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# CONTENTS

<b>Introduction</b>	Wes Misson & Sam Hutchinson, <i>Cadwalader, Wickersham &amp; Taft LLP</i>	
<b>Expert analysis chapters</b>	<i>NAV and hybrid fund finance facilities</i> Leon Stephenson, <i>Reed Smith LLP</i>	1
	<i>Collateral damage: What not to overlook in subscription line and management fee line facility diligence</i> Anthony Pirraglia, Peter Beardsley & Richard Facundo, <i>Loeb &amp; Loeb LLP</i>	15
	<i>Derivatives at fund level</i> Jonathan Gilmour, Peter Hughes & Joseph Wren, <i>Travers Smith LLP</i>	27
	<i>Subscription facilities: Through the Looking Glass and into Wonderland</i> Jan Sysel, Jons Lehmann & Kathryn Cecil, <i>Fried, Frank, Harris, Shriver &amp; Jacobson LLP</i>	39
	<i>A fund borrower's guide to NAV and Hybrid Facilities: Considerations for a "bankable" partnership agreement for fund-level leverage beyond the sub line</i> Julia Kohen, Ashley Belton Gold & Jakarri Hamlin, <i>Simpson Thacher &amp; Bartlett LLP</i>	50
	<i>Sharpest tool in the shed: A primer on asset-backed leverage facilities</i> Patricia Lynch, Patricia Teixeira & Douglas Hollins, <i>Ropes &amp; Gray LLP</i>	58
	<i>Enforcement: Analysis of lender remedies under U.S. law in subscription-secured credit facilities</i> Ellen G. McGinnis & Richard D. Anigian, <i>Haynes and Boone, LLP</i>	68
	<i>The rise of Hybrid Facilities and increasing use of capital commitments in NAV Facilities</i> Meyer C. Dworkin & Kwesi Larbi-Siaw, <i>Davis Polk &amp; Wardwell LLP</i>	90
	<i>Assessing and mitigating "bad acts" risk in NAV loans</i> Angie Batterson, Brian Foster & Patrick Calves, <i>Cadwalader, Wickersham &amp; Taft LLP</i>	96
	<i>Comparing the European, U.S. and Asian fund finance markets</i> Emma Russell & Emily Fuller, <i>Haynes and Boone, LLP</i>	104
	<i>Umbrella facilities: Pros and cons for a sponsor</i> Richard Fletcher & Yagmur Yazar, <i>Macfarlanes LLP</i>	114
	<i>Side letters: Pitfalls and perils for a financing</i> Thomas Smith, Margaret O'Neill & John W. Rife III, <i>Debevoise &amp; Plimpton LLP</i>	124
	<i>Fund finance lending: A practical checklist</i> James Heinicke, David Nelson & Daniel Richards, <i>Ogier</i>	134
	<i>Assessing lender risk in fund finance markets</i> Robin Smith, Alistair Russell & Holly Brown, <i>Carey Olsen Jersey LLP</i>	146

<b>Expert analysis chapters cont'd</b>	<i>Fund finance meets securitisation</i>	Richard Day & Julia Tsybina, <i>Clifford Chance LLP</i>	158
	<i>Fund finance in Ireland and Luxembourg: A comparative analysis</i>	Jad Nader, <i>Ogier, Luxembourg</i>	
		Phil Cody, <i>Arthur Cox LLP, Ireland</i>	166
	<i>Fund finance facilities: A cradle to grave timeline</i>	Bronwen Jones, Kevin-Paul Deveau & Brendan Gallen, <i>Reed Smith LLP</i>	178
	<i>Newer liquidity solutions for alternative asset fund managers – increasingly core</i>	Jamie Parish, Danny Peel & Katie McMenamin, <i>Travers Smith LLP</i>	188
	<i>The rise of ESG and green fund finance</i>	Briony Holcombe, Robert Andrews & Lorraine Johnston, <i>Ashurst LLP</i>	196
	<i>Robust liquidity solutions for complex Cayman Islands fund structures</i>	Agnes Molnar, Richard Mansi & Catharina von Finckenhagen, <i>Travers Thorp Alberga</i>	205
	<i>More than a decade of global fund finance transactions</i>	Michael Mbayi, <i>Pinsent Masons Luxembourg</i>	217
	<i>NAV's meet margin loans: The rise in single asset financings</i>	Sherri Snelson & Juliesa Edwards, <i>White &amp; Case LLP</i>	224
	<i>Regime change but business as usual – updates to sanctions and restructuring regimes in the Cayman Islands</i>	Alexandra Woodcock & Danielle Roman, <i>Mourant</i>	235
	<i>VC vs PE: Comparing the venture capital and private equity fund financing markets</i>	Cindy Lovering & Corinne Musa, <i>Cooley LLP</i>	245
	<i>Subscription facilities: Key considerations for borrowers – a global experience</i>	Jean-Louis Frognet, Caroline M. Lee & Eng-Lye Ong, <i>Dechert LLP</i>	251
	<i>Innovative rated note structures spur insurance investments in private equity</i>	Pierre Maugüé, Ramya Tiller & Christine Gilleland, <i>Debevoise &amp; Plimpton LLP</i>	261
	<i>Financing secondary fund acquisitions</i>	Ron D. Franklin, Jinyoung Joo & Allison F. Saltstein, <i>Proskauer</i>	269
	<b>Jurisdiction chapters</b>		
<b>Australia</b>	Tom Highnam, Rita Pang & Jialu Xu, <i>Allens</i>	278	
<b>Bermuda</b>	Matthew Ebbs-Brewer & Arielle DeSilva, <i>Appleby</i>	290	
<b>British Virgin Islands</b>	Andrew Jowett & Johanna Murphy, <i>Appleby</i>	298	
<b>Canada</b>	Michael Henriques, Alexandra North & Kenneth D. Kraft, <i>Dentons Canada LLP</i>	307	
<b>Cayman Islands</b>	Simon Raftopoulos & Georgina Pullinger, <i>Appleby</i>	314	

<b>England &amp; Wales</b>	Sam Hutchinson & Nathan Parker, <i>Cadwalader, Wickersham &amp; Taft LLP</i>	324
<b>France</b>	Philippe Max & Meryll Aloro, <i>Dentons Europe, AARPI</i>	331
<b>Guernsey</b>	Jeremy Berchem, <i>Appleby</i>	338
<b>Hong Kong</b>	James Ford, Patrick Wong & Charlotte Robins, <i>Allen &amp; Overy</i>	346
<b>Ireland</b>	Kevin Lynch, Ian Dillon & Ben Rayner, <i>Arthur Cox LLP</i>	359
<b>Italy</b>	Alessandro Fosco Fagotto, Edoardo Galeotti & Valerio Lemma, <i>Dentons Europe Studio Legale Tributario</i>	374
<b>Jersey</b>	James Gaudin, Paul Worsnop & Daniel Healy, <i>Appleby (Jersey) LLP</i>	384
<b>Luxembourg</b>	Vassiliyan Zanev, Marc Meyers & Maude Royer, <i>Loyens &amp; Loeff Luxembourg SARL</i>	389
<b>Mauritius</b>	Malcolm Moller, <i>Appleby</i>	400
<b>Netherlands</b>	Gianluca Kreuze, Michaël Maters & Ruben den Hollander, <i>Loyens &amp; Loeff N.V.</i>	407
<b>Norway</b>	Snorre Nordmo, Ole Andenæs & Karoline Angell, <i>Wikborg Rein Advokatfirma AS</i>	415
<b>Singapore</b>	Jean Woo, Danny Tan & Cara Stevens, <i>Ashurst LLP</i>	422
<b>Spain</b>	Jabier Badiola Bergara, <i>Dentons Europe Abogados, S.L. (Sociedad Unipersonal)</i>	431
<b>USA</b>	Jan Sysel, Flora Go & Duncan McKay, <i>Fried, Frank, Harris, Shriver &amp; Jacobson LLP</i>	439

# Innovative rated note structures spur insurance investments in private equity

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As insurance companies look for opportunities to invest in a diversified portfolio of funds, and funds look for ways to access additional capital, there is increasing demand for innovative rated note structures. Such investments are typically structured in one of two ways: (i) through a rated note feeder fund for investment in a single fund; or (ii) through a special purpose vehicle structure for investment in a portfolio of funds, creating a fund of funds structure. For investment in a single fund, the master fund typically creates a feeder fund that issues rated debt and equity through which the insurance company can participate as a debt-only investor or as a debt and equity investor, depending on the structure of the deal. For investment in a portfolio of funds, the special purpose vehicle is typically structured to include one or several tranches of rated debt supported by limited partnership (LP) interests in the underlying funds that comprise the investment portfolio and a tranche of equity commitments (structured as straight equity or subordinated notes), which, as the first-loss tranche, is important for the ratings analysis. The past year has seen an increase in the use of such note structures, and we expect their popularity to continue even if market conditions tighten so long as the insurance regulators do not change the investment classification of the notes issued by, or the loans incurred by, these structures.

This chapter reviews how these investments are typically structured, some important parameters that need to be determined in their structuring, the current regulatory environment, and recent trends.

## Key characteristics

- *Basic Single Fund Structure:* Structured notes obligations invested in a single master fund usually take the form of a feeder fund that issues one or more tranches of debt and equity. Typically, the investor purchases debt and equity, with the substantially larger commitment taking the form of debt (for example, 80% debt and 20% equity). This structure relies on the ability to map steady cash flows from the master fund for the ratings analysis and we therefore usually see this structure used to invest in debt funds. If the sponsor needs the ability to adapt terms for the rated debt that would not be available in a feeder fund structure, the sponsor may choose to create a parallel fund structure instead, although such a structure may add complexity.
- *Basic Fund of Funds Structure:* Structured notes obligations invested in a portfolio of funds generally involve two entities: an issuer, which is a special purpose vehicle that issues debt and equity; and an asset holdco, which is a special purpose vehicle that is a direct subsidiary of the issuer and is the entity that holds the investment portfolio. The issuer then pledges its ownership interest in the asset holdco for the benefit of the noteholders. Some transactions do not use a separate asset holdco, in which case the issuer directly pledges the underlying portfolio of fund interests.

- *Debt-like Characteristics:* Insurance companies rely on the debt characterisation of the structured notes obligations for more attractive risk-based capital (RBC) treatment, which, for U.S. insurance companies, depends on whether the investment is categorised as a bond under statutory accounting and RBC rules that benefit from more attractive RBC charges compared to equity investments. To support the accounting and RBC analysis, the return on the debt is generally structured as regular interest payments and repayment of principal, subject to a priority of payments waterfall. The equity in the issuer gets the benefit of the upside once the scheduled debt payments have been made pursuant to the priority of payments.
- *Priority of Payments Waterfall:* Structured notes issued in these structures typically have long maturity (for example, 10–15 years), although the notes are generally expected to be repaid much faster. Because of this, a structured notes obligation that relies on market performance and is supported by alternative investments that are inherently illiquid assets requires some protection from economic downturns. Common terms used to provide that protection include:
  - Payment of interest is generally required only to the extent that cash is available; otherwise, the interest is deferred until cash is next available in the priority of payments.
  - The amortisation schedule is usually a target amortisation schedule that requires amortisation payments only to the extent that cash is available in the priority of payments (with cumulative catch-up payments in subsequent periods). The amortisation schedule is often supplemented by a cash sweep if certain loan-to-value tests are not satisfied.
  - Full repayment of the debt can be targeted within a relatively short period of time (e.g., four to five years) based on modelled cash flows, but final legal maturity will often be set at 10–15 years to provide flexibility, in particular in case of an economic downturn.
  - Distributions are made to equity only once interest and target amortisation have been paid in accordance with the target schedule. Distributions to equity are also generally subject to *pro forma* satisfaction of a loan-to-value ratio and, sometimes, a liquidity ratio.
- *Funding Capital Calls:* There are certain structural holes that the investors need to be prepared to either address in the documentation or, more commonly, accept as deal risk:
  - The debt and equity committed to the issuer is generally (but not always) equal to the LP commitments made to the underlying funds. If the underlying funds can call capital to pay fees and expenses in addition to the LP capital commitment, in the absence of adequate reserve or sufficient distributions to supplement existing reserves, there is a possibility that there will not be sufficient cash available to fund a capital call to pay fees or expenses.
  - Many funds permit recycling of commitments. However, if the issuer has received a cash distribution from the underlying funds, and that cash is run through the waterfall, it is no longer available for recycling. While it is not uncommon to allow distributions to equity to be recalled, the cash may have been paid to the rated notes under the waterfall and it would be unusual to allow payments to rated notes to be recycled. The portfolio needs to provide sufficient cash into the structure to be able to cover these additional calls on capital.

In these cases, the issuer would become a defaulting limited partner if the investment portfolio does not generate sufficient cash to service these capital calls, thereby impairing the debtholders' collateral. It is therefore important to control when and how much cash leaves the structure.

- *Investment Grade Rating:* Insurance companies rely on the investment grade or quasi-investment grade rating of the debt for their RBC analysis. For U.S. insurance companies, favourable RBC asset charges are assigned based on the investment's National Association of Insurance Commissioners (NAIC) designation, which is typically determined based on the credit ratings assigned to the investment by nationally recognised statistical rating organisations. If the debt is downgraded to the extent that the rated notes are funded on a delayed draw basis, the debtholders might request an Event of Default or a draw stop on unfunded commitments until the investment grade rating is restored.

### **Critical single fund structuring parameters**

When structuring these rated note feeder fund investments, issuers must determine certain key parameters. We list four of them here, and discuss each in turn:

- whether the structure will be through a feeder fund or a parallel fund;
- whether the holder of the debt and equity commitments will be the same;
- whether the master fund will seek to pursue a subscription line facility; and
- what type of fund would support a rated note feeder.

#### Feeder fund or parallel fund

Sponsors typically choose to structure a rated note through a feeder fund to accommodate insurance companies interested in participating in a fund. Creating a feeder fund allows the sponsor to simplify the overall fund structure and keep the terms of the debt investment structure the same as the equity investment structure but for the specific debt characteristics required to make the rated notes debt. The feeder fund structure, however, does not allow the sponsor to make adjustments to the investment structure that may be necessary to achieve or maintain a particular rating or to address particular insurance company issues. To the extent that the feeder fund structure does not allow enough flexibility to make the necessary adjustments (for example, the fund is levered, which impacts the rating), the sponsor could create a standalone parallel fund. While this may add complexity to creation and maintenance for the sponsor, a parallel fund structure allows the sponsor to more closely manage the parallel fund to maintain the necessary rating and to adjust the terms as may be required by the insurance company.

#### Debt, equity or both

Typically, a rated note feeder fund is structured so that the issuer issues debt and equity interests to each investor. Subject to the ratings constraints, the interests are heavily weighted towards debt commitments in recognition of the insurance companies' preference for debt investments. When the holders of the debt and equity investment own a vertical slice of the structure, it streamlines documentation and assures that the insurance companies' investment more closely aligns with the pure equity investors. For example, the equity component allows for recycling and clawbacks. However, certain insurance companies are subject to specific internal policies, or regulatory requirements, that make any equity investment a significantly more cumbersome undertaking. For example, Korean insurance companies face a lengthy regulatory approval process for any equity investment. In such cases, the sponsor is sometimes required to structure the rated note feeder fund as a strictly debt investment for the insurance company investors. A significant complication this presents is trying to replicate equity concepts, such as recycling and clawbacks, in a purely debt structure. Another concern a sponsor may have is that if the issuer files for bankruptcy, the debt commitments are no longer enforceable against the investor, whereas equity investors would still have to fund a capital call. To address this concern, the sponsor may structure the debt commitment as convertible to an equity commitment upon bankruptcy of the issuer.

### Subscription line facilities

If a master fund intends to utilise a subscription line facility, early discussions should be had with the subscription line lenders regarding treatment of the rated note feeder fund in their borrowing base calculations. Subscription line lenders are often concerned about the quality of a debt commitment as collateral because, as noted above, in the event that the issuer enters bankruptcy, creditors are not required to fund their debt commitments. This is as opposed to the equity holders, who are required to fund capital calls even in the event that the issuer enters bankruptcy. Sponsors have tried to address this concern in various ways, including by (i) creating a mechanic that converts the debt commitments into equity commitments in the event of bankruptcy, (ii) creating the commitments as debt/equity commitments from day one pursuant to which the debt/equity commitments are shared and the issuer can choose whether to draw on the commitments as debt or as equity, or (iii) creating the feeder fund as a bankruptcy remote vehicle to dramatically decrease the likelihood that the feeder fund will enter bankruptcy. None of these methods have been truly tested in the courts, so it is unclear which method is most effective to address the subscription lenders' concern.

### Ratings and cash flows

Another consideration for a sponsor is what type of fund could support a rated note feeder suitable for insurance companies to invest in. In order to achieve the necessary rating, the issuer will need to show the ratings agency sufficient regular cash flow to support the issued debt. If the investment is in a single private equity fund, there is no pool of cash flows to rely upon, as many private equity funds do not expect distributions until five to seven years after inception. Such delayed cash flows will likely not be acceptable to a ratings agency and could result in an investment's classification as equity resulting in less favourable RBC charges under the insurance company's accounting and RBC analysis. We therefore typically see rated note feeder funds invested in debt funds, as debt investments typically produce cash flows immediately and those cash flows are regular and predictable.

### **Critical fund of funds structuring parameters**

When structuring these fund of funds investments, issuers must determine certain key parameters. We list three of them here, and discuss each in turn:

- whether the investment portfolio will be set as of the closing date;
- whether the commitments to the issuer will be funded in full on the closing date; and
- whether the issuer will be consolidated with its parent's balance sheet and whether that parent has other obligations that subject the parent and its subsidiaries to covenants with which the structured notes obligations might conflict.

### Setting the investment portfolio

The issuer needs to determine whether the asset holdco will have set the investment portfolio as of the closing date, or whether the asset holdco will build or adjust the portfolio after the closing date based on agreed investment guidelines. If the investment portfolio may change after the closing date, it is important to ensure that the investment portfolio will be sufficiently diversified to support an appropriate rating. In addition, the issuer needs to be prohibited from committing more than the aggregate principal amount of debt and equity that has been committed to the issuer. Alternatively, noteholders will have to be comfortable that expected distributions on the underlying funds will be sufficient to fund capital calls for which no matching source of funding is identified at closing.



### Funded or unfunded commitments

Another important parameter is whether the debt and equity commitments will be fully drawn on the closing date, or whether there will be a delayed drawing schedule. Having some or all of the commitments unfunded as of the closing date presents additional considerations. There needs to be a comfort level regarding the credit worthiness of the relevant debtholders and equity holders. Protections may be necessary to ensure that the issuer receives the full draw amount needed, including defaulting noteholder or equity investor provisions and a requirement that the relevant debtholder or equity investor be an entity with an acceptable rating or benefit from parent support from a rated entity, or post a letter of credit from an acceptable letter of credit issuer to support its unfunded commitment. Finally, investors investing on a delayed draw basis may require drawing conditions, such as a ratings downgrade or a loan-to-value breach, in the event that the condition of the structured notes obligation has changed since the closing date. However, the matter of drawing conditions should be approached cautiously, as a draw stop may cause the issuer to become a defaulting limited partner with respect to some or all of the underlying funds, thereby exacerbating the problem.

### Balance sheet considerations

While the issuer of a structured notes obligation is a special purpose vehicle, the equity in the issuer may be owned by a company that itself has debt obligations. If the issuer ends up being a subsidiary of an equity investor, the covenants in the parent's debt agreements may extend to the parent's subsidiaries and must be considered to ensure that the debt issuance by the issuer does not conflict with those covenants. In addition, the parent should consider whether it will be required to consolidate the notes issued by the issuer as debt on its balance sheet.

### **Liquidity facility**

Many fund of funds structured note structures include liquidity support, in the form of a revolving facility provided by a third-party lender, that can be used to bridge a funding shortfall. These liquidity facilities are generally available to fund fees and expenses, interest on the debt tranches and, usually, capital calls from the underlying funds. While these liquidity facilities are rarely used, including a liquidity facility in the structure provides stability to the structured notes obligation by supporting the ratings analysis and reducing the possibility that the structure will fail.

### **Regulatory treatment**

For U.S. insurance companies, the transaction structure for structured notes obligations is typically designed to achieve favourable RBC treatment of the notes' debt investments, which will be determined based on whether the investment is classified as a "bond" under statutory accounting rules. The NAIC, the standard-setting and regulatory support organisation created and governed by state insurance regulators, has for a number of years been exploring changes to statutory accounting principles and securities valuation office (SVO) procedures that could affect the reporting and capital treatment of structured notes obligations rated note feeder vehicles and similar structures.

Currently, the NAIC is working on significant revisions to Statement of Statutory Accounting Principles (SSAP) No. 23R and No. 43R to implement a principles-based bond definition to determine whether an investment should be considered and reported as a bond on Schedule D-1 (Long-Term Bonds) of an insurance company's statutory financial statements. The proposed statutory accounting rules define a bond as "any security representing a creditor

relationship, whereby there is a fixed schedule for one or more future payments, and which qualifies as either an issuer credit obligation or an asset backed security”. Structured notes obligations fall under the asset-backed security classification. In order to receive bond treatment, the notes’ debt obligations will generally need to have pre-determined principal and interest payments with contractual payments that do not vary based on the appreciation or depreciation of underlying collateral value or other variables and reflect underlying assets (e.g., the LP interests of debt funds) that generate a “meaningful” level of cash flows to service the debt obligations. In addition, the insurance company holder of the notes’ debt obligations must be in a different economic position than if the holder owned the underlying fund investments directly. The NAIC’s principles-based bond proposal also contemplates a rebuttable presumption that debt investments collateralised by equity interests would not qualify as bonds because they would not reflect a creditor relationship in substance. Notwithstanding this rebuttable presumption, it is possible for such a debt investment to represent a creditor relationship if the characteristics of the underlying equity interests are expected to produce predictable cash flows and the underlying equity risks have been sufficiently redistributed through the capital structure of the fund issuer.

The NAIC continues to consider comments from industry participants and the proposed revisions are not yet final. Currently, the proposed principles-based bond definition and the revisions to the statutory accounting principles relating to structured notes are expected to be finalised by May 2023 with a January 1, 2024 effective date.

Although the proposed changes to the statutory accounting rules and treatment of structured notes are not yet final and may impact the RBC treatment of these investments, we generally see the insurance company debtholders assume the risk of a change in law or of the structured notes obligation not achieving the desired capital or reporting treatment.

### **Tax considerations**

The principal tax considerations of a rated note structure for a single fund or portfolio of funds are largely the same. The tax structure of these vehicles depends on a number of factors, including whether they are being marketed to U.S. or non-U.S. insurance company investors and the nature of the underlying investment strategy. For U.S. insurance company investors, the issuers are typically structured as partnerships for U.S. federal income tax purposes to avoid entity-level tax leakage. For non-U.S. insurance company investors, issuers may be structured as either a partnership or non-U.S. corporation for U.S. federal income tax purposes depending on whether the underlying fund or funds are expected to generate (or have options to block at the fund level) U.S. tax filing and payment obligations. If structured as a partnership, transfer restrictions may apply to both the debt and equity interests in the fund in order to mitigate the risk that the fund will instead be treated as a corporation for U.S. federal income tax purposes under the “publicly traded partnership” rules (the “taxable mortgage pool” rules should also be considered if the underlying portfolio includes real estate-secured debt). In addition, equity and potentially debt tranches may be restricted such that they can only be owned by U.S. holders, to avoid the risk of subjecting the structure to U.S. withholding tax. If structured as a non-U.S. corporation (and a concern for non-U.S. investors more generally), the issuer may need to “block” income effectively connected with a U.S. trade or business via a subsidiary entity and may incur U.S. withholding tax. In each case, the associated leakage will reduce returns to investors and should be taken into account in modelling. If it is important that a tranche of debt be

respected as indebtedness (rather than treated as equity) for U.S. tax purposes (e.g., because the debt is not subject to transfer restrictions and the issuer is a passthrough entity), then the terms of the debt, expected ratings and repayment expectations will need to be scrutinised to ensure that they support such treatment – with investment grade ratings often used as the proxy for whether there is doubt as to the right characterisation.

### Recent trends

- *Decoupling of Debt and Equity Commitments in Fund of Funds Structures:* While investors in some structured notes obligations are purchasing a vertical slice of the structure that includes both debt and equity, we are increasingly seeing structures that decouple the two. This strategy works well for insurance companies that wish to invest in rated debt instruments but not the equity. The equity is then purchased by investors such as a balance sheet fund of the firm forming the structured notes obligation, family offices and other third-party investors attracted to the combination of levered exposure to multiple funds and the potential for high returns. While equity holders may be required to make an initial funding, sometimes no further funding is required (subject to certain downside events such as a loss of rating for a period of time) until the debt has been funded in full. If the portfolio produces sufficient cash flows to service future capital calls, it is possible that the equity is never drawn again but still gets the benefit of excess cash distributions out of the system. Equity funded on a delayed draw basis may be an attractive investment for insurance companies to the extent that the unfunded commitment does not attract a capital charge.
- *Equity Credit Support:* In the fund of funds structure, to the extent that equity commitments are not funded in full on the closing date, equity holders may be required to have an eligible rating or provide adequate credit support from a person with an eligible rating. This credit support frequently takes the form of a parent guaranty, a letter of credit or cash collateralisation, in each case for the full amount of the equity commitment. This credit support not only supports the ratings analysis, but also provides comfort to the debtholders that the equity holders will fund when required to do so under the terms of the transaction documents.

### Conclusion

In the current market environment, we expect to see more private equity firms and insurance companies develop and invest in these structures to maximise their access to liquidity and as a new investment opportunity. We also expect further innovations as market participants react to regulatory and other developments.

\* \* \*

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