuer in a declining interest rate environment, and funds can mitigate this risk by including an optional redemption feature in baby bonds. Baby bonds are often callable at par, with a no-call period significantly shorter than the maturity date. By way of example, a seven-year note may be callable at par after three years, a 15-year note after five years.
- **Limited negative covenants**. Unlike, for instance, private placement notes under the Model NPA, which include extensive and often heavily negotiated covenants, baby bonds are typically issued pursuant to an indenture that includes few covenants restricting the fund going forward, often limited to key concerns of debt investors such as leverage restrictions.

Baby bonds – manner of sale

- **Registered underwritten offering**. To permit wide marketing and sales to non-institutional investors (unlike private placements, which are limited to certain institutions or in some cases sophisticated accredited investors), baby bonds are sold in an underwritten offering that is registered with the Securities and Exchange Commission (SEC). This requires the filing of an N-2 registration statement and clearing SEC review and comment prior to going

effective. The offering is marketed by the issuer's underwriters using a prospectus supplement that includes, or incorporates by reference, extensive disclosure regarding the issuer, the offering and the notes.

- **Exchange listing**. To facilitate trading, baby bonds are listed on a national securities exchange. As with other features, exchange listing and convenient trading enhances the attractiveness of baby bonds to potential retail and other smaller investors.

C. Convertible Notes

As another alternative available to registered private debt vehicles considering the issuance of senior unsecured debt, convertible notes can provide access to capital from investors seeking the seniority of a note along with the potential upside available through future conversion into equity.

Convertible notes – key terms

- **Senior note**. Convertible notes are typically senior unsecured notes and are often structured with a fixed interest rate over several years to maturity (though there are also convertible notes structured with no coupon or yield to maturity), providing investors a current yield along with the downside protection afforded senior debt instruments. The interest rate on convertible notes will typically be lower than comparable instruments that lack potential conversion into equity (such as baby bonds or $1,000-par senior unsecured notes).
- **Conversion features**. Convertible notes provide for the potential conversion into equity. The conversion price is typically set at a premium to the then-current market price of the underlying equity security, typically at or in excess of 10%.
- **Anti-dilution**. The initial conversion rate is subject to adjustment for dilutive events, such as stock splits, stock dividends or the payment of cash dividends or distributions above a negotiated threshold.
- **Complex instruments with many variables**. Convertible notes offer a wide variety of features and are subject to complex tax and accounting considerations (for instance, to maintain treatment as debt). Key variables include the extent of any covenants included in the governing indenture (which may be limited), change of control or fundamental change protections, call protections and redemption terms, settlement methods on conversion (cash, shares or a mixture thereof) and whether conversion is fixed or contingent.

Convertible notes – manner of sale

- **Rule 144A offering to QIBs**. While other mechanics, such as a registered underwritten offering, are available, a convertible note issuance is often conducted as an unregistered offering under Rule 144A under the United States Securities Act of 1933, as amended (the Securities Act). Under Rule 144A, initial purchasers (analogous to underwriters in a registered offering) acquire the convertible notes from issuer in a private placement and immediately resell to Qualified Institutional Buyers (QIBs). QIBs are generally institutions that own or invest at least $100 million of unaffiliated securities on a discretionary basis.
- **Fungibility under Rule 144A**. Convertible notes issued in a Rule 144A offering must not be fungible with the listed equity security, requiring a conversion price premium of at least 10% (note that this is the lower limit and there are many Rule 144A issuances with greater conversion premiums).
- **Registration rights**. While senior notes issued in a Rule 144A offering are often subject to registration rights requiring the issuer to conduct a registered exchange offer to issue freely tradable securities, convertible notes are typically not subject to registration rights. Instead, QIBs may trade with other QIBs pursuant to Rule 144A and the issuer may agree to take steps to allow holders to sell under Rule 144 and remove the restrictive legend from notes held by non-affiliates after satisfaction of the relevant holding period.
- **Offering memorandum**. Rule 144A offerings are conducted using a confidential offering memorandum including disclosure similar in scope to what would be required in a registered offering.

D. Private Placements under the ACIC's Model NPA

What are 4(a)(2) Notes?

We use the term "4(a)(2) Notes" to describe unsecured notes issued in private placements pursuant to Section 4(a)(2) of the Securities Act, and documented using the Model NPA. Investors in 4(a)(2) Notes are typically insurance companies and other large institutional investors, which may be domestic or located outside of the United States.

How is the Model NPA Structured?

The Model NPA contains many of the necessary deal terms and mechanics that would be included in a note purchase agreement and an indenture. In particular, the Model NPA includes standard closing mechanics, conditions precedent, representations and warranties of the issuer and the purchaser, information delivery requirements, payment provisions (including prepayments with payment of a make-whole amount), affirmative and negative covenants and events of default. This allows for relatively quick and cost-effective negotiation. However, parties may also negotiate additional provisions that are not included in the Model NPA. Of particular note, the Model NPA does not contain any financial maintenance covenants, so these will need to be negotiated between the parties if desired. It is also common for parties to focus their negotiation on the prepayment and make-whole provisions. In addition, parties often add mechanics that allow the issuer to issue additional notes under the same agreement, much like an "add-on" or "re-open" of a traditional indenture.

How do 4(a)(2) Notes differ from Rule 144A notes or registered notes?

Unlike in a traditional notes placement, an issuer using the Model NPA delivers physical notes to noteholders and makes interest payments directly to noteholders. There is no need for an underwriter or initial purchaser (although a placement agent is sometimes engaged), nor is there a need for an indenture trustee or a separate indenture. In placements where notes are issued to a large number of holders, however, the issuer may choose to engage a paying agent to handle interest payments and communications with noteholders. There is often no offering document or, if one is used, it is typically much shorter than a traditional private placement memorandum or prospectus. 4(a)(2) Notes are sold only to large institutional investors that typically hold the notes until maturity. Accordingly, a resale market does not develop, which may result in the issuer obtaining less favorable pricing terms than it would have obtained in a Rule 144A placement or registered offering. 4(a)(2) Notes may be secured or unsecured.

Can the Model NPA be used for loans from private credit managers to its investment vehicles?
Yes. The standard terms and user-friendly mechanics make the Model NPA an effective way to document these loans in a quick and cost-effective manner. Also, it is not uncommon to supplement the Model NPA with affirmative, negative and financial covenants similar to those found in a fund-level revolver.

On balance, what are the pros and cons for managers of 4(a)(2) Notes?
Pros

- Ease of Execution: Relative ease of documentation results in lower costs and faster execution.
- Ease of Administration: A small noteholder base and absence of indenture trustee simplifies consent process and other communications with noteholders.

Cons

- Less Favorable Pricing: Resale restrictions and absence of trading market may result in less favorable pricing terms than in a Rule 144A private placement or an underwritten offering.
- Difficulty of Administration: If 4(a)(2) Notes are sold to a larger number of noteholders, interest payments and noteholder communications can become burdensome and the issuer may need to engage a paying agent to assist.

III Structured Credit Products

A. Product Types

1. Repurchase Agreements
What is a repurchase agreement or repo?
A repo is a bilateral contract pursuant to which the borrower, acting as a "seller," sells to the lender, acting as a "buyer," a portfolio of assets that would ordinarily be pledged to the lender as collateral in a traditional secured financing. The purchase price for the portfolio is effectively the "principal amount" of the financing. Usually, the purchase price is some percentage of the initial value of the portfolio – e.g., 60–70% – which equates to an advance rate. At maturity, the borrower repays the financing by repurchasing the portfolio. Interest payments can either be made periodically or at maturity, where the repurchase price would be increased to account for accrued interest. During the term of the repo, the parties will typically exchange margin periodically to reflect changes in the value of the portfolio of assets.

In situations where it may be too difficult or time consuming to transfer the portfolio of assets, a repo can also be structured so that the assets are retained by the borrower (or a financing subsidiary), and notes can be issued backed by those assets. In this structure, the notes themselves would be sold to the lender under the repo. In addition, the parties may negotiate what rights, if any, the borrower may have in respect of the assets subject to the repo. Repos are typically, but not always, evidenced through industry standard documentation called a Master Repurchase Agreement (MRA) under New York law or a Global Master Repurchase Agreement (GMRA) under English law.

The parties expressly state in the repo documentation that the transactions under the agreement constitute sales and purchases. Nevertheless, the MRA provides for a back-up security interest granted by the borrower as the Seller under the agreement. The MRA states that in the event that the repurchase agreement is recharacterized as a secured loan, the borrower is deemed to have pledged to the lender the portfolio of assets as security that was intended to be sold under the repo.

2. Total Return Swaps
What is a total return swap?
In a total return swap (TRS), a lender agrees to provide to the borrower the investment returns on a portfolio of loans or other assets in exchange for (or "swapped" for) periodic interest payments. A TRS is often referred to as a "synthetic" financing because the borrower does not directly receive any loan proceeds from the lender and does not hold or acquire the assets subject to the financing. Instead, under a TRS the borrower instructs the lender to acquire certain assets, and the lender agrees to make periodic payments to the borrower based on the distributions received from those assets. The borrower may also instruct the lender to dispose of some or all of the assets in the portfolio. In that case, the lender will pay to the borrower any realized gains, and the borrower will pay to the lender any realized losses. The "total return" of the swap means both the distributions on the portfolio, together with any gains or losses on that portfolio, accrued to the borrower. Generally, parties will enter into a TRS on a net basis, where the parties' payment streams are netted against one another with the borrower receiving or paying, as the case may be, only the net amount of those streams.

The borrower will also usually be required to pledge in cash a certain percentage of the initial value of each portfolio asset subject to the TRS, often 20–25%. The inverse of this margin percentage is effectively the advance rate in a TRS. As with a repo, the parties to a TRS will typically exchange margin periodically to reflect changes in the value of the portfolio of assets.

As with repos, the parties will negotiate any rights, particularly voting rights, that the borrower may have in respect of the assets under the TRS. A TRS can also be structured to require that the lender deliver the portfolio of assets to the borrower at maturity. To facilitate this type of physical settlement of the TRS, the lender will often form an SPV to hold the portfolio. At maturity, rather than transferring each individual portfolio asset, the lender will transfer to the borrower its equity interest in the SPV.

The TRS and the related collateral requirements are usually documented on an ISDA Master Agreement, a Schedule that allows the parties to modify the ISDA Master Agreement and a Credit Support Annex that sets forth the key terms of the collateral arrangements.

3. Forward Contracts
What is a forward contract?
In a forward contract, one party (here, the borrower) directs another party (here, the lender) to acquire a portfolio of assets on or after the closing date that will be sold to the borrower for a fixed price at maturity. The purchase price of the portfolio is effectively the principal amount of this type of financing. Interest payments can either be made periodically or at maturity, where the forward purchase price would also take into account accrued interest.

As with a TRS, the borrower will usually be required to deliver an upfront margin amount to the lender, which reflects the borrower's equity position in the portfolio. Similar to both a repo and TRS, during the term of the forward, the lender may mark the portfolio to market and the parties may be required to exchange margin on a periodic basis. In some cases, the lender will also pledge the portfolio to the borrower to secure the delivery of the portfolio at maturity. As with TRS contracts, forward contracts are usually documented on form ISDA documentation.

B. Structural Benefits

Why do borrowers enter into repos, TRSs and forward contracts?

Market participants structure financings as repos, TRSs and forward contracts for a variety of reasons. These transactions are entered into on industry-standard documentation that can reduce the required time and effort for negotiation and drafting. In some cases, legal opinions may not be required.

In addition, the "lender" in these types of contract enjoys preferential treatment under the Bankruptcy Code in the event of a borrower's insolvency. These contracts can be structured to qualify as protected contracts under certain applicable sections of the Bankruptcy Code. As such, a lender's contractual right to cause the "liquidation," "termination" or "acceleration" of the relevant contract generally may not be stayed, avoided or otherwise limited by operation of any provision of the Bankruptcy Code. This safe harbor from the automatic stay will also typically allow the lender to set aside less regulatory capital against these types of financings.

In addition, in each of a repo, TRS and forward contract, the lender obtains an ownership interest over the portfolio rather than a security interest in pledged collateral. The lender does not have to be concerned with obtaining a perfected security interest over the assets or with a foreclosure process in the event of a default. These structural features of repos, TRSs and forward contracts address a number of credit and market risks inherent in traditional secured financings, and together with the regulatory capital benefits for the lender, often provide borrowers with materially better financing rates.

On balance, what are the pros and cons for managers of repos, TRSs and forward contracts?

Pros

- Cost Efficient Financing: these types of products generally allow lenders to provide more attractive financing rates due to reduced capital charges.
- Ease of Execution: these products are often documented on industry standard forms that can reduce the time needed to negotiate and draft the documentation. In some cases, particularly with TRSs, legal opinions may not be required.
- Follow on Financings: once the parties agree to the documentation for an initial repo, TRS or forward, this documentation can be used for additional similar financings between the parties even in situations when the underlying assets being financed may differ.

Cons

- Ability to Manage Assets: with these products, the lenders will acquire and hold the assets being financed through the term of the transaction. Borrowers will need to negotiate what rights (e.g., voting rights) they may exercise with respect to those assets prior to the maturity of the transactions.
- Margining: each of these products will typically require periodic mark-to-market margining, which may present challenges to borrowers with liquidity needs during stressed market conditions.
- Abstruse Terminology: the standard documentation for these products, particularly TRSs and forward contracts on ISDA documentation, includes terms and provisions that may be difficult initially to understand and navigate.

As described above, there are many financing options available to a manager and each has its advantages and disadvantages. Many of the managers we advise have been able to successfully utilize several of these structures, often simultaneously, to leverage their investment portfolios and finance their private debt platforms at all levels. The availability of these structures permits managers to pursue a flexible and diversified leverage strategy that aligns with their overall investment strategy and that can adapt to evolving market conditions.

Endnote

1. The ACIC currently publishes four forms of model NPAs. The appropriate model depends on whether the issuer is a U.S. or non-U.S. issuer and the issuer's credit rating.

Contributors

This chapter was written by Dechert's Global Finance Group, with contributions by Jay Alicandri, Christopher Duerden, David Griffin, Ian Hartman, Angelina Liang, Edward Newlands and Matthew Virag.