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Subscription Credit Facilities: The Market Evolves

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We first examined subscription credit facilities in this column several years ago.[1] Since that time, the demand for these facilities, also known as capital call facilities, has continued unabated. The popularity of these facilities is a result of several factors, among them being the increase in the number and size of investment funds, and the solid credit performance of these funds as borrowers over the years, including through the 2008 recession.

In their most general terms, subscription credit facilities are revolving credit facilities for investment funds secured by the obligations of investors to make capital contributions to such funds. While these funds were initially formed to invest in real estate, they have since expanded into many other asset classes, including energy, transportation and infrastructure. As the market for these facilities has matured, borrowers have sought, and in certain cases successfully negotiated, more beneficial collateral arrangements. One example of this is that some facilities are now forgoing investor consent letters, which letters give lenders direct privity with a fund's investors. Another example is the expansion of the collateral for these facilities beyond capital call commitments to the actual investments acquired by the funds.

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Today we examine these and other recent developments in this market.

Background. Subscription credit facilities finance acquisitions and working capital needs for private investment funds. These investment funds attract highly rated investors, such as pension plans, sovereign wealth funds, governmental entities, endowments and high net-worth individuals, making them very appealing to lenders. The funds are generally organized as limited liability companies or limited partnerships and in Delaware or various offshore tax-advantaged jurisdictions, such as the Cayman Islands or British Virgin Islands.

Funds typically do not require investors to contribute their entire capital contribution upon becoming an equity participant in the fund. Rather, investors are generally required to make contributions over the specified term during which the fund makes investments, as and when the fund or its general partner or manager requests capital from investors. The contractual obligations of investors to make contributions after a capital call by the fund are the core collateral supporting, and the defining element of, subscription credit facilities.

Subscription credit facilities bridge an investment fund's need to make capital calls. Funds use these facilities primarily to: (a) make fewer, more regularly scheduled capital calls; (b) make time-sensitive investments, as funds can be made available under subscription credit facilities more quickly than through capital calls, which usually require a longer notice period; and (c) in the case of real estate or infrastructure funds, permit the fund to utilize letters of credit to support insurance or bid obligations for potential acquisitions or projects.

As noted above, the collateral for these facilities typically consists of: (a) the unpaid capital commitments of the investors in a fund; (b) the right of the fund and its general partner or manager to make capital calls and enforce the payment obligations of investors; and (c) the account into which capital contributions are required to be deposited. In general, lenders will perfect their liens on this collateral by filing UCC financing statements as well as entering into a control agreement with respect to such deposit account, although additional steps may be required under the laws of foreign jurisdictions, such as the Cayman Islands. The objective of lenders, should exercise of remedies become necessary, is to be able to make capital calls and receive capital contributions directly from investors.

> Subscription credit facilities bridge an investment fund's need to make capital calls.

Customarily, these facilities rely on a borrowing base to determine amounts available for loans consisting of the unpaid capital commitments of a subset of high credit quality investors. The facilities also incorporate certain exclusion events, which serve to

eliminate an investor's capital commitment from the borrowing base. These exclusion events typically relate to the creditworthiness of the investor and the conditionality of its obligation to make capital commitments to the fund. It is important to note that these facilities are generally secured by the capital commitments of all investors, not just those whose commitments are included in the borrowing base, providing a possible collateral cushion to lenders in the event of enforcement.

The contractual obligations of investors to make capital commitments are in a fund's organizational documents, such as a limited liability company or partnership agreement, as well as the subscription agreements executed by investors pursuant to which they agree to acquire an interest in the fund. Many funds also enter into side agreements with investors which may vary those obligations by adding certain exceptions or contingencies to payment. Accordingly, it is critical for lenders in a subscription facility to review carefully both the organizational documents and, in particular, the side agreements before determining which investors will qualify for borrowing base credit.

Investor Consents and Organizational Documents. As noted above, subscription facilities have traditionally required investors to provide lenders with estoppel letters or consents containing acknowledgements and assurances in regard to investor capital commitment obligations.[2] Having contractual privity with investors through such letters is an obvious benefit to lenders. Recently, however, borrowers have been seeking to minimize the time and expense of negotiating and obtaining individual consents from investors, particularly for funds with large numbers of investors. Some funds have tried to streamline this process by appending forms of investor letters to their partnership agreements so that investors agree to execute such forms at the time they subscribe to the fund. Other funds have strengthened the contractual provisions relating to capital commitments in their organizational documents so that the investor consents can simply cross reference such lender-friendly provisions.

Investor consents provide two distinct advantages to lenders, the first being direct privity with investors, and the second being the opportunity to override any provisions in an organizational document that are particularly problematic for a lender. Nevertheless, some lenders now permit "no consent" transactions for funds with high credit quality sponsors or significant track records if their organizational and subscription documents adequately address certain key issues, some of which are further described below.[3]

> As the market for subscription credit facilities matures, lenders and borrowers are becoming more sophisticated with respect to drafting organizational documents to ease the process of obtaining subscription financing.

Funds seeking to obtain a subscription facility, and in particular those who will request that no investor letters be required, should, approach potential lenders before finalizing their organizational and subscription documents, so that, if needed, appropriate lender-friendly provisions can be incorporated. Adequately addressing these issues should make obtaining a facility easier, whether or not the transaction involves consents, and potentially result in more attractive terms.

Governing Document Provisions Relating to Basic Facility Terms. To ensure the fund borrower and its affiliates are authorized to enter into a subscription facility (and that the investors have acknowledged and agreed to such facility and its basic terms), lenders typically require the organizational documents to: (a) explicitly authorize the facility and the ability of the fund to incur indebtedness; (b) contain an acknowledgement and consent by the investors that the fund and its managing entity may secure the facility with their capital commitments and that the lenders may rely upon such acknowledgement[4]; and (c) require that investors make all capital contributions into the deposit account over which the lenders have control. Additionally, lenders often request that the documents subordinate any investor claims against the fund to the right of the lenders to be paid in full and that the investors agree not to pledge their limited partnership or membership interests in the fund.

Given that funds often use complex structures involving alternative investment vehicles, parallel funds and similar fund entities that may share investor commitments, lenders should also confirm that the organizational documents of each entity that is a borrower or pledgor under a subscription credit facility permit cross-collateralization of obligations incurred under the facility and joint and several borrowings.

Additionally, most fund organizational documents contain limitations on indebtedness, often calculated as either a percentage of the value of the fund's investments or total commitments, to address investor concerns in regard to over-leveraging of the fund. Subscription lenders should be vigilant in assuring that their facility will be permitted notwithstanding these limitations.

Waiver of Investor Defenses; No Setoff or Counterclaim. Generally speaking, Delaware and New York law contain lender-friendly statutory provisions in regard to investor capital contribution obligations,[5] imposing duties on investors for unpaid contributions to limited liability companies and limited partnerships. Lenders nevertheless often also require additional language in fund organizational documents to the effect that investor commitments are "absolute and unconditional" and that investors waive all rights of defense, setoff, or counterclaim.[6]

Provisions Addressing Investment Period or Key Person Limitations. Fund organizational documents typically specify a time period during which investments may be made and capital commitments may be called in order to fund such investments. After this investment period, the right to call capital commitments is often limited to the payment of working capital expenses and to the funding of "follow-on investments" in existing portfolio assets, and may either purposely or inadvertently preclude capital calls to repay indebtedness. Additionally, some organizational documents prevent the repayment of indebtedness under a subscription credit facility after the invest-

ment period elapses. Fund organizational documents also often include triggers that can end the investment period if certain key employees are no longer managing the fund borrower. Thus, the resignation, death or employee transfer of such key persons could result in a termination of capital call obligations, risking loss of collateral. Accordingly, lenders should in each case ensure these provisions contain appropriate carve-outs permitting lenders to make capital calls after the investment period to repay facility indebtedness, or include other safeguards preventing the collateral from becoming unavailable.

Provisions relating to Investors. Lenders often require fund organizational documents to include certain requirements with respect to the investors, including: (a) obligating investors to deliver periodic financial statements to the lenders or, in some cases, to maintain minimum net worth; (b) limitations on the rights of investors to transfer their interests in a fund borrower; and (c) limitations on investor "excuses" from the obligation to fund capital call commitments, including in respect of particular investments.[7]

Ideally, funds should structure their governing documents so that no investor has an unfettered right to withdraw from the fund, transfer its interests in the fund or be excused from capital calls relating to particular investments, limiting such events to those necessary for an investor or the fund to comply with legal or regulatory requirements. At a minimum, organizational documents should enable the fund to delay the effectiveness of investor transfers or withdrawals so as to allow a capital call on such investor to cure any possible resulting borrowing base deficiency.

Overcall Rights. Funds historically have included various rights and remedies in their organizational documents to address investor defaults. One such right is the ability to require non-defaulting investors to make up the portion of a defaulting investor's capital contribution—a so-called overcall right. A minority of funds have limitations on these overcall rights that may take various forms, but which in general impose limitations on the amount an investor has to fund of its remaining capital commitment to cover the deficit of a defaulting investor. Lenders should ensure that borrowers either exclude their subscription facility from these limitations on overcall rights or factor such limitations into loan or borrowing base availability to account for their effect.

Hybrid Facilities. Although subscription credit facility lenders have traditionally relied solely on unpaid capital commitments as collateral, an increasing number of facilities—so-called hybrid facilities—are also allowing the underlying investment assets of the fund borrower to be included in the borrowing base as eligible collateral. There are two common types of these hybrid facilities: one in which there is a single blended borrowing base that includes both the fund's unpaid capital commitments and its underlying assets, each subject to a pre-defined advance rate, and another that segregates the unpaid capital commitments and the investments into two separate borrowing bases, such that the capital commitment borrowing base governs early in the fund's life cycle (when such commitments are largest), but upon cessation of the fund's investment period, or when a specified level of investment assets is achieved, the borrowing base is measured based on the underlying assets.

Both of these approaches pose challenges to lenders at the beginning of a fund's lifecycle since they require lenders to essentially underwrite a pool of unknown to-be-acquired assets. However, lenders are addressing these concerns through reliance on pre-agreed investment eligibility criteria, mandating a tailored investment strategy for the fund, or limiting expansion of the borrowing base beyond capital commitments until sufficient assets have been acquired by the fund.

Hybrid facilities are most common in respect of funds whose investments are in the form of loans or equity investments in portfolio companies. Inclusion of such assets into a hybrid facility often requires more due diligence to determine to what extent there may be transfer restrictions in respect of such assets, and whether an actual pledge of the assets may be feasible.

Conclusion. As the market for subscription credit facilities matures, lenders and borrowers are becoming more sophisticated with respect to drafting organizational documents to ease the process of establishing such facilities. As described above, some lenders may be willing to forgo investor consent or estoppel letters to the extent well-drafted organizational documents contain certain protective provisions that would otherwise be contained in a consent. Borrowers can also streamline the process of obtaining investor consents to the extent they already contain such lender-friendly provisions. In addition, hybrid subscription credit facilities, which expand the traditional collateral pool for these facilities beyond capital commitments, are evidence of how these facilities continue to evolve as they become more mainstream lender products.

1. See A. Christenfeld and B. Goodstein, "Subscription Loans to Private Equity Funds," 246 NYLJ No. 40, Aug. 4, 2011.
2. In addition to consents, legal opinions or certificates were also typically requested to provide for the authorization of the investor to enter into the consent as well as the subscription agreement and the fund's organizational documents, and provide for the enforceability thereof as against the investor. In a no-consent transaction, these are also not required.
3. We note that even those lenders that are amenable to a no-consent transaction, will often still require consents from investors. An organizational document may contain other deficiencies or present unique concerns requiring additional provisions protective of lenders (for example, if it contains provisions requiring disputes concerning the organizational documents to be submitted to arbitration which would present an issue in enforcement of the collateral).
4. Similarly, provisions in the organizational documents that prohibit creditors from being third-party beneficiaries of the organizational documents can be problematic to lenders, and typically lenders will seek to be carved out from such provisions.
5. See Del. Code Ann., tit.6 §17-502(b)(1)(2010), Del. Code Ann Tit.6, §15-502 (2010), N.Y. P'ship Law §106(1)(b), and N.Y. P'ship Law §106(3), which provide for statutory provisions permitting creditors to rely upon obligations of limited partners and members of limited liability companies under such organizational documents.
6. The importance of including such language to protect creditors has been illustrated in decisions such as *Chase Manhattan Bank v. Iridium Africa Corporation*. See 307 F. Supp. 2d 6087 (D.Del. 2004) and 474 F. Supp. 2d 613 (D. Del 2007). In that case, a creditor with a collateral assignment of certain reserve capital call obligations of a limited liability company brought a breach of contract action against investors for failing to honor demand notices relating to capital calls by such creditor. The investors raised various defenses, including lack of consideration, commercial impracticability and frustration of purpose. Each of these defenses was dismissed by the court based on the fact that the limited liability company agreement contained language regarding the "absolute and unconditional" nature of the investors' obligations and a general waiver of defenses language. We also note that the decisions in this case provide some support for the argument that an investor's obligations will not be considered voidable as an "executory contract" or "financial accommodation."
7. Additionally, with respect to investors that are government sponsored entities, lenders are concerned with enforcement against such investors to the extent sovereign immunity may apply. A careful consideration of these issues is beyond the scope of this article, but we note that sometimes funds have often included waivers or assurances in regard to this issue in their governing documents or side letters.

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