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Model Responses to ILPA's Subscription Credit Facility Due Diligence Questionnaire

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In June 2017, the Institutional Limited Partners Association (ILPA) published *Subscription Lines of Credit and Alignment of Interests: Considerations and Best Practices for Limited and General Partners* (the Guidelines).[2] The Guidelines noted the increased usage of subscription credit facilities (Subscription Facilities) and outlined the advantages of such facilities to investors (**Investors**) in private equity funds (**Funds**). A key part of the Guidelines set forth a list of due diligence questions regarding Subscription Facilities that Investors should consider asking fund managers and general partners (**General Partners**) prior to investing. Given ILPA's influence in the market, General Partners should be prepared to answer these questions in their negotiations with potential Investors. So too, Subscription Facility lenders should consider tailoring their structures, pitches and negotiations with these questions in mind. Below, we explore the model questions, set forth practice notes market participants should consider and offer suggested responses (with different options bracketed) that they can tailor to suit their specific business strategies and operating procedures.

[Preliminary note to include with responses for Subscription Facilities that have not yet been fully negotiated: The questions below have been answered based on the General Partner's expectations as of the date of this response. The final terms of any Subscription Facility may differ from the terms described below, and certain variations may be material.]

What is the stated purpose and intention of using the Subscription Facility?

The Subscription Facility can be used for working capital purposes, including:

1. To bridge capital calls, which will (a) enable the Fund to act quickly for time-sensitive investments, (b) permit the Fund to smooth out capital calls in terms of size and frequency (which lowers expenses of the Fund and expenses for Investors associated with the capital call process), and (c) eliminate or minimize the administratively burdensome and costly "true-up" process between initial Investors and later close Investors.
2. To provide access to letters of credit (by including this in a Subscription Facility, the Fund will avoid the time and expense of negotiating multiple letters of credit facilities).
3. To provide quick and economical access to foreign currencies.
4. To secure interest rate and foreign exchange hedging exposures without calling or reserving capital or incurring added borrowing expenses (the Subscription Facility allows the Fund to

allocate a part of the borrowing base to secure hedging exposure without actually making any draw on the Subscription Facility).

5. To permit the Fund to bridge permanent asset-level financing so the Fund will have time to arrange asset-level financing on more favorable terms and conditions.[3]

Practice Note: The loan documentation for Subscription Facilities will likely contain a "Use of Proceeds" provision which is usually structured very broadly to offer the Fund maximum flexibility. Due to Liquidity Coverage Ratio concerns, lenders should consult counsel before narrowing the scope of this section.[4]

When is use of the Subscription Facility expected to end? When is it contractually required to end, i.e., its expiration?

The Subscription Facility will have an initial [X] year term, which the Fund can extend [with][without] lender consent for an additional [Y] years.

[Each Loan under the Subscription Facility will be repaid within [X] days [in accordance with the Fund's governing documents].]

The Fund expects to use the Subscription Facility primarily during the investment period. After the investment period, the Fund [does not plan to use a Subscription Facility] [plans to only use the Subscription Facility on a limited basis to bridge capital calls and support follow-on expenses and investments].

[The Subscription Facility will be "committed," which offers the Fund reliable access to capital at attractive pricing.]

[The Subscription Facility will be payable "on demand" but includes a [X]-day grace period prior to any call that would permit the Fund to either refinance or call capital prior to its expiration.]

What are the terms for the Subscription Facility? Covenants, coverage, reset, negative provisions?

Standard Subscription Facility material covenants and terms include:

1. Restrictions on fundamental changes to the Fund's organizational structure or documents without lender consent.
2. Restrictions on making distributions to Investors during a pending default scenario.
3. Certain limitations on Fund-level indebtedness,
   [which will largely mirror the corresponding provisions in the Fund's governing documents].
4. Change of control, key man and removal events [which will largely mirror the corresponding provisions in the Fund's governing documents].

Generally speaking, the General Partner believes the terms of the Subscription Facility are less restrictive than asset-level financings and are aimed at preserving the availability of the Investors' capital commitments to the Fund, the related call rights and the related mechanics.

What was the initial size of the Subscription Facility and by how much could it be increased?

The Subscription Facility is currently sized at $[X]. As the Fund completes subsequent Investor closings, the Fund will have the option to increase the Subscription Facility [with][without] lender consent. If the target commitment level of $[X] is achieved, the Fund expects to have a $[X] Subscription Facility.

[The Fund's leverage limitations cap indebtedness at [X] percent of the uncalled commitments, which [includes] [does not include] indebtedness under any Subscription Facility.]

How many current Investors cover the Subscription Facility, i.e., "Included Investors?"

The entire Investor base factors into the lender's underwrite of the Subscription Facility and, barring very special circumstances, all Investors are responsible to fund capital contributions to repay the Subscription Facility. The Subscription Facility structure uses a "borrowing base" that must cover the amount outstanding under the Subscription Facility. The borrowing base is calculated by applying [a flat [__] percent advance rate against the uncalled capital commitments of all Investors.] [negotiated advance rates (ranging from [__] percent to [___] percent) against different classes of Investors (e.g., high net worth investors, investors' investment grade ratings)]. It is important to note that, except with respect to extremely rare, specific issues relating to individual Investors, the collateral under the Subscription Facility includes the ability to call on all Investors [(including any Investor not included in the calculation of the borrowing base)], which is equitable because all Investors benefit from the Subscription Facility.

What is the cost to initiate the Subscription Facility, and how are those expenses reported to the Investors? What is the cost to renew the Subscription Facility at the end of the term?

The fees and margins associated with the Subscription Facility will likely be notably lower than most other types of financings (e.g., leveraged loan financings).

Does the Subscription Facility cross-default in the event one of the Investors defaults?

The lender's right to call capital from Investors is simply derivative of the Fund's (or its General Partner's) right to call capital. Accordingly, because the General Partner can issue call capitals to make up shortfalls caused by another Investor's failure to make capital contributions (an "overcall"), the lender will also be able to do so. It is important to note that the Fund's ability to make overcalls is necessary to prevent a single Investor's default from effectively eliminating the Fund's ability to complete investments.

Will performance (IRRs) be calculated with and without use of the Subscription Facility?

[General Partner to answer based on its particular approach.]

Will leverage (e.g., in the case of real estate funds) be disclosed with and without use of the Subscription Facility?

[General Partner to answer based on its particular approach.]

In the event that an Investor whose commitment was used to secure the Subscription Facility needed to sell their commitment on the secondary market, how would that impact the line, the ability of the Investor to sell, and the overall partnership?

The Subscription Facility will only prohibit a transfer if it would violate sanctions provisions or would result in a violation of law. [The General Partner would, in the ordinary course, also withhold its consent to transfers that would result in these issues even if the Fund did not have a Subscription Facility.]

[Additionally, if the transferring Investor is "included" in the borrowing base, the Subscription Facility may require that, prior to the effectiveness of the transfer, the Fund make a prepayment in an amount that would cause the Fund to be over-extended on its borrowing base after giving effect to such transfer (i.e., if the transferee was ineligible for inclusion in the borrowing base and by removing the Investor's commitment the Fund would be overdrawn on the Subscription Facility). Accordingly, the Subscription Facility will not ultimately restrict the ability of an Investor to sell its interest in the Fund; it may merely require that the Fund prepay the line (which may be done by using cash on hand or by making a capital call (including on the existing Investor)) prior to the effectiveness of any transfer.]

What impact if any will the use of the Subscription Facility have on UBTI exposure for ERISA or other tax-exempt Investors?

[The Fund's counsel should be involved in structuring a response to this question.]

Practice Note: Subscription Facilities offer wide availability to accommodate Fund structures in order to satisfy any UBTI and ERISA concerns, including the use of "clean downs" and "cascading pledges."[5]

Under what circumstances (e.g., regulatory changes) could the Subscription Facility be pulled by the lender?

[The Subscription Facility is committed and cannot be pulled by the lender.]

[The Subscription Facility is "uncommitted and on demand" and thus can be pulled by the lender at anytime on a [X]-day notice, which would permit the Fund to either refinance or call capital prior to its expiration. The Fund prefers this structure as it avoids certain fees that "committed" Subscription Facilities typically charge.]

Is LPAC approval required to open or extend the Subscription Facility? Does initiating or extending the line require any amendments to the LPA?

The Fund's governing documents do [not] require advisory board approval. [The Subscription Facility will not require amendments to the LPA.] [The Subscription Facility lender has requested the following amendments to the LPA: [XYZ].]

Practice Note: Most Funds seek comments from lenders prior to their first Investor closing in order to avoid having to amend their governing agreements.

In an event of default (EOD), what recourse does the lender have to the uncalled commitments or assets of included Investors?

The Subscription Facility will not be recourse to any asset of the Investors. It will only be recourse to the Fund (i.e., the ability to make and enforce capital calls (on a secured basis)) and the other assets of the Fund (on an unsecured basis) and other loan parties. Thus, after an Investor has funded its capital commitment, in accordance with the Fund's governing agreement (including any with respect to any overcall (as explored above)), the lender will be barred from turning to the Investor to makeup any loss it experiences on the Subscription Facility.

What process was followed by the General Partner in the selection of a lender?

[General Partner to answer based on its particular approach.]

Practice Note: While this will vary from Fund to Fund, the Fund should solicit and evaluate term sheets from multiple lenders that set forth pricing, the proposed structure, the proposed borrowing base and other key terms. Other considerations should include a lender's proven execution capabilities, commitment to the space, and track record.

Endnotes

1. Bryan Barreras is a partner in Mayer Brown's New York office and a member of the global Banking & Finance and Fund Finance practices. Doug Donahue is a Banking & Finance partner in the New York office of Mayer Brown. Marcin Perzanowski practises in the Banking & Finance practice of the London office as Of Counsel.
2. The Guidelines are available at https://ilpa.org/wp-content/uploads/2017/06/ILPA-Subscription-Lines-of-Credit-and-Alignment-of-Interests-June-2017.pdf.
3. Note that this list is not exhaustive and the use of Subscription Facilities by Funds will vary widely. For a more detailed description of the possible uses of subscription credit facilities, see https://www.mayerbrown.com/files/Publication/96e93616-8f87-407c-ac3c-c0d151b512b3/Presentation/PublicationAttachment/b3947934-6123-45f9-9c2f-ce336d07be75/Subscription-Credit.pdf
4. For more information on the implications of the Use of Proceeds provisions in Subscription Facilities, please see Capital Commitment Subscription Facilities and the Proposed Liquidity Coverage Ratio, available at https://www.mayerbrown.com/Capital-Commitment-Subscription-Facilities-and-the-Proposed-Liquidity-Coverage-Ratio-12-20-2013/ .
5. For more information on structuring Subscription Facilities for UBTI concerns, see https://www.mayerbrown.com/addressing-ubti-concerns-in-capital-call-subscription-11-12-2012/ and for ERISA concerns, see https://www.mayerbrown.com/subscription-credit-facilities-certain-erisa-considerations-07-29-2013/.