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Default Remedies under Subscription Credit Facilities: Guide to the Foreclosure Process

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Although the growing market for subscription-backed credit facilities (each, a "Subscription Facility") has witnessed very few defaults or similar events necessitating non-consensual enforcement actions (each, a "Default"), Subscription Facility lenders and other secured parties thereunder (the "Secured Parties") nevertheless should understand and, if necessary be prepared to quickly enforce their rights in the collateral pledged under such Subscription Facility—a point consistently reinforced by both bank regulators and risk teams at many of our clients. Similarly, private equity fund borrowers (each, a "Fund") and fund sponsors should also understand the remedial actions a Secured Party may take under a Subscription Facility so that they can be prepared to respond appropriately should a Default arise and the Secured Parties elect to exercise their enforcement rights. Although certain rights and remedies may be available to Secured Parties following a Default, in most circumstances the most effective method of managing a Default will be for the Fund and the Secured Parties to develop a mutually agreeable strategy on how best to address the Default. In the event that the parties cannot agree on a strategy to work through the Default, the relationship between the Fund and the Secured Parties has turned sour or if the circumstances warrant an immediate exercise of remedies (e.g., the investors have moved to remove the Fund's general partner or change the investment manager or the Fund or investment manager has committed fraud), the Secured Parties may determine exercising remedies in lieu of negotiating a workout is necessary.

To that end, this legal update examines the rights and remedies typically available to Secured Parties following a Default under customary, agented Subscription Facility documentation and provides recommendations for additional, preemptive actions that Secured Parties should consider incorporating into their standard policies to prepare for the contingency of a Default. It is important to note, however, that certain remedies discussed herein may be stayed or otherwise may be found to be ineffective or unenforceable under bankruptcy or other applicable law, particularly if the Fund has been, or is subject to, certain insolvency proceedings. While this update includes a general discussion of the legal principles applicable to possible enforcement scenarios, the Secured Parties seeking to exercise remedial measures under a Subscription Facility should always consult appropriate counsel with respect to Fund bankruptcies or other specific Defaults.

Background

A Subscription Facility is typically secured by a lien on, among other things, the Fund's (or its general partner's) ability to (a) issue and direct capital calls, (b) receive capital contributions and (c) enforce default remedies against

"defaulting investors" pursuant to the Fund's governing document. The lien on this collateral is granted in favor of the Subscription Facility's collateral agent (the "Agent") and is perfected under United States law by filing a Uniform Commercial Code ("UCC") financing statement in the applicable filing office.[1] Additionally, Subscription Facilities generally require that the Fund grant a security interest in favor of the Agent in the deposit or securities account into which capital contributions are deposited by investors when called by the Fund (or its general partner) (the "Collateral Account"). Perfection of the lien on the Collateral Account is usually achieved either by requiring the Collateral Account to be held at and maintained with the Agent, as account bank, or by the entry into a tri-party control agreement over the Collateral Account among the Fund, the Agent, and the account bank at which the Collateral Account is held and maintained.[2]

Remedies

While most market participants have a general understanding of the basic nature of Subscription Facility collateral, sometimes overlooked is how an Agent, acting for the benefit of the Secured Parties, would practically enforce remedies against such collateral following a Default. The following table sets forth (a) certain actions that Agents and Secured Parties might contemplate prior to actually enforcing remedies following a Default (referred to below as the "Pre-Enforcement Stage") and (b) remedies typically available to the Agent and Secured Parties that should be considered once the decision to enforce remedies has been made following a Default (referred to below as the "Enforcement Stage"). Every Default scenario is unique, and the Agent and Secured Parties must take into account the specific facts and circumstances giving rise to the Default when determining the approach to take. Accordingly, the following table should be treated as a list of potentially available remedial options and not as a preordained, step-by-step guide. Similarly, while certain action items below have been categorized as either "Pre-Enforcement Stage" or "Enforcement Stage," the actual facts and circumstances surrounding a particular Default scenario may lead to different timing of any specific action or actions. Upon the occurrence (or suspicion) of a Default, and certainly prior to the exercise of any remedy, Secured Parties should consult with competent legal counsel, and no remedial actions should be initiated without careful planning; Funds would likewise benefit from consulting with counsel when it becomes apparent a Default may arise.

Pre-Enforcement Stage

Action	Commentary
1. Consult legal counsel	Both in-house and external counsel should be consulted prior to taking remedial measures, and ideally as soon as a Default appears reasonably likely to occur. Engaging counsel early in distress scenarios usually is more time- and cost-efficient, as the parties may be able to negotiate an amendment, forbearance or other consensual (and mutually agreeable) resolution of a Default rather than requiring enforcement actions to be taken. Likewise, engaging in an open dialogue with counsel well before enforcing rights and remedies

	helps to ensure a more complete understanding of the facts surrounding the Default, thus enabling the Secured Parties to obtain full and informed advice from counsel. Additionally, legal counsel should be consulted in the Agent's (and Secured Parties') confirmation of the actual existence of a Default prior to any remedy being taken. Secured Parties could potentially expose themselves to liability should they take remedial measures in the absence of an actual default under the Subscription Facility documentation or in a manner that courts later determine to be improper. With that in mind, Secured Parties should work with counsel to mitigate the risk of a lender liability claim in a Default scenario. For example, legal counsel may suggest the Secured Parties obtain a declaratory judgment against the Fund prior to enacting any remedies. Legal counsel will also help the Agent understand its obligations, including to the lending syndicate, and the requisite notice and voting requirements that may govern enforcement actions. Finally, external counsel representing the Agent in the documentation of the Subscription Facility may be prohibited from representing the Agent in an enforcement scenario (e.g., the Fund oftentimes will waive a client conflict in connection with documenting the Subscription Facility so long as such counsel agrees to resign as counsel for the Agent in the event of any adverse proceeding or enforcement scenario related thereto). If this is the case, the Agent will need time either to seek a waiver of the conflict or to engage new counsel (in which case, new counsel will need to be apprised of the Default and to work through various pre-enforcement items with the Agent).
2. Review files to make sure documents are organized and complete	The Agent and its counsel should ensure their loan files are current and complete. All Subscription Facility documentation (including all notices sent between the parties, loan requests, borrowing base certificates and compliance certificates) and investor documents (including subscription agreements, side letters and "most favored nation" elections that have been delivered before and after the Subscription Facility has closed) are well organized to enable the Agent to act quickly, if needed.
3. Confirm UCC filings are valid and refresh lien searches	As a rule, UCC financing statements expire five years after the date on which such financing statements are filed, unless renewed by the Secured Party, and financing statements are also occasionally misfiled by filing offices. The Agent should confirm that all UCC financing statements filed during the term of the Subscription Facility remain valid (and, if not, the Agent should promptly resolve any issues regarding such financing statements with the assistance of counsel). New lien searches will not only confirm that the UCC financing

	statements were properly filed, but also may show any new tax, judgment or other liens on the assets of the Fund, or other new obligations or competing liens that may have attached to the collateral. Understanding the universe of what else is "out there" as it relates to the Secured Parties' lien on the Subscription Facility collateral will help the Agent determine how much flexibility it may have in enacting remedies.
4. Confirm delivery of investor notices	In many non-U.S. jurisdictions, perfection and priority of the Agent's security interest requires that the investors receive notice of the Subscription Facility and the grant of a security interest to the Agent thereunder. While most Subscription Facilities require these notices to be delivered both in connection with the initial closing of the Subscription Facility and promptly upon a new investor joining the Fund, the Agent should confirm that all applicable investors (including those having joined in subsequent investor closings) have received investor notices, particularly since the Fund may have failed to strictly comply with this delivery requirement after the initial closing of the Subscription Facility.
5. Review the account control agreement (especially in relation to timing and notice requirements)	While a well-drafted control agreement will provide the Agent with perfection control over the Collateral Account on day one, most control agreements for a Subscription Facility require advance notice to be provided by the Agent to the account bank as a prerequisite for the Agent to exercise exclusive control over the Collateral Account (typically two or more business days). Agents contemplating taking remedial steps following a Default should factor such timing into their decision-making process. Similarly, many control agreements prescribe specific notice procedures, particularly with respect to the Agent delivering a notice of exclusive control over the Collateral Account (e.g., notices of exclusive control must be sent by fax and signed by a specific officer of the Agent for whom the account bank has received evidence of incumbency or authority). Agents therefore should familiarize themselves with any express notice requirements and be prepared to act quickly to comply with any such requirements.
6. Request updated investor contact information	If it needs to issue a capital call to repay outstanding obligations under the Subscription Facility, the Agent will need the contact information for each investor. While investor subscription agreements should contain contact information for each investor, such contact information is typically current as of the date the investor joined the Fund (and such information frequently changes after such date). Accordingly, in a Default scenario the Agent should promptly request updated investor contact information from the Fund, even if the Fund is otherwise required under the Subscription Facility documentation to provide ongoing updates of such investor

	contact information. While most Subscription Facilities require prompt notice of any changes to such investor contact information, the Fund may not have strictly adhered to this requirement (and, in any event, having contact information confirmed, up-to-date and readily available will assist and make more efficient any foreclosure process undertaken by the Agent and/or the Secured Parties).
7. Gain ability to "post" to the investor portal	Most Funds issue capital calls via Internet portals to which each investor has access rights. In the event the Agent plans to or must issue a capital call as part of taking remedial measures after a Default, issuing such capital call via the Internet investor portal will likely be the most efficient way of doing so. Investors presumably will be more inclined to fund their capital contributions on time (and without challenging such capital call) if the Agent's process of calling capital following a Default largely mirrors the Fund's typical capital call process (and delivery means), with which the investors are already familiar.
8. Refresh governing document and investor document diligence, especially related to capital call mechanics and excuse rights	The Agent and its counsel should refresh their diligence of the Fund's governing document provisions relating to capital calls (e.g., the period within which investors must fund capital contributions when called), the calculation of capital calls (e.g., whether capital contributions must be funded "pro rata" when called) and any applicable investor excuse rights or overcall limitations. The Agent should account for any investor excuse rights or overcall limitations in its initial capital call in order to avoid having to issue multiple capital calls to the investors.
9. Take inventory of all Defaults	The Agent should thoroughly review all existing Defaults under the Subscription Facility. If a material Default has occurred, an increased risk exists that other technical Defaults or undiscovered material Defaults have also occurred. All Defaults should be addressed and evaluated in connection with any assessment of how to best proceed.
10. Prepare reservation of rights letter and/or a notice of Default	The Agent should consult with counsel to determine if it should send a written notice of default or a reservation of rights letter to the Fund. Such written notice of default or reservation of rights letter can help establish a documentary precedent acknowledging the Agent's attention and response to the Default.
11. Conduct a site visit	The Agent will typically have the right to conduct a site visit to the Fund to review the Fund's books and records, even if no Default has yet occurred or exists. After a Default, however, the Agent should consider conducting a site visit to collect any needed data that could potentially be helpful in the enforcement process (e.g., investor contact information, investor correspondence, applicable records relating to the use of loan proceeds).

12. Organize conference calls with the Secured Parties	The Agent should hold conference calls with their counsel, the Secured Parties, and where applicable, the Fund and their counsel, to examine the nature of the Defaults, any mitigating or aggravating circumstances and to determine the best course of action.
13. Organize conference calls with Investors or the Fund's Advisory Board	The Agent may also consider organizing (likely with the Fund) Investor and/or Advisory Board conference calls to identify any Defaults or other issues for the Investors, gauge their reaction and remind them of their contractual obligation to make capital contributions.
14. Open replacement Collateral Accounts	he Agent may also consider opening one or more replacement Collateral Accounts, held at the Agent, to mitigate operational risk associated with the account bank. Additionally, most control agreements permit the account bank to terminate the control agreement governing the Collateral Account by giving prior notice (typically, thirty days). In a Default scenario, an account bank may wish to extract itself from the dispute and simply terminate the control agreement or close the Collateral Account. In order to avoid a scenario wherein the Agent temporarily lacks a Collateral Account (or control of such accounts for perfection purposes), the Agent may wish to open one or more new Collateral Accounts as a matter of course. Nevertheless, due to ERISA concerns and requirements often included within the governing document of the Fund, replacement Collateral Accounts may need to be opened in the name of the Fund (in which case the Agent may need to use the power-of-attorney granted in the Subscription Facility documentation to open such replacement Collateral Accounts). For any replacement Collateral Account, the Agent should ensure it places a "blocked at all times" instruction on such account to avoid any operational risk with a shifting control concept.
15. Calculate outstanding obligations	The Agent should calculate the existing outstanding obligations under the Subscription Facility (including unpaid principal, letter of credit liabilities, accrued interest, unused fees, letter of credit fees, agency fees, facility fees, obligations under any secured hedges and fees and expenses of counsel), which will assist the Agent in understanding the total risk inherent in a Default scenario.
16. Prepare for cash collateralization of letters of credit	Letter of credit issuers should consider opening cash collateral accounts for any outstanding letters of credit and preparing related documentation (e.g., control agreements over such cash collateral accounts).
17. Request pre-signed capital call notices	The Agent should also consider requiring the Fund to deliver pre-signed, but undated, capital call notices in escrow (which could then be delivered by the Agent, via the power of attorney granted under

	the Subscription Facility documentation). Possession of (and ability to deliver) these pre-signed capital call notices in the form typically delivered to investors, and signed by the individual who typically signs such capital call notices, could allow the Agent to recover from the investors more efficiently.
18. Prepare capital call notices	The Agent should consider preparing capital call notices, using the most recent capital call notices delivered to investors as a template (unless in possession of pre-signed capital call notices, as discussed above). Investors receiving a capital call notice in the same form typically delivered by the Fund will increase the likelihood that investors will fund their capital contributions on time (and without challenging the call). Additionally, the most recent capital calls will oftentimes include each Investor's current notice information (hence one reason why most Subscription Facilities require that all capital call notices (and not simply an exemplar copy) be delivered to the Agent concurrently with the distribution to the investors). The Agent should also consider how it frames the purpose of the capital call (a description of which is typically included in each capital call notice). The facts and circumstances surrounding the delivery of a capital call by the Agent (including if a Default exists) will help determine the proper tone and message describing the purposes of the capital call (and the Agent should consult with experienced counsel to discuss proposed approaches).
19. Identify internal conflicts of interest	To avoid lender liability claims, Secured Parties should, prior to any enforcement following a Default, be aware of, and account for, any actual or potential conflicts of interest affecting the Secured Parties.
20. Request additional collateral	To mitigate risk, the Agent and Secured Parties may also consider requesting additional collateral (e.g., cash collateral and other assets of the Fund (including the Fund's equity positions in portfolio companies)).
21. Restructure the Subscription Facility documentation	The Agent and Secured Parties additionally should consider using the Default to negotiate a restructuring of the Subscription Facility (e.g., restricting the borrowing base mechanics, adjusting pricing, imposing additional mandatory prepayment and/or notice requirements).
22. Consider requirements for (including concessions for) waiver of the Default	In the event the Secured Parties decide to not impose remedies following a Default, the Agent should work with counsel to document a waiver of the Default (including any potential fees or other consideration therefor). Documenting waivers is especially important to protect the Secured Parties' position and to guard against a potential claim that, through a "course of dealing," the Secured Parties have effectively waived their rights to enforce remedies relating to certain types of Defaults in the future.

23. Assign or participate the loan	Individual lenders may want to consider whether they wish to remain "in the deal" in an enforcement scenario, including potential foreclosure on the collateral or if they instead prefer to seek to assign or participate their interest in the loan to an existing lender or to another third party.

Pre-Enforcement Stage

Action	Commentary
1. Charge default interest	Depending on the specific Subscription Facility documentation, the Agent (or the Secured Parties) may need to affirmatively elect to charge default interest.
2. Suspend the availability of LIBOR loans	In order to mitigate losses associated with break-funding, LIBOR conversions and continuations may be blocked.
3. Take exclusive control over the Collateral Account	The Agent may be entitled to sweep the Collateral Account to repay obligations or, if the control agreement does not require a daily sweep, simply freeze funds deposited in the Collateral Account (and the ability for the Fund to withdraw such funds or issue instructions related thereto) while an acceptable resolution with the Fund is negotiated.
4. Notify investors of the Default	In certain circumstances, the Agent might consider distributing notices to the investors informing them of the occurrence of a Default under the Subscription Facility. This approach can be advantageous in certain Default scenarios, such as where the general partner has (or may have) committed fraud against the investors (thus creating an increased risk that the investors might be less likely to cooperate with the Fund in funding capital contributions).
5. Instruct the Fund to issue a capital call	While the Agent cannot always count on a cooperative Fund post-Default, in many cases (except, perhaps, where fraud has been committed and other, similar events), the odds of a full recovery will likely be optimized if the Fund (or the general partner) itself issues a capital call in form and manner consistent with the Fund's (or the general partner's) standard practice. Many Subscription Facilities will specifically grant the Agent the right to instruct the Fund (or its general partner) to issue such a post-Default capital call as a stand-alone contractual remedy (in addition to the security interests granted in the collateral).
6. Issue a capital call via the power of attorney	If in possession of pre-signed capital call notices, the Agent may consider utilizing the power of attorney granted in the Subscription Facility documentation to deliver such capital call notices to the investors.

	Alternatively, the Agent could potentially use its power of attorney to prepare and sign capital call notices (as the Fund's attorney-in-fact). Using the power of attorney (instead of the collateral assignment, as described below) could prove useful in avoiding certain ERISA concerns relating to issues of privity between the Agent and the investors.
7. Issue a capital call via the collateral assignment	In other circumstances, particularly where the Fund (or its general partner) has committed fraud against the investors, the investors may be more inclined to fund a capital call if such capital call is issued in the name of the Agent (as collateral assignee of the Fund).
8. Prepare overcall capital calls	If the Agent made a capital call, while such initial capital call is pending, the Agent should prepare a second set of capital call notices for use should a shortfall occur in connection with funding the initial capital call as a result of a defaulting or excused investor failing to fund all or a portion of its required capital contribution.
9. Enact default remedies against investors	The Agent can enforce (or leverage its right to enforce) the enumerated remedies set forth in the Fund's governing document against any defaulting investor. This course of action, however, likely should be a remedy of last resort (e.g., to be used if an overcall on the non-defaulting investors (to make up funding shortfalls due to defaulting or excused investors) is still insufficient to recoup all amounts due and owing to the Secured Parties), and the Agent should consult with counsel prior to any such enforcement.
10. Terminate the revolving commitments	Terminating the revolving commitments will "term-out" the obligations.
11. Accelerate the maturity date and declare all obligations due and payable	Accelerating the Subscription Facility maturity date and declaring all obligations thereunder immediately due and payable will enable the Agent to demand prepayment of all obligations prior to the scheduled maturity or repayment date (which, as noted above, would help mitigate added risk during the process of enforcing rights and remedies following a Default).
12. Apply the enforcement proceeds	The Agent should allocate post-Default remedial proceeds received from the Fund in accordance with the enforcement waterfall found in the Subscription Facility documentation, including to cash collateralize letters of credit, to settle secured hedges and to pay expenses.
13. Enact remedies under the UCC, offset laws and other applicable law	In the event available remedies contemplated in the Subscription Facility documentation (and as described above) do not adequately result in the Fund's full repayment of the Fund's obligations thereunder, the Agent should consider other possible remedies available under the UCC or other applicable law – including offset, litigation, and pursuing relief under applicable insolvency laws.

Conclusion

While the Subscription Facility market has historically experienced very few instances of Defaults, and even fewer requiring the exercise of many of the above described remedies, Funds, Agents and Secured Parties should be familiar with available remedial options under Subscription Facility documentation and Fund constituent documentation following the occurrence of a Default. Although the table provided above sets forth a litany of such remedial options, some of those options may not be available or recommendable in any particular situation, and market participants should always consult with experienced counsel to effectively manage a Default without exposing themselves to undue risk or liability.

Endnotes

1 Under UCC § 9-310, a financing statement must be filed to perfect all security interests (other than those security interests perfected via a different method (e.g., via control) expressly enumerated in the UCC).

2 Under UCC § 9-314, a security interest in a Collateral Account may be perfected by control (e.g., if the Collateral Account is a deposit account, the Agent has a perfected security interest in the Collateral Account if the Collateral Account (1) is held at and maintained with the Agent; (2) the Fund, the Agent and the account bank have agreed in an authenticated record that the account bank will comply with instructions originated by the Agent directing disposition of the funds in the Collateral Account without further consent by the Fund or (3) the Agent becomes the account bank's customer with respect to the Collateral Account).