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# In the Tranches: Subline Issues in Structured Credit

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***In the Tranches*** is a videocast in which Proskauer's Structured Credit partners discuss the transactions, strategies, and developments shaping structured credit. Together, we explore the issues driving the market — from collateral and cash flow analysis to capital structure, credit enhancement, financing terms, documentation, and the future of asset-backed and private credit finance. We aim to help market participants navigate evolving asset performance, documentation, regulation, liquidity, and investor demand across the asset-backed finance and esoteric securitization markets, including warehouse facilities, CLOs, CFOs, rated note feeders, and other bespoke financings.

In this episode, we discuss the challenges of including a rated note issuance from a fund platform in the subscription facility borrowing base of the underlying fund and explore potential solutions to common issues.

Blake Gilson: Hello, I'm Blake Gilson. I'm a partner here in the Structured Credit Group at Proskauer, and welcome to a new episode of *In the Tranches*, our video podcast where we examine issues in the structured credit market. Today, I'm joined by my partners Jon Burke and Stew Ross, and we're going to be discussing sub-lines in the structured credit context. I'll let you guys introduce yourselves.

Jon Burke: Yeah, I'm Jon Burke. I'm a partner in the Structured Credit Group. I primarily represent asset managers and CLO and warehouse ABL transactions. I'm excited to be here today and discuss with Stew.

Stew Ross: Thank you, Jon and Blake. I'm Stew Ross. I'm a partner in the Fund Finance Group, handling the full range of fund finance transactions, including these subscription credit facilities, NAV facilities, GP financings, et cetera.

Blake Gilson: Thanks, Jon and Stew. So, as I said earlier, we're here to discuss sub-lines in the context of structured credit. And so, let's first of all just level step by talking about what a sub-line is. Stew, every fund has a sub-line, right? Can you tell us about that?

Stew Ross: Pretty much. They really have become ubiquitous these days. You know, often right after the initial closing of the funds, the fund manager will want to put a sub-line in place for working capital for the fund, expenses, bridging capital contributions, providing letters of credit, sometimes secured hedging, or some managers will use them for longer term leverage. You know, there's really a wide range of use cases for these subscription credit facilities. So, they're very popular. To define what is a subscription credit facility, it's really defined by its collateral. A subscription credit facility is any one that is secured by the uncalled capital commitments of the fund and the account into which those capital commitments are funded by the investors. Sometimes that will also include collateral below the funds, which we'll refer to as a hybrid facility. But any subscription credit facility is defined by that pledge of capital commitments.

Blake Gilson: Right. Thanks very much, Stew. Right. And so, in my world and in Jon's world,  where we're doing these structured credit products, the funds subscription facility can intersect in various ways. So, for example, in rated note feeders, which are a product that I work on commonly, they are always going to be an issue because a rated note feeder is, after all, a feeder into a fund, and therefore it has an aspect of it where it's a limited partner in that fund. And therefore, the capital commitments that back that rated note feeder are — or should be part of the borrowing base for that, for that fund sub-line.

Now, it's not always the case because in some situations, I've seen managers say, "We don't need borrowing-based credit against this feeder", but the vast majority of cases, they're looking for borrowing-based credit. And so, one place where I'll see this is in what we call a vertical rated note feeder. So, for those that are not familiar, a vertical rated note feeder is one where every investor into the rated note feeder takes a vertical strip, a pro rata slice of every tranche issued by the rated note feeder, including the debt tranches and the equity. And there I would generally see, you know, an equity commitment letter being sufficient to get sub-line lenders comfortable. That's a commitment letter from the investors that their debt commitments may be treated as equity in the case of the sub-line lender wants to call on those commitments in satisfaction of the sub-line facility. Stew, is that what you see?

Stew Ross: Yeah, and you know, those obligations, they could be in an investor letter from the investors, or in this case, from rated note investors holding debt commitments in the rated note feeder, or they could be in the feeder's documents itself. You know, sometimes the note purchase agreement will contain these acknowledgments and waivers from the investors that are needed to get the sub-line lender comfortable. We see different approaches that way. But essentially, the sub-line lender wants these note investors to be giving all of the same sorts of undertakings that it sees from its regular equity investors in the fund. It doesn't want to make any exceptions for the rated note feeder investors.

Jon Burke: So sorry. To interject — are you saying that if the rated note feeder sort of governing transaction documents don't, like, the CPs to funding aren't met, but like, let's say there is a funding under the sub-line, like, the sub-line lender would want basically the investors to sort of acknowledge that they still have to fund notwithstanding the CPs if the rated note feeder documents aren't satisfied?

Stew Ross: Yeah, and that's a tricky one. You know, of course, you need to close the rated note feeder, but it would want the standard waivers, for instance, that there are no defenses, set-offs, or, you know, excuses to funding their note commitments in the same way that they get those same waivers from the equity investors and the funds.

Blake Gilson: Speaking as having worked on these note purchase agreements directly, Jon, you raise a good point because that is something investors will pick up on. That said, as a matter of market practice, investors will usually get over the hump if you tell them: this is to satisfy the sub-line lender. Because at the end of the day, those investors want the benefit of the sub-line, which for the investor is the ability to fund on something like 10 business days' notice, as opposed to two business days' notice or three business days' notice. And also the ability to fund regularly, say once a quarter when the fund trues up their sub-line, as opposed to randomly whenever investment is identified at the fund level. So I want to say a word, and Stew, I want to get your take on this. The reason, my understanding of the reason why sub bond lenders in particular focus on rated note feeders and whether or not to give full credit to those commitments or what sorts of documentation they will need in order to give full credit for the commitment of a rated note feeder, part of which is backed by debt commitments at the investor level, is because debt commitments — as opposed to equity commitments of investors — are fundamentally different in a bankruptcy context. And this all comes out of Section 365(c)(2) of the Bankruptcy Code, right, Stew?

Stew Ross: Yeah, that's exactly right. And, you know, there are questions as to whether those debt commitments will always be enforceable in a bankruptcy context. But I think I'd turn it over to you for the details on that.

Blake Gilson: Yeah, well, I think it's interesting because if you look at the statute, it clearly says that the trustee in the bankruptcy of a debtor, so in this case, the debtor here would be the fund and presumably the rated note feeder as well, or even if it weren't the rated note feeder, the rated note feeder would be obligated to fund on the sub-line as a, as a guarantor or as a co-borrower. But in the bankruptcy of, of the fund, those commitments to fund are not freely assumable the way that other contractual obligations would be. So if you look at 365(c)(2) of the Bankruptcy Code, you'll see that in general, the bankruptcy trustee can cause the debtor to assume or reject contracts. And so contracts that are revenue positive, it will assume, and contracts that are revenue negative, it will reject, presumably, to improve the overall health of the debtor so that it can cover more of its obligations and emerge in bankruptcy able to continue to perform and function and grow. But 365(c)(2) says that if you're a lender to that entity, you are not going to be obligated to lend into the bankrupt entity. And this is different from the equity commitments, which are not specifically discussed in 365 of the Bankruptcy Code, but therefore most people believe can be enforced in the bankruptcy. That is to say, if a fund were bankrupt and limited partners of that fund had commitments remaining to that fund, the fund would be able to assume those commitments and cause them to fund into the fund. Whereas with the debt commitments, it's pretty clearly not the case unless you work around that in some way. And so I see in no purchase agreements that I work on waivers of 365 of the Bankruptcy Code on behalf of the debtors — of the debt holders and other provisions as we were discussing. And this comes up in a vertical rated note feeder where all the investors are essentially like LPs who happen to hold some notes and therefore are willing to sign all kinds of documentation to waive their rights as debt holders. In a CFO — or a horizontal rated note feeder, which we'll come to in a minute — it's a little bit different. Jon, do you want to talk about what a CFO looks like and why this is more of an issue there?

Jon Burke: Yeah, I mean, you know I think we discussed in our last podcast, there's two types of CFOs, right? We have a GP-led CFO and an LP-led CFO. I think for these discussion purposes, like an LP-led CFO isn't as relevant because in almost every case, like those deals are fully funded, so you don't have to worry about the investors necessarily being called — the investors in the CFO being asked to sort of fund additional sort of draws on the CFO notes, right? But in a GP-led CFO, typically there — they are undrawn, right? And I guess you're seeing the same sort of issues that you would see in a rated note feeder that you would see in like a CFO?

Blake Gilson: Yeah, right. And what I see in a horizontal rated note feeder again is definitely that sub-on lenders will require significantly stronger language protecting their rights, right Stew? Do you want to talk about some of the things that you would — you would see in a — in a debt issuance document for a horizontal rated note feeder?

Stew Ross: Sure, And quickly getting back to the enforceability, I feel like a big part of that is the case — the [**Laughter**] court decisions. You know, I mean, for the enforceability of equity commitments, we've got a valuable case, the Iridium case in Delaware. And so long as the lenders are reasonably relying upon the investors' capital commitments in making the facility available, you know, that they are comfortable, that those capital commitments are going to be enforceable, including in a bankruptcy context, in order to repay the debt. And so kind of waiting for a decision to come down at some point, getting, you know, one good court precedent to establish that same sort of pattern for debt commitments would be extremely valuable. So that could change the landscape here. But yeah, in terms of language that the lender is looking to see in a note purchase agreement to ensure that — that it can enforce against debt holders, looking for the same sorts of obligations from those debt holders about these commitments being able to be called in the form of equity from day one, really, you know, which really puts the lender in the same position as any other feeder funds, you know, as it would be vis-a-vis any other feeder fund and the investors in that feeder fund. So that's been the solution that lenders counsel have been asking for, that all of these debt commitments also be able to be called in the form of equity and not in a just springing upon bankruptcy, but you know right from the start of the fund upon any event of default on the subscription credit facility.

Blake Gilson: Absolutely. Yeah. And I've seen the same thing. And I would add also that the devil is really in the details. And in addition, that perhaps because there isn't the comfort of good case law out there that we've seen, at least in the deals I'm working on, we've seen sub-line lender counsel become increasingly demanding on the details of how these provisions are laid out. So if you have language that may have worked in getting sub-line credit for a horizontal rated note feeder a year ago, you can't assume that same language will pass muster now. And I am now encouraging all of my sponsor clients that want to get sub-line credit to have the note purchase agreement shared with sub-line lender counsel prior to closing the rated note feeder. So it used to be the case that you might be able to go to them later and you'd basically have something you knew would work, and that's not the case anymore. So we do need to make sure sub-line lender councils looped in early. So lastly, I guess I just wanted to touch briefly on ABLs and their interaction with the sub-lines. Stew, do you want to talk a little bit about how those work together and maybe we'll get Jon's take?

Stew Ross: Sure, you know just real quick, you know an ABL is the, the term that we typically use for putting financing in place on their underlying assets. So it's the underlying loans of these private credit funds being financed with an asset-based loan, the ABL. And so they would typically create a special purpose vehicle below the fund that would hold these loans and be the borrower under that ABL. And we sometimes see that financing combined with the subscription facility of the funds. You can pledge both the uncalled capital commitments of the funds and its underlying assets for a type of hybrid facility. But sometimes that's cumbersome, and sometimes you can get better terms using two separate facilities. So we do often see one fund have both an ABL down below and a subscription credit facility up above.

Blake Gibson: Great. And Jon, do you see this as well, hybrid facilities, or you primarily work with—

Jon Burke: Yeah, right. I mean, managers — our manager clients sometimes explore them. I think a lot — I mean, Stew, let me know if you have a different experience, but I think a lot of times that's that sort of structure is being proposed by the lenders and not by the borrowers. The reasons you said, right? Like I think it's — you could probably get better pricing by separating them.

Stew Ross: Yeah, yeah but lenders, they of course — they, they want more of that business. And I often see it actually in the context of continuation vehicles. When you see a private credit fund CV, you often see a hybrid solution where the lenders want more security, they want a big financing package to secure their obligations, and they'll take both sets of collateral.

Blake Gibson: Great. All right, well, this has been a really interesting discussion. Thanks, both gentlemen, and we hope that the listeners have gotten something out of this as well. We look forward to seeing you on Episode Three of *In the Tranches* on a topic yet to be discussed.

Jon Burke: Thanks, Stew.

Stew Ross: Thanks, Jon. Thanks, Blake. Bye.

Blake Gibson: Thanks, Stew and Jon.

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