

Most Favored Nations Clauses: Potential Impact on Subscription-Backed Credit Facilities

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Introduction

The terms of the business arrangement between a private equity fund (a “Fund”) and an investor (an “Investor”) are generally contained in the constituent documents of the Fund, often a limited partnership agreement (an “LPA”), which sets forth the rights and obligations of the general partner and each Investor. An LPA typically will address, among other things, capital commitments, the general partner’s right to call capital, each Investor’s right to partnership distributions, transfer and withdrawal rights, and indemnification obligations. In addition to the LPA, an Investor will likely execute a subscription agreement that often includes, among other terms and provisions, a power of attorney over the Investor, which permits the general partner to execute the LPA on the Investor’s behalf. The subscription agreement and the LPA form the basis of the Investor’s commitment to the Fund and are generally consistent among all Investors in a Fund.

In certain negotiations with potential Investors where the Fund does not want to alter the LPA or subscription agreement, the Fund and an Investor will execute a side letter that will serve, separate and apart from any other Investor’s agreement with the Fund, to modify the terms of that Investor’s subscription agreement and/or the LPA. A side letter generally grants an Investor additional rights or privileges or otherwise limits the applicability of certain LPA provisions as

applied to the Investor. While side letters are, by design, Investor-specific, the inclusion of a Most Favored Nations clause (“MFN”) changes that dynamic and potentially could make every provision of all side letters available to every other Investor.

MFNs have become more common with the proliferation of side letters and side letter requests from Investors. For the reasons discussed below, MFNs can have significant, negative effects on a Fund’s subscription-backed credit facility (a “Credit Facility”). In such a Credit Facility, the lenders (the “Lenders”) are granted a security interest in the uncalled capital commitments of the Fund’s Investors, and the Lenders rely on the Investors’ obligations to fund capital contributions as the primary source of repayment. The Lenders’ rights under a Credit Facility are derivative of the rights of the Fund and its general partner and, therefore, depend significantly on the substance of the Fund’s LPA and any side letters. Because of an MFN’s potentially disastrous impact on a Credit Facility’s borrowing base or viability, as discussed below, it is very important to carefully review and understand not only the MFN, but also each provision of every side letter between a Fund and its Investor where the Investor has an MFN in its side letter.

MFNs Generally

At its most basic, an MFN serves to protect an Investor’s interest by ensuring the Fund does

not offer better terms to another Investor in a side letter. Accordingly, in a side letter's MFN, the Fund agrees that the Investor will be entitled to elect any more-favorable right or privilege granted to other Investors in separate side letters. Thus, an MFN potentially allows an Investor to obtain benefits under any other Investor's side letter. Typically, however, MFNs contain some limits, or "carve-outs," curtailing the provisions that an Investor can elect from such side letters.

While not necessarily included within the text of an MFN, the process by which an Investor can elect provisions from other Investors' side letters varies from Fund to Fund. Some Funds will provide that each Investor with an MFN receives copies of all other side letters, other Funds will provide a list of all side letter provisions and other Funds will circulate a list of only those provisions that an Investor is eligible to elect. In addition, Funds differ both in what is distributed to Investors eligible to make an MFN election and when such an MFN election can be made. Most Funds permit an Investor with an MFN in its side letter to make an election only after the final Fund closing.

Impact on Subscription-Backed Credit Facilities

MFNs can negatively impact, or even completely preclude, a Credit Facility in a number of ways. Because an MFN permits an Investor to elect terms and provisions from other Investors' side letters, the presence of an MFN can have far-reaching effects, particularly on the Fund's borrowing base. In a Credit Facility with the absence of an MFN, an Investor with one or more problematic provisions in its side letter simply can be excluded from the borrowing base. While Investor exclusion is hardly ideal, excluding one Investor is rarely fatal to a Credit Facility's viability. If, however, a similar scenario arises and an MFN exists in one or more side letters,

thereby permitting other Investors to elect such problematic side letter provisions, large swaths of the borrowing base could be excluded, thus jeopardizing the feasibility of a Credit Facility.

For example, if a side letter permitted an Investor to opt out of LPA provisions requiring it to fund its capital commitment without counterclaim, defense or set-off, a Lender may decide to exclude that Investor from the borrowing base.² If there are no MFNs in other side letters, or if any such MFNs are drafted to include applicable carve-outs discussed below, other Investors will be precluded from electing such provisions for their own side letters. The Fund and Lender thus can limit the negative impact on the borrowing base. If the above scenario occurs, however, and one or more other Investors have an MFN in their side letters that allows them to elect the same provision, the ramifications could be catastrophic for the borrowing base.

The potentially far-reaching effects of MFNs on a Credit Facility mean that each provision in every side letter matters. The best practice for both Funds and Lenders, therefore, is to review any proposed side letters prior to their execution to ensure that an MFN will not impair the Fund's borrowing base or a contemplated Credit Facility. Early and clear discourse between the Fund and Lender with respect to side letters will provide the opportunity to negotiate side letter provisions, especially MFNs. To be sure, renegotiating already-executed side letters is a difficult process for all parties, and there is no guarantee that doing so will adequately resolve potential issues. As a result, Funds and Lenders alike should consult with experienced counsel to help review each side letter, to advise and assist in negotiating a side letter's terms, and to ensure that an MFN is well-drafted to include sufficient carve-outs to ensure the viability and success of a contemplated Credit Facility.

Carve-Outs

The most effective way to limit the potentially negative effects of an MFN is through the use of “carve-outs,” or restrictions, in the MFN that limit the types of provisions that an Investor with an MFN may elect from other Investors’ side letters. As side letters have grown in length and as more Investors have requested MFNs, Funds have sought to limit the applicability of MFNs and associated potential Credit Facility issues by including a number of MFN carve-outs, thereby prohibiting the election of certain types of provisions. Because carve-outs vary in scope and substance, an MFN should be crafted and reviewed with the assistance of experienced legal counsel to meet the unique requirements of each transaction and to limit the potential negative effects on a Credit Facility. There are a number of typical MFN carve-outs discussed below that can be helpful to both Funds and Lenders in connection with their Credit Facilities.

One very common MFN carve-out links an Investor’s ability to elect more favorable rights to the size of the Investor’s capital commitment. Such a carve-out precludes a small Investor from electing provisions that a Fund’s larger Investors may have negotiated. Such capital commitment-based carve-outs can be structured in a number of ways, including setting a minimum commitment threshold for any Investor to have an MFN in its side letter, permitting an Investor to elect side letter provisions of any Investor with an equal or lesser commitment, or establishing a commitment threshold above which an Investor may elect any provision from any other Investor, regardless of the other Investor’s commitment.

Another typical MFN carve-out imposes policy/jurisdictional/regulatory limits on side letter-electable provisions. Certain Fund Investors, by virtue of their written policies or guidelines or by jurisdictional or regulatory

status, may be entitled to certain accommodations on account of such status that the Fund may not want to extend, or are otherwise inapplicable, to other Investors. Such an MFN carve-out would allow an Investor to elect additional rights only if the Investor is subject to similar policies, guidelines, or jurisdictional and regulatory schemes.³ Investors subject to the same policy, jurisdictional or regulatory regimes thus will be able to elect such provisions, but the Fund and Lender will still be protected from having to offer the same rights to additional, non-qualifying Fund Investors with an MFN. There is some debate among practitioners as to whether the broad use of policy/jurisdictional/regulatory status language to preclude election under an MFN would be enforceable in all circumstances, but such carve-outs nevertheless are utilized widely in side letters to try to limit MFN risk exposure.

Potentially most important for facilitating a Credit Facility is a carve-out prohibiting any Investor from electing additional rights that may affect provisions of the LPA related to the Fund’s ability to enter into a Credit Facility. Such a carve-out would apply to, among other things, provisions regarding funding without counterclaim, defense, or setoff, agreement to produce or deliver financial statement, investor acknowledgments, investor letters, and/or investor opinions. By preventing all Investors from electing provisions so closely linked to a Credit Facility, a Fund and a Lender can effectively limit negative impacts to the borrowing base and thus ensuring feasibility of a Credit Facility.

Conclusion

As discussed above, MFNs in side letters can have a potentially significant and negative impact on a Credit Facility. Although Investors may insist upon an MFN in their side letters, a Fund and a Lender can take reasonable steps,

such as adding carve-outs to the MFN's applicability, thereby protecting the Fund's borrowing base from problematic provisions in a side letter and, by extension, the viability of a Credit Facility. Early review and, if necessary, negotiation of proposed side letter provisions by both the Fund and the Lender

with the assistance of experienced and skilled counsel is the recommended best practice. In doing so, a Fund can ensure its borrowing base remains intact, and a Lender can get comfortable relying on the capital commitments of the Fund's Investors for repayment.⁴

Endnotes

- ¹ Mark Dempsey is a partner in the Banking & Finance and Fund Formation & Investment Management practices. Frank Falbo concentrates his practice on private investment funds, joint ventures and other corporate and securities transactions.
- ² For a detailed discussion of some current problematic side letter issues, see the article, "Developing Side Letter Issues" on page 8 in this issue of *Winter 2015 Fund Finance Market Review*.
- ³ Common examples include (i) inapplicability of waiver of defenses or counterclaim for tax purposes, (ii) reservation of rights with respect to sovereign immunity, and (iii) variation from confidentiality restrictions.
- ⁴ Investor consent letters are typically required by the market for highly concentrated investor pools (including single-investor Subscription Facilities) even with ideal LPA provisions.

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