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Article

Limitations on Lender Assignments To Competitors In Subscription Credit Facilities and Other Fund Financings

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In a typical syndicated credit facility, the lenders are generally prohibited from assigning their rights and obligations under the credit agreement without the borrower's consent (typically not to be unreasonably withheld) unless the borrower is in default of its obligations under the credit agreement or the assignment is made to an existing lender, an affiliate of a lender or a non-natural person that meets certain other specified criteria[2] (each such person, an "Eligible Assignee"). Many credit agreements provide the borrower with additional rights with respect to assignments; for example, by giving the borrower a consent right to lender assignments at all times other than if a payment or bankruptcy event of default exists, by prohibiting assignments to competitors of the borrower or its financial sponsor (if relevant) regardless of whether a default exists, by permitting assignments of term loans to the borrower's debt-fund or other affiliates, by allowing term loan buy-backs by the borrower or by omitting any "deemed consent" provisions where the borrower's failure to object to a request for an assignment within a short time frame constitutes consent. The nature and extent of any such borrower rights, and the degree to which lender participations are similarly restricted, will depend on many factors, including the borrower's credit profile, industry, whether a financial sponsor is involved, general market conditions and the administrative agent's and initial lenders' preferences and policies.

One of the key underlying tensions in negotiating lender assignment provisions is balancing the lenders' desire to maximize the pool of potential assignees in the event a lender needs to liquidate its position to manage its loan portfolio or otherwise, and the borrower's desire to manage the identity and number of its lending partners and maintain the confidentiality of its proprietary information, particularly from the borrower's (or its sponsor's and affiliates') competitors if they are potential assignees or participants. The administrative agent will also have practical operational concerns about the extent to which it may be asked to administer bespoke provisions governing the composition of the syndicate on an ongoing basis. As more fully described below, when a private equity real estate or private equity fund (a "Fund") directly enters into a credit facility as a borrower or other obligor, the Fund's need to limit assignments to competitors may be heightened as potential competitors of the Fund, such as credit funds, debt funds, hedge funds and other pooled investment vehicles, are potential assignees or participants with respect to the Fund's debt. Accordingly, care must be taken to address the Fund's business needs while taking the administrative agent's and lenders' competing objectives into account.

Background

A subscription credit facility, also frequently referred to as a capital call facility (a "Subscription Facility"), is a secured loan made by a bank or other credit institution to a Fund. What distinguishes a Subscription Facility from other secured lending arrangements is the collateral package: the Fund's obligations are typically not secured by the underlying assets of the Fund, but instead are secured by the unfunded capital commitments (the "Capital Commitments") of the limited partners of the Fund (the "Investors") to fund capital contributions when called from time to time by the Fund or the Fund's general partner (the "General Partner"), and certain related rights including collection and enforcement thereof, in each case pursuant to the Fund's constituent documents.

Thus, the collateral package of a Subscription Facility by its very nature includes proprietary information related to the Fund and its Investors. This information includes the Fund's Investor list and Investor details, the Fund's constituent documents (principally the limited partnership or other operating agreement), subscription agreements, any side letters entered into between the General Partner and an Investor in connection with the Investor making its Capital Commitment to the Fund and information concerning the Fund's overall investment and management structure. Side letters in particular have the potential to contain highly sensitive information about a Fund, such as additional or special economic, informational or other concessions the General Partner made to a specific Investor to secure its Capital Commitment.[3] Because Funds and their General Partners invest significant time and resources in developing Investor relationships and negotiating constituent document and side letter terms with Investors and potential Investors, ensuring that such sensitive information is not obtained by competitors (through a debt assignment or otherwise) is of paramount importance to a Fund. If a Fund's competitor obtained its Investor list, Investor Capital Commitment information, and other Fund documents as a result of an assignment or participation by a lender under a Subscription Facility, the competitor would instantly gain an informational and competitive advantage and could use the Fund's trade secret information in its own business to the detriment of the Fund and the benefit of the competitor. Therefore, controlling which entities may gain access to the Fund's non-public information through lender assignments and participations is an important business concern for a Fund. It is worth noting that these concerns may arise not only in a traditional Subscription Facility but also with other types of Fund financings,[4] such as hybrid facilities, unsecured lines of credit with a Fund obligor, financings structures where a Fund provides a guaranty or other credit support and other arrangements where a lender would need to conduct due diligence on the Fund's constituent documents, assess a Fund's Investors from an underwriting perspective or undertake "know your customer" or similar checks on the Fund and its equity holders.

LSTA's Model Credit Agreement Provisions

There are a variety of ways market participants may address lender assignments to competitors in Subscription Facilities and other Fund financings.[5] The Loan Syndications and Trading Association (the "LSTA") recently published a revised version of its Model Credit Agreement Provisions ("MCAPs") on August 8, 2014 that address, among other topics, prohibitions on lender assignments to so-called "disqualified institutions" (commonly also referred to as "ineligible institutions" or "disqualified lenders") (a "Disqualified

Institution"), which specifically contemplate limitations on assignments to the borrower's competitors. The LSTA's new assignment provisions create a structure (the "DQ Structure") that may be useful to Funds, their lenders and respective counsel in negotiating assignment provisions in Subscription Facilities.

In brief, prior to closing, the MCAPs DQ Structure allows the borrower to establish a list of entities that cannot own its debt (which may include both competitors and entities that the borrower desires to "blacklist"; for example, an entity with which the borrower has previously had a bad experience). After closing, the MCAPs permit the borrower to update the list of Disqualified Institutions (a "DQ List") on an ongoing basis with entities that are "Competitors." The MCAPs do not, however, include a definition of "Competitors," and it is left up to the parties to negotiate how "Competitors" should be defined for the particular borrower. Assignments and participations to Disqualified Institutions are prohibited at all times, even if the borrower is in payment default. The MCAPs authorize (but do not obligate) the administrative agent to distribute the DQ List and any updates thereto to each lender and to post the DQ List to the electronic transmission platform for all lenders; the precise mechanics governing who must receive the DQ List and the amount of advance notice the borrower is required to give of a change in the DQ List, however, are left to the parties to determine. The consequences of a lender becoming a Disqualified Institution, or if an assignment is made to a Disqualified Institution, are described in detail in the MCAPs.[6] The MCAPs provide that the borrower is permitted (x) to terminate the revolving commitments of the Disqualified Institution, (y) prepay or repurchase the Disqualified Institution's term loans at the lowest of par, the amount the Disqualified Institution paid for the assignment [or the "market price"][7] and/or (z) require the Disqualified Institution to assign its commitments and loans to an eligible assignee.[8] In addition, the DQ Structure sets forth various limitations on Disqualified Institutions, including prohibiting Disqualified Institutions from receiving information provided by the borrower to the lenders, barring the Disqualified Institution from attending lender-only meetings and effectively limiting the Disqualified Institution's voting rights both before and after the commencement of a bankruptcy proceeding of the borrower.

Considerations in Applying the MCAPs DQ Structure to a Subscription Facility

In applying the LSTA's DQ Structure to a Subscription Facility determining who counts as a "Competitor," the extent to which the Fund is permitted to update the DQ List post-closing and who receives the DQ List will be areas of intense scrutiny for the transaction parties. For a Fund, defining "Competitor" as expansively as possible to include any private equity fund, hedge fund or other pooled investment vehicle or any entity whose primary business is the management of such entities and their affiliates, would be appealing and highly protective of the Fund as it would permit the Fund to designate a wide universe of potential assignees as Disqualified Institutions under the DQ Structure. The lenders, however, would object that such a definition is unduly broad and would cover commercial banks that have fund affiliates (including debt funds) and many secondary market participants, in particular, credit funds, hedge funds and similar institutional investors that are likely potential purchasers of bank debt but with whom the Fund may not truly be competing in terms of investment strategy and potential Investors. Including carve-outs to expressly exclude commercial banks regardless of whether the commercial bank sponsors pooled investment vehicles or private equity funds or make private equity investments in the normal course of its/its affiliates' business from such a definition would ensure that the borrower cannot designate commercial banks as Disqualified Institutions post-closing simply because they may have affiliates conducting private equity-type activities.

Another potential alternative would be to limit the definition of "Competitors" solely to private equity funds with the same primary investment strategy as the Fund (e.g., buyout, energy, real estate, infrastructure, etc.), which would allow for assignments to commercial banks, hedge funds and private equity funds of a type different from the Fund (which are less likely to be competing for Capital Commitments from the same Investors as the Fund). With credit funds especially, this may be a less palatable solution for the lenders, since it would enable the borrower to deliver an exhaustive DQ List that includes many likely secondary market investors. In such a case (and generally), limiting the total number of entities that may be set forth on the DQ List at any time, prohibiting the borrower from updating the DQ List after closing without required lender consent and/or otherwise limiting the frequency with which the borrower may update the list may be ways to balance the Fund's need to limit assignments to competitors against the lenders' interest in ensuring that most of the likely secondary market purchasers are not on the DQ List.

The transaction parties may also consider whether dispensing with the DQ List element of the DQ Structure altogether is appropriate, and instead simply prohibit assignments to all "Competitors" without specifically naming those entities on a list. While this approach may be attractive to a Fund that views its DQ List as trade secret information and does not want it shared with the lending syndicate, it injects an element of uncertainty into the deal to the extent the lenders and prospective assignees and participants are not readily able to confirm whether an assignment or participation would comply with the credit agreement. Where such heightened sensitivities exist, the transaction parties may decide to give the borrower the right at all times to review each proposed assignee or participant to determine if they are a "Competitor" prior to the effectiveness of any trade, thus giving the borrower a (limited) veto right even when the borrower is in default. At the other end of the spectrum (and in the approach outlined in the MCAPs), the parties would agree to the parameters defining "Competitors" and the administrative agent would be authorized to post the DQ List to the electronic transmission platform for all lenders to access. Where participations are subject to the same restrictions as assignments, the lenders will argue that it is only fair for a specific DQ List to be made easily accessible to them with reasonable advance notice.

In addition to determining how to handle the scope and mechanics around updating and distributing the DQ List, the transaction parties will also want to decide whether the remedies and consequences of assigning or participating in a loan to a Disqualified Institution outlined in the MCAPs are appropriate. For example, while the MCAPs include the remedies and consequences outlined above (including yank-a-bank provisions), the Fund may prefer to specify different rights and consequences or provide that offending assignments are void ab initio. Taking such an approach, however, may result in confusion later, particularly if there are multiple assignments following a trade to a Disqualified Institution that need to be unwound.

Conclusion

In negotiating lender assignment provisions in Subscription Facilities, the transaction parties may look to the MCAPs for guidance on how to structure limitations on assignments and participations to Disqualified Institutions, including a Fund's competitors. In applying the MCAP's DQ Structure to a particular Subscription Facility, care must be taken in balancing the competing business and operational needs of the borrower, the lenders and the administrative agent. A slight modification to one element of the DQ Structure may have unintended consequences in other areas of the credit agreement. As a result, Funds and their lenders will want to seek guidance from counsel well-versed in Subscription Credit facilities and the unique needs of Funds when negotiating limitations on assignments and participations in Subscription Facilities.

Endnotes

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[2] Assignments to entities commonly referred to as "Approved Funds" that are (a) engaged in making, holding, purchasing or otherwise investing in commercial loans, bonds and similar credit extensions in the ordinary course of their business and (b) managed or administered by a lender, an affiliate of a lender or an entity or an affiliate of an entity that manages or administers a lender, are often included within the scope of Eligible Assignees in a credit agreement to an operating company.

[3] See article on Developing Side Letter Issues for additional information about select topics commonly addressed in side letters on page 8 in this issue of Winter 2015 Fund Finance Market Review.

[4] For more detailed discussions of other types of Fund financings, please see Mayer Brown's Summer 2013, Winter 2014 and Summer 2014 Fund Finance Market Reviews.

[5] For simplicity, as used herein, "Subscription Facilities" includes all such Fund financings.

[6] The MCAPs provide that assignments may not be made to any entity "that was a Disqualified Institution as of the date (the "Trade Date") on which the assigning lender entered into a binding agreement to sell and assign all or any portion of its rights and obligations under this Agreement." Thus, retroactive effect is not given to the designation of an assignee as a Disqualified Institution after the Trade Date, and the parties may settle their trade without violating the credit agreement; the borrower, however, has certain rights against the Disqualified Institution assignee.

[7] The reference to market price is bracketed in the MCAPs. This is an acknowledgement that it may be difficult to establish a market price for a particular loan at any given time, and the parties may prefer to remain silent on this issue in the credit agreement.

[8] Note that an assignment to a Disqualified Institution under the MCAPs would not render the assignment void; instead, the enumerated consequences would apply.