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Sharpest tool in the shed: A primer on asset-backed leverage facilities

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Introduction

Over the past few years, Ropes & Gray has seen an increased demand for asset-backed leverage facilities from our private credit fund clients, who recognise these facilities as a powerful tool to enhance returns to their investors. An asset-backed leverage facility, (relatively) simply put, is a medium-term revolving or term loan credit facility backed by a defined pool of a credit fund's portfolio assets that have been isolated in a bankruptcy-remote special purpose vehicle (SPV) in a manner similar to the structure found in many securitisations. In effect, an asset-backed leverage facility is a "mini-securitisation" designed to provide capital to a credit fund more cheaply and over a longer timeframe than other, more widespread types of credit. For a credit fund, a leverage facility can be a sharp tool: powerful in impact, narrow in focus, but with accompanying rough edges; as with many traditional securitisations, the advantages of this type of financing are accompanied by certain legal and regulatory challenges. Navigating the structural idiosyncrasies of an asset-backed leverage facility is therefore critical for supporting credit fund clients as they implement this increasingly popular technology.

This chapter aims to begin to demystify fund leverage facilities, first by briefly discussing the major reasons for implementing them, then by describing the structure and collateral pool of a typical facility, and finally by highlighting several of the major distinguishing features and key considerations facing legal advisors to credit fund clients who seek to put these facilities in place.

Right tool for the job: Why asset-backed leverage facilities?

As with any specialised tool, an asset-backed leverage facility may be called for in a specific set of circumstances; so, before examining the structure of a leverage facility in detail, it is worth considering why a credit fund would consider having such a facility in the first place. An asset-backed leverage facility can complement a fund's existing credit facilities in a number of ways: in particular, (a) it is secured by a discrete pool of assets, and (b) it has a longer term than a traditional subscription facility. In contrast to a subscription facility, a leverage facility is secured not by the commitments of a fund's investors to contribute capital to the fund, but by the assets that the fund has acquired (whether with capital contributions, with borrowings under the fund's subscription facility or with the proceeds of advances under the leverage facility). This type of collateral is quite conducive to leverage, even more so once isolated in an SPV, shielding the lender from any ancillary risks faced by the fund itself. Moreover, unlike a subscription facility, which may mature initially only a year or two after effectiveness, a leverage facility can have an initial term of up to five years. Taken together, these factors result in a greatly reduced cost of capital for the fund.

Of course, as with any credit facility, a leverage facility can be adapted to suit the needs of a given fund. Certain of a fund's investors may have less of an appetite for leverage, so funds will typically create levered and unlevered sleeves in order to provide levered returns only to those investors that desire it. Some investors might invest in both the levered and unlevered sleeves in percentages that achieve a desired risk/return profile. A single fund could even set up multiple SPVs for the purpose of entering into multiple leverage facilities, further enhancing its returns.

To illustrate the potential of a leverage facility, consider a hypothetical Fund A, which has a $150 million leverage facility, and a hypothetical Fund B, which does not. Each of Fund A and Fund B has $100 million of capital with which to make debt investments, earning a blended return of 7%. However, Fund A's leverage facility, with an assumed interest rate of 5.75%, allows Fund A to invest in (and earn a 7% return on) $150 million of additional assets. Thus, despite having an equal amount of committed capital as Fund B, Fund A earns a net return of 8.875%. In both instances, the gross return on investment would be reduced by any management fees and distributions to general partners, further reducing Fund B's return relative to that of Fund A. Still, even accounting for such fees, the impact of a leverage facility on a fund's performance is clear.

Some assembly required: A typical structure

Whether structured as a revolving credit facility, a term loan credit facility, or a delayed draw facility, a typical leverage facility follows a basic framework. A borrower is created as a subsidiary of a fund,[1] typically as a Delaware limited liability company (LLC).[2] At the closing of the facility, the parties will implement certain mechanics designed to make the borrower "bankruptcy remote" from the fund. As in a traditional securitisation, the concept of "bankruptcy remoteness" refers to an entity being sufficiently isolated from the rest of its corporate structure that a bankruptcy court would be unlikely to use its equitable powers to (a) consolidate the entity with the rest of the corporate structure, or (b) void any transfers of assets to the entity. In the context of a leverage facility, a consolidation of the borrower with the fund would be burdensome to the lenders, which expect to be over-collateralised and to be the only creditors of the borrower. Alternatively, if a bankruptcy court were to recharacterise any sales or contributions of portfolio assets to the borrower as loans from the borrower to the fund, secured by assets owned by the fund, the lenders' ability to realise on their collateral would be severely diminished, as they might have to compete with the fund's other creditors for access to those assets.

With the borrower mechanics in place, the collateral pool can be created. The fund will sell or contribute portfolio assets to the borrower under a separate purchase agreement, either at closing or from time to time thereafter (or often both).[3] For efficiency's sake, the fund may also participate loans to the borrower (which participations will be elevated to full assignments at a later date, often within 60 days); these participations are typically acknowledged in the credit agreement and governed by a master participation agreement entered into at closing. As in any asset-based facility, lenders will not advance 100% of the value of the collateral, so the borrower will pay for a portion of the value of each portfolio asset sold by the fund through debt incurred under the facility, and the remainder will be contributed by the fund.[4] At closing, the borrower will pledge all of its assets (i.e., the portfolio assets) as collateral. The fund also frequently pledges the equity of the borrower as collateral.

As part of the bankruptcy remoteness structure, it is important that these sales or contributions of portfolio assets constitute "true sales" or "true contributions".[5] A true sale analysis is not

exact, but a major factor is whether the relevant transaction shifts the risks and benefits of ownership effectively. It is thus critical that, under the purchase agreement, the fund does not remain liable for any debt (or receive any surplus) in respect of any transferred portfolio asset and does not guarantee the collectability of any portfolio asset or accept any risk of loss.[6]

Several characteristics about the borrower itself also support the bankruptcy remoteness analysis. First, the borrower's operating agreement (and often the credit agreement itself) will contain a number of separateness covenants designed to ensure that the borrower is viewed by third parties as a separate entity from the fund. These customarily include obligations to (a) observe proper LLC/limited partnership formalities, (b) hold itself out to the public as separate and distinct from any other entity and conduct business solely in its own name, including by maintaining separate books and records and even its own stationery, (c) pay its expenses from its own funds, (d) not be consolidated with another entity (other than for tax and accounting purposes), (e) not commingle assets with another entity, and (f) not guarantee the debt of another entity. Second, the borrower's management will include an independent director or manager (customarily employed by a third-party service provider) whose consent will be required for any material actions, including any mergers or asset sales by the borrower, any insolvency filings involving the borrower, and any dissolution of the borrower. Finally, the transaction documents should include non-petition provisions that prevent a third party from dragging the borrower into a bankruptcy proceeding before the end of the applicable preference period.

Several other parties are involved in the operation of a leverage facility. The portfolio manager or servicer, which is typically either the fund or the investment advisor to the fund, is responsible for making decisions with respect to the buying and selling of the portfolio assets by the borrower and other management of the collateral pool throughout the life of the facility, for servicing the portfolio assets held by the borrower, and for certain reporting obligations. The borrower may pay the portfolio manager a fee, or, if the portfolio manager is the investment advisor to the fund, the fee may be subsumed in the investment advisory fee that the fund pays. The administrative agent and the collateral agent fulfil their traditional responsibilities under the facility. And the collateral custodian, which is sometimes the same party as the agents, is responsible for holding and verifying the required documentation for each of the portfolio assets.

The lifecycle of a leverage facility customarily follows three phases. Often, a facility will include a ramp-up period, during which the borrower is allowed to borrow funds and acquire portfolio assets subject to a lower commitment fee (or even no commitment fee at all). During this period, the eligibility criteria and concentration limitations (both discussed below) with respect to the portfolio assets may also be relaxed. During the reinvestment period, the mechanics of the facility will operate normally, and the borrower may invest the proceeds of the facility, and reinvest returns from its portfolio, in additional portfolio assets or in certain pre-approved categories of assets (e.g., U.S. government debt securities and highly rated short-term bank deposit products, money market funds, and commercial paper). Finally, there is usually a wind-down period,[7] during which the borrower will no longer be able to borrow money or reinvest proceeds and will be expected to pay down the facility and sell any remaining portfolio assets.

Defining the collateral pool

The upshot of the carefully planned bankruptcy-remote structure discussed above is that a leverage facility is anchored by a borrower that is effectively an empty vessel holding a

collateral pool that provides the lenders' entire recourse. The valuation of the assets in the collateral pool is critical and heavily negotiated, as is the proportion of the collateral pool against which the lenders will advance.

Worth every penny: The art of collateral valuation

The lenders set very specific and heavily negotiated criteria on the assets that the borrower can acquire. In some facilities, the administrative agent will have approval rights over any assets purchased by the borrower. Other facilities allow the borrower to freely add assets to the portfolio as long as such assets meet certain pre-established eligibility criteria. Customary criteria include (a) basic requirements that mirror standard borrower representations and warranties and include the borrower having good and marketable title to an asset, (b) type of asset (e.g., loan, bond, structured finance obligation, letter of credit, equity security), (c) whether an asset is secured, (d) payment currency, (e) frequency of interest and principal payments, including any required cash or payment-in-kind spread, (f) term to maturity, (g) credit rating, (h) minimum purchase price, and (i) size of the total facility or issuance. Typically, the loan documentation underlying a portfolio asset must satisfy certain basic requirements, and often the loan transfer documentation is required to be on LSTA standard forms. Other, more bespoke criteria with respect to a portfolio asset can include (1) the lack of any significant risk of declining in credit quality or market price, (2) the lack of any material non-credit-related risk, (3) the lack of any required future advances to the underlying obligor, (4) the required number of available bid-side price quotations (the "bid depth"), and (5) the asset not being subject to partial or non-cash offers or redemptions. There may also be criteria related to relevant tax and regulatory concerns.

As with any asset-based credit facility, the collateral pool is generally also subject to certain concentration limitations designed to ensure the diversity of the portfolio assets. These limitations can be based on any of the eligibility criteria listed above but also frequently include restrictions on the proportion of the pool that can be occupied by loans to the largest individual obligors or groups of obligors. Some facilities also include restrictions on loans to obligors within certain S&P or Moody's industry classifications; indeed, recently, some facilities have included restrictions with respect to certain industries particularly impacted by the COVID-19 pandemic. Other possible concentration limits relate to the proportion of obligors affiliated with the fund, the proportion of distressed loans or the borrower's unfunded exposure amount (i.e., the amount still potentially to be paid to the obligor under, for example, a delayed draw loan).

With the range of potential portfolio assets sorted, how are those assets to be valued once they are part of the collateral pool? Terminology varies widely among lenders with respect to valuation mechanics, but generally, valuation follows a common framework. Typically, when a portfolio asset is acquired by the borrower, the administrative agent will value the asset at its purchase price (assuming it was not acquired above market value, in which case it would be valued at par); any *de minimis* original issue discount (often 3% or less) will be disregarded in this calculation. In certain cases, the administrative agent may revalue each portfolio asset, usually as the product of its market value (as a percentage of par) and its outstanding principal balance, either at its discretion or on certain prescribed dates throughout the life of the facility. These dates generally include the measurement dates for any monthly collateral reports, the dates of any borrowings or repayments, the dates of any reinvestments of portfolio asset principal collections, and the dates of any sales or substitutions of portfolio assets by the borrower.

But how exactly is the market value of a portfolio asset determined? If an asset is sufficiently liquid, its market value will usually be determined by reference to the bid prices published by certain reputable independent valuation firms (e.g., LoanX/Markit or Loan Pricing Corporation) or, in the absence of published quotations from those firms, other nationally recognised competitors (either alone or averaged). If an asset is not sufficiently liquid or if quotations are not available from any independent valuation firms, the administrative agent will generally determine the value of an asset itself. In these circumstances, administrative agents are generally required to act in good faith and with commercially reasonable discretion. The borrower should also have a right to challenge a valuation by the agent with which it disagrees, usually by reference to observable market prices, by submitting bids or by obtaining a valuation from one or more independent valuation firms, in each case within a certain window of time after receipt of the agent's valuation.

Certain facilities do not permit the administrative agent to revalue the portfolio assets in the ordinary course. Importantly, however, these facilities permit a portfolio asset to be revalued upon the occurrence of certain adverse events (often called "value adjustment events" or "market trigger events"). These revaluation triggers typically include payment defaults or insolvency events with respect to the obligor, after which an asset will often be given a $0 value. Other potential value adjustment events include (a) a portfolio asset being on non-accrual status or not being collectible, (b) defaults in the obligor's financial covenants, (c) an obligor's failure to deliver its periodic financial statements, and (d) material modifications to the underlying loan documentation,[8] including (i) waivers or modifications of any principal or interest payments or capitalisation of any interest, (ii) reductions in interest rate, (iii) structural or contractual subordination of payments or liens, (iv) modification of the maturity date or any prepayment date, (v) changes to any *pro rata* sharing, payment, or distribution mechanics, (vi) the release of a material guarantor, (vii) substitutions, alterations, or releases of liens on a material portion of the underlying collateral, and (viii) amendments to the obligor's financial covenants. Facilities with periodic valuation mechanisms typically also permit revaluation in these circumstances.

The penny drops: Calculating loan availability

As with other types of asset-based credit facilities, the borrowing capacity under a leverage facility is less than the full value of the collateral pool. Loan availability is generally implemented through a borrowing base mechanic.[9] A percentage (the "advance rate") of each potential type of collateral will be specified, and the value of the collateral pool multiplied by the applicable advance rates (the "borrowing base") provides the current borrowing limit. The borrowing limit is deal-specific, but, importantly, because of the revaluation mechanics in a leverage facility, that limit can fluctuate more than it would in a subscription facility.

If the value of the borrowing base falls below the outstanding amount of the loan at any time (a "borrowing base deficiency" or "borrowing base shortfall"), the consequences for the borrower often vary depending on the size of the deficiency. In the case of a small deficiency, the only consequence for the borrower may be the temporary suspension of its ability to borrow under the facility and/or to make distributions to the fund. If the borrowing base deficiency is larger, however, the borrower will be required to "cure" the deficiency – i.e., to bring the borrowing base into line with the outstanding loan amount – using one or more of the following options:[10] (a) contributing cash or additional portfolio assets to the collateral pool; (b) selling or substituting one or more portfolio assets; or (c) prepaying one or more of the outstanding advances under the facility. Generally, a borrowing base deficiency that is not cured within a certain period using one of these methods will become an event of default.

Rough edges: Unique features

As is likely apparent from the discussion thus far, the power and complexity of a leverage facility – the sharpness of this specialised tool – brings with it a number of complexities and idiosyncrasies for legal advisors to consider when guiding clients – rough edges that must be refined or at least looked out for. While many of the standard provisions that appear in any traditional credit facility also feature in asset-backed leverage facility documentation, the bespoke structure that gives a leverage facility its strength also leaves lenders requesting certain additional protections.

Allocating proceeds

The bankruptcy-remote structure involved in a leverage facility results in two features that distinguish it from a subscription facility. Because the borrower's only assets are the collateral pool securing the facility, similar to a more traditional securitisation, a leverage facility will include a payment waterfall to carefully control the use of the proceeds of the portfolio assets and to avoid leakage of the collateral from the borrower to the fund before the secured parties have been paid. Principal and interest payments on the portfolio assets are required to be paid to a collection account that is pledged to the secured parties, and the borrower is typically required to run those collections, as well as proceeds of any other permitted investments, through the waterfall on a monthly or quarterly basis. The funds will then be applied to (a) any fees or costs and expenses due to the agents, the custodian, the lenders, or the portfolio manager, (b) certain other administrative expenses due to third parties, (c) any interest or margin due to the lenders, and (d) any required amortisation payments. The borrower will also be required to pay down any outstanding advances as necessary to cure any borrowing base deficiency. During the reinvestment period, any excess interest proceeds are generally permitted to be distributed to the fund so long as no event of default exists, while any excess principal proceeds may be reinvested in additional assets, subject to the satisfaction of any concentration limits.[11] After the reinvestment period, all excess proceeds are generally required to be applied to pay down the loan.

Because the borrower is permitted to distribute and/or reinvest its cash during the reinvestment period, subject to the waterfall, rather than keeping it on hand, lenders will customarily require the borrower to maintain a reserve account in which is deposited a sufficient amount of cash (in the eyes of the lenders) to cover any lending obligations under any portfolio assets comprising revolving or delayed draw debt. Often the borrower will be required to periodically replenish the reserve account (including as part of its waterfall payments) if it contains insufficient funds, and the borrower is usually required to top up the account at the end of the reinvestment period so that there is sufficient cash to meet any funding needs under the portfolio loans as the leverage facility is paid down.

Getting to know your product: Representations, warranties, and covenants

Because of the bespoke nature of the collateral pool in a leverage facility, lenders typically ask for fairly extensive collateral reporting. Generally, the borrower or the portfolio manager will be required to submit to the secured parties monthly reports on the collateral pool, including information on the eligibility, type, value, and status of each portfolio asset, certain financial metrics, and information as to any modifications to any portfolio asset. Some facilities also require these reports to calculate compliance with any financial covenants and to detail any contributions to and distributions by the borrower. Reports with respect to months during which waterfall payments are due customarily also include certain information related to those payments, such as outstanding principal and interest proceeds

and amounts on deposit in any reserve accounts. Furthermore, the lenders may require a firm of nationally recognised independent public accountants to perform certain agreed-upon procedures with respect to the monthly reports and the portfolio manager's servicing of the collateral on an annual basis.

Additionally, the borrower will generally be required to submit to the administrative agent one or more of the following documents with respect to portfolio assets held by the borrower: (a) any financial reporting packages delivered by the obligors, including any financial statements; (b) any management discussion and analysis provided by the obligors; (c) copies of any material modifications or waivers of loan documentation; (d) notice of any credit event or material litigation; and (e) in certain cases, portfolio monitoring reports. The collateral agent may also request monitoring access to any collateral or custodial accounts in order to view balances in real time.

Apart from the reporting requirements, a typical leverage facility will usually contain certain covenants restricting the activities of the borrower due to its bankruptcy remoteness. Generally, the borrower will be permitted to engage solely in those activities contemplated under the facility or necessary to carry out the borrower's obligations thereunder. As such, the borrower will customarily be prohibited from engaging in other transactions or incurring other indebtedness outside the scope of the facility.

In case of emergency: Events of default

In addition to customary events of default, leverage facilities have a few notable events of default that underline the importance lenders place on the bankruptcy-remote structure of the borrower and a healthy collateral pool. A failure to maintain the bankruptcy remoteness of the borrower can often directly trigger an event of default. A failure to maintain a perfected lien on the collateral or to properly maintain any collateral accounts can also trigger an event of default (with minimal opportunity to cure). There are also usually defaults specific to the portfolio manager that can include a key person event or change of control with respect to the portfolio manager.

Remedies for events of default include those customary for any other credit facility, but the nature of the collateral pool means the administrative agent generally has some additional rights. The borrower will be prohibited from purchasing further portfolio assets or investing any funds on hand. The administrative agent will be permitted to seize and distribute any cash in any collateral accounts according to a default waterfall described in the credit agreement and to direct the portfolio manager in the servicing and sale of any portfolio assets in order to prepay any outstanding advances under the facility. In addition to these remedies, a portfolio manager default usually triggers the administrative agent's ability to terminate the portfolio manager and appoint a successor. To forestall these remedies, a fund can sometimes negotiate the right to contribute assets to the borrower or sell assets. A borrower can also sometimes require the lenders to seek bids for any portfolio assets being sold in order to avoid a fire sale. Finally, a fund may request a right to match the highest offer for portfolio assets being sold or to have a last look at those assets.

Second opinions: True sale and non-consolidation

The final consequence of the bankruptcy-remote structure is some additional opinion requirements beyond those found in a traditional credit facility. Borrower's counsel will customarily deliver a true sale and contribution opinion with respect to the assets transferred from the fund to the borrower, stating that a bankruptcy court would likely not claw any portfolio assets back into the bankruptcy estate of the fund in the event of an

insolvency, and a non-consolidation opinion, stating that a bankruptcy court would likely not substantively consolidate the assets and liabilities of the borrower and the fund in the event of an insolvency. Because the U.S. bankruptcy courts have considerable discretion in making such determinations, these opinions are reasoned and fact-intensive and often require a healthy amount of time to prepare.

Conclusion

Despite a unique and complex structure, leverage facilities are a powerful "sharp tool" in a private credit fund's toolbox, able to enhance the fund's returns to its investors relatively cheaply and over a longer timeframe than other types of financing. However, as with any specialised tool, a leverage facility is suited for certain circumstances; for example, a fund manager should consider whether such a facility would place material constraints on the fund's ability to manage its credit portfolios during times of market uncertainty. In addition, a fund and its counsel will need to navigate the "rough edges" of a leverage facility's bankruptcy-remote structure, collateral pool valuation mechanics, and ongoing obligations if the facility is to successfully integrate with the fund's other projects. Thoughtfully addressing these and other considerations is key to helping the fund accomplish its objectives.

* * *

Endnotes

1. Usually, the borrower is created prior to closing using basic organisational documents, allowing for tax forms to be completed and collateral accounts to be opened. The organisational documents are then amended and restated at closing.
2. The borrowers under certain leverage facilities are Delaware limited partnerships with general partners that are Delaware limited liability companies. In such a structure, the bankruptcy-remote mechanics discussed should be put in place at the level of the general partner.
3. Some facilities also allow the borrower to purchase portfolio assets on the open market, upon advice from the portfolio manager. This mechanic can also be used to warehouse assets for a future collateralised loan obligation offering.
4. The contributed value also accounts for any original issue discount or other market discounts.
5. The fund and the borrower generally expressly state their intention that any transfer of assets constitutes a true sale or true contribution; nevertheless, out of an abundance of caution, the fund will also grant a "back-up" security interest in the relevant assets to the borrower (which security interest will be perfected at closing through a UCC filing) in case any transfer is recharacterised.
6. Some purchase agreements require the fund to repurchase or otherwise substitute portfolio assets in the case of breaches of certain limited representations and warranties that are given by the fund at the time that the relevant asset is transferred to the borrower, but this mechanic should not interfere with the true sale analysis as long as the relevant representations do not relate to the credit quality of the asset or otherwise guarantee collectability.
7. In some facilities, the reinvestment period lasts until the final maturity date.

8. The negative covenants in leverage facilities may also place certain limits on the borrower's ability to modify the documentation for its asset portfolio, in order to avoid negative effects on the quality of the collateral pool.
9. Some lenders prefer to calculate availability through a loan-to-value ratio mechanic, which has the same practical effect.
10. Some facilities allow even greater flexibility than is described here.
11. Certain facilities permit the distribution of excess principal proceeds during the reinvestment period as well.

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