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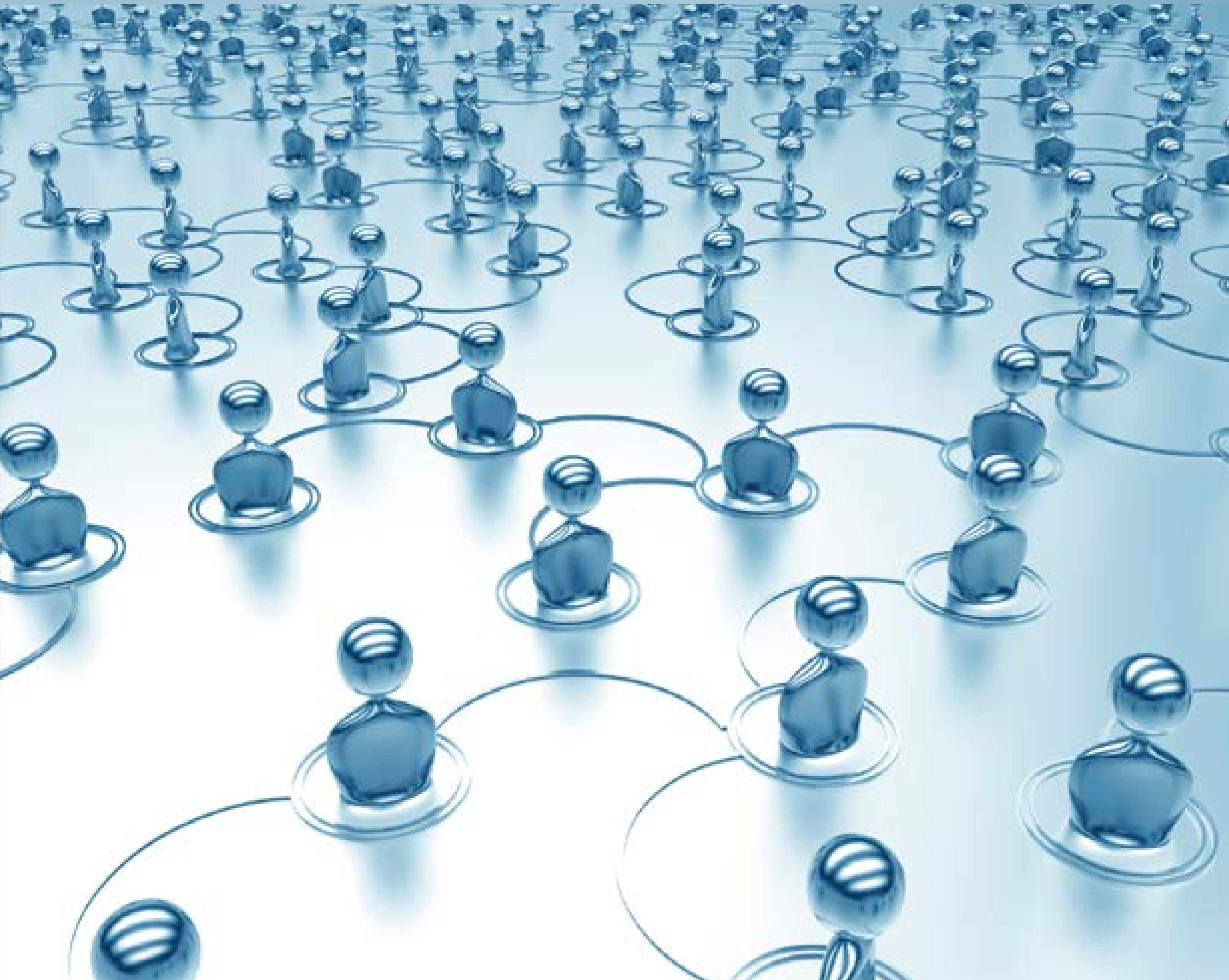
Spring 2018

# Fund Finance Market Review

## Trends and Developments in the Subscription Credit Facility and Fund Finance Markets



In this Spring 2018 edition of our *Fund Finance Market Review*, we discuss noteworthy developments in the subscription credit facility and fund finance markets and provide our views on the continued proliferation of private credit funds. We also explore the various forms of credit support available in the fund finance space and analyze unencumbered asset pool facilities as well as fund financing for series LLCs.

Finally, we discuss customary default remedies available in fund finance and proffer a potential guide to the accompanying foreclosure process.

# Fund Finance Market Review

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# Fund Finance Market Review

Kiel Bowen
Ann Richardson Knox

Our outlook for the fund finance market for 2018 is positive, as we expect the market to build upon the successes experienced over the last calendar year. In 2017 strong credit performance, record-breaking fundraising and product expansion fueled significant market growth. In addition to a significant uptick in the number of traditional subscription credit facility (each, a "Subscription Facility") closings, Mayer Brown closed a record number of alternative fund financings. As expected with any mature market, however, we did see episodic defaults and borrowing base exclusion events in 2017. Such defaults were primarily technical in nature, and the exclusion events were isolated in respect of individual investors (each, an "Investor") and did not indicate broader systemic issues for the Subscription Facility market or the private equity fund (each, a "Fund") asset class. Below, we expand on our views on the state of the fund finance market as well as current trends likely to be relevant in 2018.

## 2017 Fundraising and 2018 Outlook

Fund fundraising experienced a banner year in 2017. Investor capital commitments ("Capital Commitments") raised in 2017 exceeded $453 billion, representing the largest amount of capital raised in any year, according to Preqin.[1] This continues the upward trend experienced in 2016 and is only the second year ever in which total fundraising has exceeded $400 billion.[2]

As we predicted in our last Market Review, Investors continued to flock to a smaller group of preferred sponsors in a flight to perceived quality, with fewer funds being closed but with a larger total Fund size.[3] This trend was evidenced by numerous Fund asset classes raising their largest single funds ever—including buyout, infrastructure and private debt Funds.[4] So too, consistent with prior years, we witnessed significant growth in the number of Facilities in favor of single managed accounts (also known as funds-of-one)—a trend we think will continue in 2018.

The rise of private credit and direct lending Funds (both in number and size) has been notable as they continue to fill the gap in the lending market left by traditional banks scaling back their lending operations in light of regulations imposed as a result of the last recession.[5] Notwithstanding recent indications that regulators may ease pressure on traditional banking institutions, many market participants expect that the leverage loan markets will continue to be popular with private credit arms of less-regulated Funds. Thus, the trend of sponsors forming credit funds has continued its upward trajectory through 2017 with many sponsors recruiting traditional bankers to Funds in order to increase their capacity and fine-tune their expertise. This optimism in the private credit and direct lending asset classes was evidenced by 136 vehicles closed and over $107 billion being raised for funds in this sector last year.[6] While we expect 2018 to continue this trend, many market participants expect fundraising to ease as a result of the fact that dry powder is also at a record high as a result of successful fundraising.[7]

Consistent with prior years, most of the capital raised in 2017 originated in North America with North American-focused private equity Funds raising $272 billion and Europe-focused funds raising $108 billion.[8] Additionally, Preqin's data indicates that Investors continue to have a positive outlook on the industry, with 63 percent of Investors having a positive perception of private equity and a majority seeking to increase their allocation in the longer term.[9]

## Product Diversification

Consistent with this data, our experience and anecdotal reports from a variety of market participants strongly suggest that the Subscription Facility market continues steady growth and is as robust as ever. We also continue to see diversification in fund finance product offerings, including hybrid, umbrella and unsecured or "second lien" facilities. In particular, "Alternative Fund Financings," such as fund-of-hedge fund financings, management fee lines, 1940 Act lines (i.e., credit facilities to Funds that are required to register under the Investment Company Act) and net asset value credit facilities have garnered more interest by Funds and lenders alike. We have also seen more open-ended Funds interested in Subscription Facilities. Accordingly, many lenders have customized their loan programs to capitalize on this need. For more information on these alternative financings, including structural considerations, please visit our webpage at www.mayerbrown.com/experience/Fund-Finance/.

## Trends and Developments

### TAX REFORM

The recent Tax Cuts and Jobs Act passed into law by the United States will significantly impact Funds and their portfolios. In addition to the much-publicized drop in US corporate income tax rates, changes in the tax rates for "pass-through" entities and the ability to repatriate overseas earnings, the legislation altered the tax treatment with respect to "carried interest."

Carried interest refers to equity interests that the general partner or sponsors of a Fund may receive as compensation. By characterizing this compensation as equity, the general partner or sponsor will benefit from a lower long-term capital gains tax rate (as opposed to ordinary income or short-term capital gains) on such compensation. The deduction for "carried interest" has largely survived the tax reform with certain tweaks to how and when it is calculated. One of the most significant is that in order to obtain long-term capital gain treatment, the required asset holding period has been changed from at least one year to at least three years. Additionally, amounts that fail to meet the three-year test are not treated as ordinary income but rather are treated as short-term capital gain. In addition to the carried interest, other changes to the tax code also affect Funds and Facilities, which among others, include:

*Deductibility of interest expense* - The limitation of deductibility of interest expense on debt negatively impacts the private equity industry as Funds often rely upon leverage to finance transaction purchases and sales. Previously, there was no limit on the amount of interest that could be deducted. Favoring the use of leverage by Funds, a company can now only deduct interest expense equal to 30 percent of its EBITDA (earnings before interest taxes, depreciation and amortization) (and, after 2022, 30 percent of EBIT (earnings before interest and taxes)). This will likely result in a higher cost of capital and may affect valuations for assets making them relatively more expensive.

*Long term Capital Gains* - As noted above, the changes now require Funds to own companies for three years before getting lower capital gains tax treatment, although real estate Funds are exempt from this requirement.

*Excise Tax on University Endowments* - Certain private colleges and universities will be subject to a 1.4-percent excise tax on their net investment income. Given that these endowments are frequent Investors in Funds, this will likely impact their strategic planning and the investable assets available for private equity allocations.

*Others* - Other changes that may have an impact include limitations on the usage of net operating losses and limiting UBTI loss offsets to income to require such offsets from the same unrelated business (and not other businesses as was previously permitted). Additionally, the taxation of gains and losses on partnership interests owned by foreign investors have also changed and may also negatively affect their tax position when they choose to dispose of such investments in private equity funds. The totality of the impact of the tax overhaul on Investors in Funds and Funds themselves remains to be seen, and an experienced tax advisor is necessary to determine the impact on any particular set of Investors and Funds.

## FLEXIBLE BORROWING BASE APPROACHES AND BRIDGE FACILITIES

Traditionally, lenders in the United States have employed one of three standard borrowing base approaches for Facilities: (1) a borrowing base of only highly rated "included" investors with a high advance rate; (2) a low advance rate across all investors for a larger fund; or (3) a two-tier approach, which provides for both highly rated included investors with a high advance rate and a designated investor class, where the latter has a lower advance rate. However, in the case where a Subscription Facility is being looked at during the early stages of fundraising, lenders have not always had the flexibility to optimize the borrowing base approach to best fit a Fund's needs, and Funds have had to make a decision as to the best approach for their borrowing base, guided by an estimate of what their final investor pool will be. More lenders have started to respond to this issue by offering flexible borrowing base approaches. One approach consists of single bank bridge facilities until a final investor closing. This can help in that the Fund can determine what borrowing base will ultimately work best. Other lenders have included an option in the loan documentation that permits the Fund to switch to an alternative borrowing base approach within a short window of time after the final investor closing. Another approach being used with more regularity is to increase advance rates once investors have funded a predetermined percentage of committed capital. Likewise, as we have noted in prior Market Reviews and above, more lenders are offering "hybrid" credit facilities—where the borrowing base is calculated off both the uncalled capital commitments and the assets of the Fund.

## INCREASED SCRUTINY

Given the significant growth of the Subscription Facility market, many lenders have reported that they are being audited by internal risk officers and bank regulators with greater frequency. Among other things, these audits have focused on how lenders calculate and monitor the overall credit exposure to each Investor, the lender's portfolio management systems and whether the lender has an action plan for both market-wide disruptions and credit-specific defaults. In response, we are working with many lenders to adopt a standardized approach to track investor-by-investor and fund-by-fund exposure, restructuring their compliance and portfolio management programs, and adopting a written policy on how best to address default and foreclosure scenarios. (For more information on possible foreclosure remedies, see *Default Remedies under a Subscription Credit Facilities: A Guide to the Foreclosure Process*, page 8.)

### LENDER RESPONSES TO TECHNICAL DEFAULTS

In response to the increased focus by regulators and auditors and in the rise in the number of technical defaults, lenders are starting to require more robust collateral monitoring provisions. For example, more lenders now require that the collateral accounts be held at the agent bank rather than a third-party depository. Generally, Funds establish their treasury management relationships ahead of entering into a Subscription Facility, resulting in lenders often agreeing to use the existing accounts held at a third-party institution as the collateral accounts. In such event, such accounts are subject to a lien permitting the agent to take control of the account during an event of default, including if a mandatory prepayment is not made. However, more lenders are now implementing the approach used in the broader loan markets, which provides a collateral sweep mechanic during the pendency of a mandatory prepayment from a collateral account, rather than simply using the control over the account as a default remedy. Given this approach is operationally difficult with an account that is not at the agent bank (due to the need to block and unblock an account multiple times), another route to achieving this result is requiring the accounts be held at the agent bank. This permits intermittent account blocks and sweeps to be achieved in a simpler and less costly manner.

### ADDITIONAL EXCLUSION EVENTS

As reported in our last Market Review, market participants have been closely monitoring the impact of currency controls imposed on Investors by foreign regulators. As more Investors have defaulted under their capital commitment in light of these currency controls over the last quarter, many lenders are now contemplating adding a specific "exclusion event" to Subscription Facility loan documentation that would remove Investors subject to these restrictions from a Subscription Facility's borrowing base. We expect that this exclusion event and other exclusion events aimed at even larger geopolitical issues may develop over the next year to become common.

## Industry Conferences

### FUND FINANCE ASSOCIATION GLOBAL FUND FINANCE SYMPOSIUM IN NEW YORK

Once again, Mayer Brown will be a platinum sponsor at the Global Fund Finance Symposium. Held in New York City on March 21, 2018, this year marks the symposium's eighth anniversary. As the founding institution of the symposium, Mayer Brown is proud to support the Fund Finance Association and the significant growth of the conference—as well as the addition of the European Fund Finance and Asia-Pacific Fund Finance symposiums. Building on the prior success, we expect this year's symposium to bring together leading market participants to share their insights on the trends affecting the fund finance industry.

### FUND FINANCE ASSOCIATION WOMEN'S EVENT

Mayer Brown is proud to host the next Women in Fund Finance event on March 20, 2018, in our New York office. The Women in Fund Finance Speed Networking Event is an opportunity to meet with some of the leading names in alternative investment for an evening of networking and conversation. To register for this event or to learn more, please go to www.womeninfundfinance.com/events.

### MAYER BROWN MID-YEAR MARKET REVIEWS

Mayer Brown will also host Mid-Year Market Reviews in New York City and Chicago this autumn. These Mid-Year Market Reviews traditionally address market developments in fund finance and focus on providing real-world advice on how such developments should be addressed by market participants. For more information on these events or to register, please email Dena Kotsores at dkotsores@mayerbrown.com.

## Conclusion

After 2017 ended with steady growth in the fund finance market, and given the fund closings achieved through year end, we expect an uptick in the number of fund financings to occur in the near term—especially in favor of private credit funds and single managed accounts. While the impact on the recent tax reform remains to be seen, we envisage that overall health of the market for Subscription Facilities and other Fund Financings will continue through 2018.

## Endnotes

1 *Preqin Global Private Equity & Venture Capital Spotlight*, January 2018, p. 10.

2 *Id.*

3 *Preqin Q4 2017 Fundraising Update*, December 2017.

4 *Id.*

5 For more information on this trend, see m.mayerbrown.com/Files/Publication/0197402c-15f7-449e-87b7-f43e617b316f/Presentation/PublicationAttachment/1f741412-5427-4917-82f4-f7518ee59814/Leveraged-Loan-Regulatory-Spring-2016%20.pdf.

6 *Id.*

7 Fund Manager Says Red-Hot Private Debt Market May Cool Off, *Institutional Investor Online*, January 21, 2018, by Alicia McElhaney.

8 *Preqin*, p. 10.

9 *Id.*, p. 10

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

Kiel Bowen
Sean Scott

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.<br><br>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.<br><br>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. |

| ACTION | COMMENTARY |
| --- | --- |
| 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.<br><br>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. |

| ACTION | COMMENTARY |
| --- | --- |
| 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 | The 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.<br><br>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. |

| ACTION | COMMENTARY |
|---|---|
| 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).<br><br>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. |

## 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.<br><br>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. |

| ACTION | COMMENTARY |
| --- | --- |
| 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).

# Forms of Credit Support in Fund Finance

Jon Rosaluk
Mark Dempsey

In the fund finance market, there are a wide array of financing structures that are utilized by private investment funds ("Funds") to improve liquidity and/or obtain leverage and a variety of collateral and credit support packages that lenders rely upon for repayment.[1]

While the fund finance market has unique characteristics when compared to other types of corporate borrowers, the types of credit support used by Funds and lenders have much in common with traditional lending facilities and rely heavily on tried and true lending instruments. This article will examine three types of credit support commonly used in the fund finance market: (i) the unfunded equity capital commitments of limited partners of a Fund ("Capital Commitments"), (ii) a guaranty ("Guaranty") and (iii) an equity commitment letter ("ECL"). Each of these forms of credit support are broadly accepted cornerstones of fund finance that provide a suitable and reliable means by which a Fund can access debt while providing a lender with an enhanced credit profile in any transaction.

## Capital Commitments

Perhaps the most well-known type of credit support in the fund finance market is the unfunded Capital Commitments of third-party investors in a Fund. Under a subscription-backed credit facility or a capital call facility ("Subscription Facility"), a Fund and its general partner pledge (a) the rights to the unfunded Capital Commitments of the limited partners, (b) the right of the general partner of the Fund to make a call ("Capital Call") upon the unfunded Capital Commitments of the limited partners after an event of default and to enforce the payment thereof pursuant to the terms of the partnership agreement, and (c) the account into which the limited partners fund capital contributions in response to a Capital Call, in each case in order to secure the obligations of the Fund owing to a lender.[2] Upon a default by the Fund under the Subscription Facility, a lender may enforce the right of the general partner of the Fund to make a Capital Call upon the unfunded Capital Commitments of the limited partners and require the payment of capital contributions pursuant to the terms of the partnership agreement. As contrasted with other types of credit support, such as a Guaranty, the obligation of the limited partners to honor their Capital Commitments and make capital contributions in response to a Capital Call will run directly in favor of the Fund as opposed to the lender.

Capital Commitments, however, do not necessarily need to be pledged as collateral in support of repayment obligations and can be used as credit support in facilities that are not a standard Subscription Facility. For instance, in connection with a Fund level credit facility that is secured by all or a portion of the Fund's underlying investment portfolio, the collateral pledged by the Fund may consist of deposit or securities accounts or the equity shares held by the Fund in a portfolio company and various rights relating thereto. For these types of facilities, the unfunded Capital Commitments may be viewed by a lender as a potential source of repayment rather than as a direct part of the collateral. To support this view, the loan documents for such a facility may include representations, warranties and covenants related to the amount of unfunded Capital Commitments that must be maintained by the Fund for the duration of the facility, with the expectation that if the underlying assets of the Fund are insufficient to repay the facility, there is another liquid and substantive source of repayment that the Fund may rely upon. This type of credit support may provide the Fund with needed flexibility to avoid placing a lien on the Capital Commitments, which may in fact be prohibited under the terms of the partnership agreement, while allowing a lender to rely on the Fund's access to the Capital Commitments as a potential source of repayment. Using Capital Commitments as credit enhancement may provide a Fund with significant debt opportunities while at the same time bolstering its credit profile in the eyes of a lender.

## Guaranties

A second type of credit support commonly used in the fund finance market is a Guaranty. A Guaranty is an agreement by one entity ("Guarantor") in favor of a lender to support the repayment by a principal obligor of its outstanding obligations to such lender in connection with a credit facility. The Guarantor is most commonly a Fund that provides a Guaranty in support of the obligations incurred by one of its subsidiaries or portfolio companies, but a Guaranty may also be provided by a sponsor, a feeder fund or portfolio company, in each case to support repayment by the Fund of its obligations. Guaranties have wide applications in the fund finance market, and the use of a Guaranty may be preferable in a scenario where a portfolio company incurs debt but does not itself have the ability to call upon the unfunded Capital Commitments of the parent Fund. The Fund may agree to provide a Guaranty in such instance in order to provide the appropriate amount of credit support requested by the lender to support the repayment obligations of the portfolio company. The obligation of the Guarantor to make payments under a Guaranty on behalf of the principal obligor, should it default on its obligations, runs directly in favor of the lender.

There are several types of Guaranties employed in the fund finance market, and they will vary both in scope of the guaranteed obligations and the liability of the Guarantor thereunder. The scope of a "bad-boy" Guaranty, for instance, is typically limited to losses incurred due to certain bad-acts or material misrepresentations made by the general partner of a Fund under a credit facility, but will not be triggered by the Fund's financial ability to make payments to the lender. Payments from the Guarantor under a "bad-boy" Guaranty will only be required if the loss results directly from the bad-act or false misrepresentation specifically covered by the terms of such Guaranty. Whether a Guaranty is a guaranty of payment versus a guaranty of collection is another distinction. A guaranty of payment will typically be an absolute and unconditional Guaranty that permits the lender to seek payment directly from the Guarantor without any obligation to first seek payment from the principal obligor. A guaranty of collection, also known as a conditional guaranty, will require that the lender exhaust its remedies against the principal obligor (including, without limitation, foreclosing on any collateral) prior to seeking payment from the Guarantor. Under New York law, a guaranty of payment is presumed unless the parties have otherwise explicitly agreed that the Guaranty is a guaranty of collection.[3]

The relationship of the Guarantor to the principal obligor is as important as the substance of the Guaranty itself. Upstream guaranties (i.e., a Guaranty given by a subsidiary of a Fund), cross-stream guaranties (i.e., a Guaranty given by a sister entity or other affiliate of a Fund) or downstream/

parent guaranties (i.e., a Guaranty given by a Fund to support a portfolio company) are all potential types of Guaranties that may be employed in the fund finance market. Understanding the nexus between the Guarantor and the principal obligor will allow a lender to assess the validity of a Guaranty and whether the Guarantor has received adequate and fair consideration in exchange for providing the Guaranty. This analysis is fundamental to the enforceability of the Guaranty, is particularly relevant in respect of an upstream or cross-stream Guaranty, and will be necessary to help avoid any fraudulent transfer defenses that other creditors of a Guarantor may invoke if a Guarantor is later deemed insolvent after making a payment under the Guaranty.[4] Experienced legal counsel can assist both Funds and lenders in navigating the specifics of using a Guaranty as credit support.

## Equity Commitment Letters

A third commonly used form of credit support in the fund finance market is an ECL. An ECL is an agreement that evidences a commitment to contribute capital or other financial support by one entity (the "ECL Provider") in favor of another entity (the "ECL Recipient") and may be used to demonstrate to a lender that the ECL Recipient has additional resources for the repayment of its obligations under a credit facility.[5] Use of an ECL may be more expedient or efficient in some instances than arranging for other types of credit support and provide a potentially significant credit enhancement. ECLs have broad application in the fund finance market, but the most common scenario for employing an ECL is when a Fund issues an ECL in favor of one of its portfolio companies to support repayment of debt incurred by such portfolio company. A lender may be wary of relying strictly on the performance of a portfolio company for purposes of repayment, and the use of an ECL by a Fund in this instance will provide added comfort to the lender that there are additional sources of repayment available to the portfolio company. There are a variety of applications for an ECL, and the use thereof does not need to be limited to the Fund/portfolio company scenario described here for illustration.

An ECL should be distinguished from other similar arrangements, such as a keepwell agreement, pursuant to which a sponsor may undertake to monitor and safeguard the financial health of a Fund, or a letter of support/comfort letter, the purpose of which is to provide a lender with some assurance that a Fund will be able to meet its obligations to such lender. In the fund finance market, an ECL should be viewed as a *commitment* by the ECL Provider to contribute capital to the ECL Recipient and stands in contrast to a keepwell agreement or letter of support/comfort letter that are merely statements of *intent* rather than an actual commitment to undertake financial support. The obligation of the ECL Provider to contribute capital under and pursuant to the terms of the ECL runs in favor of the ECL Recipient, with only the ECL Recipient having the right to enforce the terms of the ECL. A lender, however, may be specifically designated as a third-party beneficiary under the terms of the ECL, and the rights of the ECL Recipient under and pursuant to the ECL can also be collaterally assigned to a lender under a credit facility.

Each ECL is a bespoke instrument that implements the specific level of credit support required and the conditions under which such credit support will be available. For purposes of the fund finance market, an ECL will also likely include, among other things, waivers of defenses, counterclaims and offset rights (including with respect to those rights arising under the US Bankruptcy Code that may pertain to a bankrupt ECL Recipient) in respect of the ECL Provider's obligation to contribute capital to the ECL Recipient and other suretyship-related defenses that may be available to an ECL Provider under applicable law. Experienced legal counsel can assist both Funds and lenders in tailoring an ECL to achieve the necessary level of credit support while ensuring that it is distinguishable from other types of credit support.

## Comparing Capital Commitments, Guaranties and ECLs

While Capital Commitments, Guaranties and ECLs can each be used as credit support in the fund finance market, the nuances specific to each type of credit support will dictate the effectiveness of the applicable credit support when applied to a specific lending arrangement.

As noted above, the use of unfunded Capital Commitments as credit support (as opposed to being pledged to the lender as collateral under a Subscription Facility) will run in favor of the Fund. The lender, by placing parameters around maintaining a certain level of unfunded Capital Commitments, is effectively relying on a liquidity test and ensuring that capital will be available to the Fund in order to repay indebtedness owed the lender. The lender will not have the ability, however, to enforce the payment of the unfunded Capital Commitments when used simply as credit support as opposed to collateral. In contrast, a Guaranty is credit support that runs in favor of the lender and allows the lender to seek payment directly from the Guarantor. With direct recourse to the Guarantor under a Guaranty, a lender will effectively have two sources of repayment – the principal obligor and the Guarantor. An ECL will artificially create two sources of repayment (the ECL Recipient and the ECL Provider), but the ECL will only run directly in favor of the ECL Recipient. The use of a collateral assignment of an ECL, however, will permit the lender to enforce the terms of the ECL on behalf of the ECL Recipient.

## Conclusion

The use of Capital Commitments, Guaranties and ECLs are all appropriate ways to provide credit enhancement in the fund finance market and can be utilized effectively in numerous situations. Each of these types of credit support, while tailored to the particular characteristics of fund finance, are not novel to fund finance and are widely accepted forms of credit support in lending generally. Despite the prevalent use of these forms of credit support, the effectiveness of the credit enhancement and the strength of the credit support provided thereby must be determined on a case-by-case basis. The strengths and weaknesses of Capital Commitments, Guaranties and ECLs must be determined by analyzing a variety of factors including the proposed credit structure, the supporting documentation and the specific language included therein. Only after a detailed review can any of these forms of credit support be viewed as the preferred solution in a given financing. When used properly and with the assistance of experienced legal counsel, each method of credit support can provide a creative solution that delivers needed access to debt and liquidity for a Fund and appropriate credit support for a risk-averse lender.

## Endnotes

1 For a detailed update on current trends and developments in the fund finance market, please see Mayer Brown's *Fund Finance Market Review Spring 2018* page 3.

2 For a more detailed description of the subscription facility market and features of the subscription-backed credit facility product in general, please see our article "*Subscription Credit Facility Market Review*" in *Fund Finance Market Review, Fall 2016 at* www.mayerbrown.com/Fund-Finance-Market-Review---Fall-2016-09-26-2016/

3 NY Gen Oblig L § 15-701 (2016).

4 See *Restatement (Third) of the Law of Suretyship and Guaranty § 9*.

5 Equity commitment letters are often used in more traditional acquisition financings as evidence that the acquisition vehicle has sufficient funds to complete the acquisition but are equally effective in the fund finance market as a commitment to ensure repayment of the indebtedness incurred by a Fund or one of its portfolio companies.

# Lending to Series Limited Liability Companies: Subscription Credit Facility Considerations

Kristin Rylko
Haukur Gudmundsson
Vincent Zuffante

## Introduction

As the private equity asset class continues to expand[1] and private equity fund managers respond to demand by investors for ever-more bespoke products and tailored investments, there has been an increase in the use of alternative fund structures to accommodate such demand. In addition to the proliferation of separate accounts, funds-of-one and co-investment structures, the use of vehicles that employ series, cell or other asset and liability segregation technology has increased, bringing with it opportunities and potential challenges when leverage at the fund or individual series level is sought.

The use of series in a limited liability company (a "Series LLC")[2] offers many potential benefits to a private equity fund (a "Fund") manager and its investors; however, for lenders interested in advancing credit to a Series LLC or a series thereof, it is important to understand how Series LLCs differ from traditional forms of limited liability entities. This article discusses the nature and benefits of Series Entities in the private equity context[3], as well as potential issues that lenders will want to take into account when considering advancing credit to a series under a Series Entities secured by investor capital commitments.[4]

## Background

A Series LLC is generally created pursuant to the laws of the applicable jurisdiction of formation. A defining feature of a Series LLC is the ability to create an unlimited number of segregated subunits or series (each, a "Series") under the umbrella of a single "master" LLC (or LP), permitting each Series to have separate members, managers, equity interests, assets, liabilities and business objectives associated to it, with an internal liability shield as among the Series that is intended to be enforceable against creditors and other counterparties. This is in contrast to a traditional limited liability company, which may have different classes of members that have different rights, assets or liabilities associated with such class, but such internal organizational structure is not intended to impact the obligations and liability of the limited liability company as against creditors and counterparties.

At its heart, the Series structure promises the ability to segregate the assets and liabilities of each Series, such that the liabilities and other contractual obligations of any given Series may be enforced only against the assets of that particular Series and not the assets of any other Series or the "master" entity itself, so long as the relevant statutory formation and procedural requirements are met.[5] In this respect, a Series LLC with liability segregation promises owners the personal liability protection as against third parties of a limited liability company, while also permitting contractual flexibility to effectively create mini-LLCs under the Series LLC umbrella, whose activities are insulated from each other and the Series LLC itself. Thus, in the Fund context, each Series can have different investors, with different investment strategies and commitment periods associated with it, as if each Series was an individual stand-alone vehicle.

In the context of a Fund formed as a Series LLC, each Series may be governed by a common master Fund-level limited liability company (an "Operating Agreement"), or by both a Series-specific Operating Agreement (or supplement or addendum) and a master Fund-level Operating Agreement. Each such Operating Agreement may provide different operational, distribution, and membership mechanics with respect to each Series, and each Series may be administered by a separate manager, although the same manager (or general partner) is often used for all Series in a Series LLC. Funds may use Series LLC technology to facilitate establishment of different Investor commitment periods for each Series and to house separate investments in individual Series, thereby permitting investors to commit capital to the Fund for particular periods or specified uses.[6]

Other potential benefits to implementing a Series structure include reduced formation and administrative cost. In some States, use of a Series LLC allows a Fund to avoid registering multiple entities with the State of organization, maintaining multiple registered agents and filing multiple sets of annual reports and tax returns. Further, rather than requiring a Fund sponsor to form a new entity each time new investor capital is raised, the Fund's Operating Agreement may provide for the creation of additional Series from time to time. Funds that use a master Fund-level Operating Agreement to govern each Series may also reduce legal costs associated with the creation and negotiation of multiple fund vehicles and Operating Agreements. Aside from possible savings attributable to reduced long-term formation and start-up costs, use of Series Entities may result in minimized filing costs, State franchise fees and compliance costs as well as tax savings as compared to creating separate entities instead of Series of a Series LLC.

While there are many potential benefits to a Series LLC organizational structure, there may be risks in certain circumstances as well. There remains uncertainty as to the State and federal income tax treatment of Series Entities and the Series within a Series LLC, as well as their treatment for employment tax purposes.[7] In addition, as more fully described below, it is not clear whether the separate liability protection of a Series will be upheld by the courts of a State that has not enacted legislation providing for Series provisions for State law liability purposes.[8] Further, accountants, lawyers and other service providers may not have sufficient familiarity with the series structure to provide adequate advice on the unique issues that may arise in relation to a Series LLC.

## Facility Structure and Loan Documentation; Special Considerations for Series Entities

The basic loan documentation for a Facility advanced to a Series under a Series LLC borrower is similar to the loan documentation typically used for a Fund that does not have a Series construct and will usually include the following: (a) a credit agreement that contains all of the terms of the loan, borrowing mechanics, conditions precedent, representations, warranties and covenants, events of default and miscellaneous provisions typically found in a commercial credit agreement; (b) a promissory note; (c) a pledge or security agreement pursuant to which the Lender is granted a security interest in the Collateral; (d) account control agreement(s) over the account(s) into which investors fund Capital Contributions in response to a Capital Call to perfect the Lender's security interest therein and permit the Lender to block withdrawals from such account(s); (e) Uniform

Commercial Code financing statements filed in respect of Article 9 collateral against the applicable debtors; and (f) other customary deliverables such as officer's certificates certifying as to the relevant organizational documents, resolutions and incumbency signatures, opinion letters and other diligence deliverables, as appropriate. While the basic loan documents required under a Facility made to a Series under a Series LLC are comparable to those under a Facility made to a traditional commingled Fund, there are a number of potential issues that should be considered during the underwriting and documentation process, as more fully described below.

### A. OPERATING AGREEMENT PROVISIONS.

As with any Fund finance product, the Operating Agreement of a Series LLC will need to be scrutinized prior to execution of a Facility to ensure that the Operating Agreement contains adequate Facility-related provisions. In addition, because the assets and liabilities of a Series in a Series LLC are often intended to be separate and distinct from those of another Series and the Series LLC itself, the Lender will need to confirm whether the Operating Agreement adequately provides for such segregated liability. This is particularly important in determining the borrower structure, understanding which Capital Commitments are associated with (and thus available to) which Series, and assessing the potential impact on one Series of debt being incurred by another Series. For example, in the Operating Agreement for a Series LLC, one would expect to see prohibitions on the ability of the Fund manager to issue a Capital Call to, incur indebtedness on behalf of, or grant a security interest in the assets of, one Series to repay indebtedness incurred with respect to another Series. As such, the borrowing base for a Facility involving a Series LLC would need to be established on a Series-by-Series basis, with several liability among the Series. As described above, however, there are Funds that employ Series technology for reasons other than asset and liability segregation, in which case, a joint and several Series-borrower structure may be permissible, which would impact how a Lender underwrites a Facility.

### B. STATE LAW; RECOGNITION BY COURTS; BANKRUPTCY CONSIDERATIONS.

A Lender that is considering offering a Facility to a Series of a Series LLC will want to understand whether the Fund's State of formation, as well as the governing law of the Facility, recognizes a Series LLC structure. The Series LLC was first recognized under Delaware law in 1996, and under current Delaware law, a Series is authorized, in its own name, to enter into contracts, hold assets, grant liens and security interests in those assets, and sue and be sued.[9] As of the date of publication of this article, however, only about a third of States recognize the Series LLC, and among the States that do, there is no uniformity in law.[10] In order for the segregation of assets and liabilities of a Series to be recognized, some States require specific legal hurdles to be cleared during the formation process, including the use of specific language applicable to the Series in the Operating Agreement, and some States require certain procedures to be maintained during the life of the Fund, such as the maintenance of separate books and records with respect to each Series. Other States, such as Illinois, require each Series to publically register with the State. Understanding the State's Series LLC statutes will help a Lender assess whether the necessary formalities have been observed by the Series LLC, whether it is possible to structure a Facility to a Series of a Series LLC on a Series-by-Series basis and whether the Facility should contain statute-specific covenants.

As the Series LLC is a relatively new creature of State law, there is limited jurisprudence addressing the interrelation between States that have statutes that provide for the segregation of assets and liabilities between Series and those that do not, and it is not settled whether courts in States that do not have Series LLC statutes would recognize the segregation of assets and liabilities across Series formed under the laws of another State with a permitting statute. Further, the treatment of a Series LLC and the Series thereof under the US Bankruptcy Code is uncertain.[11] It is unclear whether Series may constitute a "debtor" under the Bankruptcy Code and thus if a Series may file bankruptcy independent of the Series LLC and other related Series, and whether a bankruptcy court would uphold the segregation of assets and liabilities if a Series related to a Series Borrower or the Series LLC itself was subject to a bankruptcy proceeding.[12]

In addition, a Lender should be aware that the application of the equitable doctrine of substantive consolidation could impact the outcome of a bankruptcy case involving a Series LLC. The substantive consolidation doctrine permits a Bankruptcy Court to disregard the separate legal existence of entities when they are determined to operate more as a single entity instead of as separate individual entities. Because the internal liability shield afforded by a Series LLC does not hold when a Series LLC fails to satisfy the statutory requirements for achieving separate liability, a Series LLC may be at greater risk for being substantively consolidated than individual limited liability companies that sit under a parent limited liability company.[13] As such, to minimize the risk of substantive consolidation, a Lender to a Series of a Series LLC will want to ensure that the Series borrower is acting in its own name (which is clearly identified in the Operating Agreement), is generally acting independently of each other Series), maintains separate books and records, does not commingle assets or prepare consolidated financial statements, and is not cross-accelerated, cross-guaranteed or cross-collateralized with any other Series or the Series LLC. Accordingly, it may be prudent for a Lender to require that the Operating Agreement of each Series and/or the Series LLC, and any debt instrument entered into by any Series or the Series LLC and a Lender, contain provisions (i) acknowledging the segregation of assets and liabilities between the Series, (ii) providing that a creditor has recourse only to the assets of the particular Series to which the debt relates and not to the assets of the Series LLC or any other Series, and (iii) providing that a creditor shall not be entitled to petition for the liquidation or bankruptcy of any Series or the Series LLC on the basis of the failure of a borrower Series to repay any debts or liabilities owing to a creditor. On the other hand, assuming no third-party creditor has a lien on the Capital Commitments related to any other Series, one can envision scenarios under which substantive consolidation resulting in elimination of the internal liability shields in a bankruptcy proceeding could potentially benefit a Facility Lender by increasing the pool of Investors upon which a Capital Call could be made to repay indebtedness. A review of the relevant State statues and case law may reveal that other State-specific provisions should also be included in the loan documentation for Facility to a Series.

### C. SECURITY INTEREST AND PERFECTION MATTERS.

State law governing the formation of the Series LLC and the Series must be carefully considered in connection with secured Facilities, as such laws will inform what steps should be taken by a Lender to perfect its security interest in the Collateral. As a threshold issue, a Lender will need to confirm how the Capital Commitments are held, as Series LLC statutes often permit multiple alternatives; for example, the Capital Commitments under the Operating Agreement may be held by the Series LLC itself, through a nominee or by a particular Series of the Series LLC, and if held by a Series, it is not always clear what the name of the Series may be. A Series may or may not be a legal person separate from its related Series LLC under the laws of its jurisdiction of formation; if the Series is not a separate legal person, then the Series possibly cannot be a "debtor" for purposes of Article 9 of the Uniform Commercial Code (the "UCC"). As a result, consideration should be given as to whether the Series LLC, in addition to the Series borrower itself, should be included as a grantor under the security and pledge documentation and in the related UCC financing statement filings.

Assuming the Series can be a "debtor" under Article 9 of the UCC, the Series may not necessarily be a separate "registered organization" for Article 9 purposes, unlike the Series LLC itself to which the Series is associated.[14] This is relevant for the UCC

Article 9 rules for determining where to file a UCC financing statement and the legal name of the Series to use in a UCC filing. Under UCC Article 9, a "registered organization" is "located" for Article 9 purposes in the State of its jurisdiction of formation.[15] Thus, for example, a Lender would file a UCC against a Delaware limited liability company in Delaware; however, if the Delaware limited liability company is a Series LLC, and the borrower Series has its sole place of business in New York, then it may be the case that a UCC filing against the Series should be in New York and not in Delaware.[16]

Further, the legal name of the Series to use for purposes of filing a UCC financing statement may be uncertain given the Lender may not be able to look to the "registered organization" naming rule (i.e., one looks to the registered organization's name as stated on the public organic record most recently filed with the organization's jurisdiction of formation (e.g., a certificate of formation for a Delaware limited liability company)). For example, if the Operating Agreement of ABC, LLC provides for Series 2018-1, is the legal name of such Series "ABC, LLC, Series 2018-1" or "Series 2018-1 of ABC, LLC" or "Series 2018-1"? In some cases, the Operating Agreement or certificate of formation of the Series LLC, as applicable, may refer to a Series in multiple ways. Because of such uncertainties, it may be prudent for a Lender to file multiple financing statements and require that the Fund specifically name each Series in the Operating Agreement and refer to each Series in a consistent way throughout the Operating Agreement and in its business dealings. In light of these ambiguities, careful legal analysis will be needed in order to ensure that the Lender's security interest in relation to a Series borrower is adequately granted and properly perfected. A Lender will also want to consider what legal opinions are feasible in light of the potential uncertainty around these collateral issues and what level of opinion comfort it will need in extending a Facility to a Series.

### D. OTHER FACILITY CONSIDERATIONS.

As mentioned above, in connection with documenting a Facility, the Lender should consider whether Series-specific and statutory-related restrictions are appropriate. The parties may agree that the creation of a new Series or any change to the name or structure of an existing Series shall require Lender approval. The parties may also agree whether any new Series will require Lender approval as a general matter, and also prior to such Series being added as a Borrower and receiving its own borrowing base under a Facility (as may be done in a legally several umbrella Facility structure). It is not unusual for such Facilities to include ongoing representations and warranties to be given by the Fund to the Lender as to various statements of fact relating to the operating of the Series to address the consideration and issues described above. In conceptualizing how to address some of the unique features of a Series LLC, Lenders may look to some of the technology used in credit facilities to Irish collective asset-management vehicles and Cayman Islands-exempted segregated portfolio companies, which employ segregation technology not dissimilar to a Series LLC (albeit, under different legal regimes).

## Conclusion

As more Fund sponsors consider implementing Series LLC structures because of the cost and administrative benefits they may offer, the number of Facilities featuring a Series LLC is likely to grow in the coming years. Lenders considering advancing a Facility to a Series of a Series LLC should be aware that there remains uncertainty surrounding the treatment of a Series under State law and the Bankruptcy Code, but that there are techniques available to help mitigate the related risks. With adequate legal and credit due diligence and careful structuring, Lenders may be able to arrange credit Facilities to Series that meet the needs of its Fund clients while also adequately protecting the Lenders' downside credit risk.

Please feel free to contact the authors with questions regarding Facilities to Series LLCs or the various structuring alternatives and considerations attendant to such Facilities.

## Endnotes

1 *See*, e.g., *Private Capital: Record-Setting Pace in 2017,* Preqin Ltd., docs.preqin.com/press/Fundraising-2017.pdf.

2 Note that some states, including Delaware, also permit both limited partnerships and trusts to elect a series structure. *See Del. Code Annotated, Title 12, §3806(b), Del. Code Annotated, Title 17, §218.*

3 This article provides a basic overview of certain potential benefits and challenges of lending to Series LLCs. Specific reference to the enacting statutes of a particular jurisdiction and the terms of the constituent documents of a Series LLC borrower must be undertaken in assessing the suitability of lending to a Series LLC or any Series thereof. This article is not a comprehensive treatment of the subject.

4 By way of background, a subscription credit facility, also known as a capital call facility (a "Facility"), is a loan or line of credit made by a bank and other credit institutions (each, a "Lender") to a Fund that is secured by (a) the unfunded commitments (the "Capital Commitments") of the investors to fund capital contributions ("Capital Contributions") to the Fund when called from time to time by the Fund (or its general partner, managing member or manager (a "Manager")), (b) the rights of the Fund or its Manager to make a call (each, a "Capital Call") upon the Capital Commitments of the investors and the right to enforce payment of the same, and (c) the account into which investors fund Capital Contributions in response to a Capital Call (collectively, the "Collateral").

5 *See*, e.g., Del. Code Annotated, Title 6, §18-215(b), which requires that various corporate formalities be followed in order to establish a Series LLC and achieve asset and liability segregation, including the certificate of formation and Operating Agreement including notations as to the limitation of liabilities, maintenance of proper books and records, and accounting for the assets and liabilities of each Series on a separate basis.

6 There are numerous other potential applications of the Series construct in a Fund context. Series LLC technology may be used to facilitate co-investments and as a means to internally track revenue streams and asset allocations within a Fund. A Fund-of-one may use Series LLC mechanics to manage investment activities and annual spending with a particular manager, using, for example, a new Series corresponding to annual commitment periods or to cap Capital Commitments with respect to particular investments. In such cases, the need for a liability shield as between various Series within a particular Series LLC may or may not be a primary factor in selecting a Series LLC organizational type.

7 Proposed federal tax regulations have been promulgated but to date have not been finalized. Under Proposed Regulation §301.7701-1, 75 Fed. Reg. 55,699 (2010), each Series within a Series limited liability company agreement would be treated as a separate entity for federal income tax purposes and have its own classification for such purposes (e.g., a partnership, an association taxable as a corporation or disregarded).

8 For a comprehensive discussion of the subject, see Thomas E. Rutledge, *"To Boldly Go Where You Have Not Been Told You May Go: LLC, LLPs, and LLLPs in Interstate Transactions," 58 Baylor L. Rev 205 (Winter 2006).*

9 *See Del. Code. Sec. 18-215(c).*

10 At its annual conference meeting in July of 2017, the National Conference of Commissioners on Uniform State Laws approved a proposed uniform state law titled the "Uniform Protected Series Act," which is intended to allow assets within an LLC Series to be protected from the credit and other liability risks associated with assets owned by such LLC or other LLC Series. It remains to be seen how many States will enact Series legislation based on the proposed Uniform Protected Series Act.

11 For additional discussion, *see ABA Commercial Law Newsletter, "Secured Lending to Series of LLCs: Beware What You Do Not (and Cannot) Know*," Norman M. Powell, November 16, 2015.

12 *Id.*

13 In comparison, in the situation of multiple separate limited liability companies existing under a parent limited liability company, a court would undertake a veil-piercing/alter-ego analysis to determine if the separate legal existence of the limited liability companies should be disregarded. The factors considered by courts under the veil piercing/alter ego doctrine are often similar to those applied in a substantive consolidation analysis. A detailed discussion of the substantive consolidation doctrine is beyond the scope of this article.

14 For a detailed discussion of these and related issues concerning the intersection of Article 9 and Series LLCs, *see "Dissonance in the Attempt to Harmonize LLC Series and Article 9*," Norman M. Powell, UCC Law Journal, Vol. 46 (November 2015).

15 *See UCC Official Text Section 9-307(e).*

16 *See UCC Official Text Sections 9-307(b)(2)-(3) .*

# Structural Changes in Hedge Fund Financing Transactions

Bryan Barreras

A fund of hedge funds ("FoHF") is an investment vehicle that offers its investors exposure to a portfolio of hedge funds selected by the investment manager of the fund. The investment manager uses his/her knowledge, diligence and expertise to select and manage the hedge fund portfolio, saving his/her investors from the need and the operational and resource commitments to do so. In implementing their investment strategy, FoHFs often utilize financing transactions for various purposes, among them to provide leverage and liquidity. Regardless of purpose, because these funds have no natural life span, the financing transactions typically remain in place for lengthy periods of time. And because of their relatively long durations, these transactions often require amendments to accommodate changes to the fund, transaction or structure of the pledged collateral. While many such amendments are routine in nature and may require limited legal analysis, amendments related to, or arising out of, certain changes to the structure of the fund or its investment portfolio present potential legal issues that should be considered in detail.

## Discussion

The hedge funds that comprise the investment portfolio of a FoHF typically offer liquidity only through redemptions, and these hedge funds have the ability to restrict redemptions upon certain events. During the 2008 financial crisis and the resultant reduction in the value and liquidity of investments in hedge funds generally[1], many FoHFs were faced with investor redemption requests and often restricted or delayed access to their hedge fund investments (through to the implementation of gates or the suspension of redemptions). Among other things, the crisis highlighted the importance of financing transactions to FoHFs as a tool to manage their liquidity requirements— such transactions could be drawn upon to meet investor redemption requests if a FoHF was unable or reluctant to redeem its underlying hedge fund investments. As a result, such funds now typically maintain financing transactions even if they are not pursuing a leveraged investment strategy, potentially for the duration of the fund. Given the many changes that such a fund can undergo during its life, these financing transactions often require amendment or modification, and such amendments can be routine or they can be quite complex and present potential legal, regulatory, structural and other issues. This article will highlight some common changes to the structure of a financing transaction that present legal issues to be considered and addressed.

## Change of Custodian

Most FoHFs hold their hedge fund portfolios through a third-party custodian (as opposed to holding the hedge funds directly), and this is especially true for funds with financing transactions in place. A typical FoHF financing transaction is secured by, among other things, a pledge of the fund's hedge fund portfolio. Having this portfolio held through a custodian in a securities account substantially simplifies the collateral structure and allows the bank[2] to perfect its security interest by entering into a control agreement with the custodian.[3] The custodian also serves as an institutional third party that the bank can rely on for reporting and to control ordinary-course investments, movements of cash and redemptions of the hedge fund portfolio (and ultimately to effect redemptions of the portfolio of hedge funds in the event the bank needs to enforce its remedies under a financing transaction following an event of default).

Because the custodian plays such a key role in these financing transactions, a proposed change of custodian by the fund raises issues that need to be properly considered and addressed (such as whether the bank will consent to the change), as well as the following:

- Many custodians that serve FoHFs have a global presence, so it is not uncommon for a change of custodian to result in a change of applicable law with respect to the bank's security interest[4], requiring local counsel in the new custodian's jurisdiction to be engaged and new security documents to be executed.
- Operationally, re-registering the hedge fund portfolio to the new custodian may take several months, during which time the bank will require a perfected security interest over the custody accounts at both the prior and new custodian (as well as reporting from both custodians during this time).
- The Hague Securities Convention, which became effective in the United States in April 2017, has been especially relevant for FoHF financing transactions due to both the nature of the pledged collateral and the global presence of the custodians that serve this market, as mentioned above. The Hague Securities Convention should be considered for any financing transaction, especially those with a non-US custodian (in part due to its "qualifying office" requirement).[5]

## Change of Fund Structure

A change in the structure of the fund would typically take the form of the addition or removal of feeder funds and/or guarantors, which could involve a new jurisdiction (if any such entity was formed in a different jurisdiction). This could be requested in order to provide leverage or liquidity at the level of a feeder fund, to gain access to additional collateral or to facilitate derivatives transactions (such as foreign-exchange transactions) at a feeder fund. While not as common as adding or removing an entity, a change of jurisdiction of the fund could be requested by the fund. Such a change with respect to the fund may be sought as a way to increase the investor base available to the fund. Some issues to be considered here include:

- The ability of an entity to provide a guaranty, or the extent of such guaranty, may be limited and/or restricted (and, even if not strictly limited, may raise fiduciary concerns that should be considered). In addition, certain jurisdictions impose additional requirements with respect to guaranties.
- Because of the affiliation between a feeder fund and a master fund, a pledge consent is typically obtained from the master fund (if the feeder fund is pledging its master fund shares), and such consent may grant other rights to the bank (which again may raise fiduciary concerns that should be considered). Whether any additional security is required (such as a guaranty from the master fund) will need to be determined.
- Certain jurisdictions require funds to engage a local custodian. To the extent the fund wishes to continue to use its existing custodian, a sub-custody arrangement may be requested by the fund, which raises the points mentioned under "Change of Custodian" above.

## Change of Form of Transaction

A change to the form of the financing transaction (for example, from a note purchase or a derivative transaction to a credit facility) is not common and, when it does occur, it is typically at the request of the bank, most commonly in response to regulatory requirements or the transfer of the transaction to a different group within the bank. One example that led to such changes was the implementation of the Dodd-Frank Act, which affected certain FoHF financing transactions that were in the form of derivatives transactions.

Another change to be considered here is the addition or replacement of a bank in the transaction. Because financing transactions with FoHFs have traditionally been in the form of bilateral or occasionally club transactions, the financing documents do not always include the mechanics to easily add or replace a bank.

- While a change to the form of a financing transaction presents a number of issues, one in particular to highlight here is the security interest of the bank. To the extent the pledged collateral remains the same (which may not be the case if the original transaction was a derivative transaction where the bank owned the hedge fund portfolio), the bank will want to maintain the priority of its security interest (or put in place a new or revised security interest, if necessary).[6]
- A principal consideration when adding or replacing a bank is whether all banks will be party to the same financing agreement. While utilizing a single financing agreement (with an agent to act on behalf of the banks) may be mechanically simpler, the banks may wish to employ their own collateral valuation models and/or have different pricing and other terms and therefore prefer separate agreements (and the fund may also prefer separate agreements for similar reasons), necessitating an intercreditor agreement and/or some form of sharing or segregation of the fund's hedge fund portfolio as collateral.

## Other Matters Requiring Consideration

While this article has focused on structural changes to financing transactions, there are other changes that arise in order to maintain such long-dated transactions that should be mentioned as well. To note just a few, these include: (i) facility increases (due to, e.g., organic growth of the fund or an increase in the use of leverage); (ii) maturity extensions (to keep the facility in place); (iii) revisions to investment guidelines and/or haircut models (e.g., to accommodate changes in the portfolio of hedge funds); and (iv) breach cures (e.g., to reflect changes in the collateral or the operations of the fund over time). While these changes tend to be relatively routine and often require a simple amendment, procedures and/or responsibilities should be put in place to ensure that these changes are properly authorized and addressed in a timely and proper manner and to ensure that any legal issues that may arise are identified and considered.

Finally, there is one last point that should be noted with respect to amendments to transactions. The form of the amendment to address any of the matters raised herein can affect the rights of the parties to these transactions. Care should be taken to ensure that the amendment does not constitute a novation of the existing transaction (unless this is desired), especially if any agreements are being amended and restated, as this could result in the termination of the related security interest.[7]

## Conclusion

Financing transactions with FoHFs can be an attractive product. For the funds, they can address liquidity and leverage requirements and can be used to facilitate transactions such as derivatives that would otherwise require the fund to hold cash. As for the bank, as these transactions often remain in place for as long as the fund itself remains active, they can provide long-term relationships with funds and fund managers. However, they require attention and maintenance to address the needs and changes of the fund and to protect the security interest, and other benefits, of the bank providing the financing.

## Endnotes

1 Hedge fund industry assets under management (AUM) decreased from more than $2 trillion in 2007 to less than $1.5 trillion in 2008. Hedge fund AUM remained below $2 trillion until late 2013. BarclayHedge – Hedge Fund Industry Assets Under Management – Historical Growth of Assets.

2 FoHF financing transactions take the form of, among others, credit facilities, note issuances and derivative transactions. For ease of presentation, this article generally discusses credit facilities—most issues presented herein are relevant to each of these transaction forms.

3 See www.mayerbrown.com/files/Publication/a444f5f4-2fa2-42a5-8779-12064cb84b24/Presentation/PublicationAttachment/c20e9433-1b84-4a67-a43e-1c896cbc79a1/Fund-of-Funds-Financing.pdf for a discussion of the pledge of a securities account holding assets that may be subject to transfer restrictions.

4 Because the pledged asset is the fund's custody account and the rights related thereto, a pledge under the law of the custodian's jurisdiction is usually required.

5 See www.mayerbrown.com/files/Publication/4aaa2cb9-a25f-4b4f-aa79-d282bc9d4032/Presentation/PublicationAttachment/3307e5af-af83-4ec9-847c-dad50de4cf9c/170511-UPDATE-BF-Lending-FundFinance.pdf for a discussion of the Hague Securities Convention, which includes the requirement to maintain a qualifying office.

6 See www.mayerbrown.com/Amended-and-Restated-Financing-Agreement-Should-Clearly-State-If-Not-Intended-as-Novation-11-29-2016/ for a discussion relating to maintenance of security interests.

7 See ibid for a discussion relating to amending and restating financing transactions.

# Unencumbered Asset Pool Credit Facilities: An Alternative to Subscription, NAV and Hybrid Products

Todd Bundrant
Vincent Zuffante
Kristin Rylko

## Introduction

As the fund finance market continues to expand, we have seen a growing interest among real estate and other private equity funds (each, a "Fund") in unleashing the value of their assets to optimize investment returns. In order to meet the financing needs of these Funds, a growing number of banks and other credit institutions (each, a "Lender") are providing credit facility products supported by a pool of the Fund's unencumbered assets (each a "UAP Facility"). While loan availability under UAP Facilities is most often based on the value of a Fund's unencumbered real properties, recently we have seen unencumbered private equity assets serve as a basis of loan availability in an increasing number of transactions. In light of this trend, this article will discuss common features of UAP Facilities and compare UAP Facilities to subscription-backed credit facilities (also known as "capital call" or "capital commitment" facilities, and each a "Subscription Facility"), net asset value credit facilities (each a "NAV Facility") and hybrid credit facilities (each a "Hybrid Facility").

## Common Features of Subscription Facilities, NAV Facilities and Hybrid Facilities

Loan availability under a Subscription Facility is subject to a borrowing base, which is typically tied to the value of the pledged uncalled capital commitments of investors satisfying certain eligibility requirements, multiplied by an advance rate. Subscription facilities commonly outline certain events (e.g., investor bankruptcy, failure to fund capital contributions, withdrawal or excuse rights) that exclude investors from the borrowing base calculation. In connection with a Subscription Facility, a Lender will customarily receive a pledge by the Fund and its general partner of their respective rights: (1) in and to unfunded capital commitments of the investors in the Fund; (2) to make capital calls and enforce the obligations of the investors to contribute capital; and (3) to the deposit accounts into which the investors are required to fund their capital contributions.

In contrast to Subscription Credit Facilities (which look "up" to capital commitments of investors to determine loan amount availability), NAV Facilities look "down" to the net asset value of the underlying portfolio investments of the Fund in determining borrowing availability. Consequently, NAV Facilities may be particularly useful for mature Funds in which the investors have already funded a majority of their capital commitments and the Fund has deployed this equity for purposes of assembling a portfolio of investments. Loan availability under a NAV Facility is customarily limited to the net asset value of the "Eligible Investments," multiplied by an advance rate, subject to certain adjustments and limitations. Similar to Subscription Facilities, Lenders under a NAV Facility will typically impose certain eligibility criteria when determining which Eligible Investments to include in the borrowing base (including considerations based upon investment strategy, liquidity and diversification of investments), and ongoing inclusion is subject to the absence of specified adverse credit/exclusion events (e.g., liens, bankruptcy or insolvency events with respect to the investments; failure by the Fund or portfolio company to pay obligations; breaches of material contracts with respect to the investments; etc.). Although some Lenders will consider NAV Facilities on an unsecured basis in the case of high-quality asset classes, most Lenders will require a pledge of collateral that typically includes: (1) distributions and liquidation proceeds from the Fund's portfolio investments; (2) equity interests of holding companies through which the Fund holds such investments; and (3) in certain cases, equity interests relating to the investments themselves.[1]

Hybrid Facilities represent a combination of the collateral characteristics supporting Subscription Facilities and NAV Facilities an approach that allows Funds and Lenders maximum flexibility in structuring the credit facility. And although Hybrid Facilities were originally utilized by Funds nearing the end of their investment period (and following the accumulation of portfolio investments), they are now also being put in place at the time of the initial investor closing to provide seamless funding throughout a Fund's lifecycle. In determining loan availability under a Hybrid Facility, Lenders will typically look down to the net asset value of the underlying portfolio investments of the Fund, as they would in a NAV Facility; however, unlike a NAV Facility, Hybrid Facilities almost always include a borrowing base component tied to undrawn investor commitments and covenants that ensure there is a sufficient surplus of uncalled capital commitments. As a result, hybrid facility Lenders typically coordinate between product groups and share institutional knowledge in order to provide bespoke collateral support solutions in the form of uncalled capital commitments and a pool of known and potentially unknown portfolio assets (as proceeds from the Hybrid Facility may be used to purchase these assets). And because support for a Hybrid Facility is typically made up of some combination of the collateral pledged under Subscription Facilities and NAV Facilities, both Lenders and Funds are able to craft customized liquidity solutions based on the availability and suitability of such collateral.

## Common Features of UAP Facilities

Unlike Subscription Facilities (which look to the uncalled capital commitments of certain investors) or NAV Facilities and Hybrid Facilities (which primarily look to the net asset value of Eligible Investments), UAP Facilities look to the value of a subset or pool of the Fund's and/or its affiliates unencumbered assets to determine loan availability and are unsecured. Lenders will only give borrowing base credit with respect to assets that are unencumbered, meaning the assets are free and clear of all secured indebtedness and liens and encumbrances, and the value of such assets is typically multiplied by an advance rate and subject to certain deal-specific adjustments. Similar to Subscription Credit Facilities, NAV Facilities and Hybrid Facilities, Lenders will often impose additional borrowing base eligibility requirements when determining loan availability under a UAP Facility. For example, in a UAP Facility where the unencumbered asset pool is real estate, common eligibility criteria include requirements that: (1) the owner of the property has no secured or unsecured indebtedness with respect to the property, subject to certain carve-outs; (2) the owner of the property has the rights to create liens on the property to secure its indebtedness and to sell, transfer or otherwise dispose of the property; (3) the property is fully developed and the improvements thereon are completed; (4) the property is wholly owned by the

Fund or an affiliate thereof; (5) the property is located within a specific geographic area; and (6) the property is in compliance with laws and regulations and is free from major architectural deficiencies, title defects, environmental conditions or other adverse matters. Likewise, UAP Facilities typically provide mechanics for removal of unencumbered assets that may cease to satisfy the eligibility criteria and addition of unencumbered assets that meet the eligibility requirements after the closing of the facility.

The ability to add and remove assets from the availability pool provides the Fund with tremendous flexibility relating to its financing options for such assets. In many cases, a Fund may utilize a UAP Facility during the process of acquiring a portfolio of investments due to the efficiency of adding assets to the line. Thereafter, a Fund may optimize individual asset pricing and liquidity by negotiating secured financing terms (and simply removing the asset from the UAP Facility pool). And although UAP Facilities are commonly comprised of unencumbered real estate assets, in recent years we have also seen Lenders extend credit to Funds and their affiliates based on the net asset value of unencumbered private equity assets. The borrowing base for these UAP Facilities have included pools of equity interests in a Fund or portfolio company, portfolio company indebtedness and equity securities issued by an entity in connection with collateralized loan obligations.

In terms of UAP Facility covenants, perhaps the most prominent provision is the negative pledge with respect to the unencumbered assets (meaning that the Fund and the other loan parties agree not to pledge the unencumbered assets receiving borrowing base credit to secure indebtedness). And unlike a NAV Facility, which will typically prohibit liens on all assets of the Fund and its affiliates (subject to specific carve-outs), the negative pledge featured in a UAP facility is customarily limited to the unencumbered assets receiving borrowing base credit and the equity of the entities holding such assets, thus affording the Fund and its affiliates the flexibility to encumber properties that are excluded from the borrowing base to meet ongoing business needs. UAP Facilities typically also include financial covenants applicable to the Fund and/or its affiliates, such as maximum leverage ratios, maximum indebtedness levels, minimum net worth, interest coverage, fixed charge coverage, etc. These covenants serve to give the Lender comfort as to the financial health of the applicable loan parties.

While the nature and extent of the collateral is a distinguishing feature of Subscription Credit Facilities, NAV Facilities and Hybrid Facilities, UAP Facilities, by contrast, are typically unsecured. As such, Lenders will often require each owner of the unencumbered assets included in the borrowing base to fully guaranty the obligations under the UAP Facility to the extent that such owner is not a direct borrower under the facility. UAP Facilities also often include specific financial covenants addressing the unencumbered assets used to support the borrowing base, such as minimum asset value, minimum number of assets and concentration limits with respect to such assets (e.g., no more than a certain percentage of the aggregate value of unencumbered assets is attributable to any single unencumbered asset or no more than a certain percentage of assets are located in a single jurisdiction). Some UAP Facilities include a covenant that the Fund will grant a security interest in some or all of the unencumbered assets included in the borrowing base if certain performance metrics are not satisfied. Further, UAP Facilities may also be structured without a borrowing base, in which case the Lenders rely on financial and other covenants to monitor the asset pool and financial condition of the Fund.

## Conclusion

As the fund finance market matures, Lenders and Funds continue to explore new and innovative ways to finance investments and otherwise obtain liquidity from existing pools of assets. Alongside the rise in NAV Facilities and Hybrid Facilities, we have seen a number of Funds in recent years seek out financing under UAP Facilities for a growing number of asset classes. Because UAP Facilities provide Funds with an alternative method for satisfying financing needs and optimizing returns for Fund Investors, we expect to see continued growth of these facilities in the coming years.

## Endnote

1 For further discussion of NAV and Hybrid Facilities, see "Net Asset Value Credit Facilities" in the *Mayer Brown Fund Finance Market Review (Summer 2013), available at* www.mayerbrown.com/files/Publication/5fd578e0-4b3c-44ca-9be1-067497f87f8b/Presentation/PublicationAttachment/f7a7e13d-58af-4d95-9b92-271daf64e4f7/Mayer%20Brown_Fund-Finance-Market-Review-Summer-2013.pdf, and "Hybrid Credit Facilities" in the *Mayer Brown Fund Finance Market Review (Fall 2017), available at* www.mayerbrown.com/files/Publication/5d762917-53ee-4b79-abba-8628bdbe46a0/Presentation/PublicationAttachment/5f040404-e76e-4bfa-8e07-a1e-6528bebb3/Fund-Finance_Review_Fall_2017.pdf.

# Mayer Brown's Fund Finance Team

Christopher Arnold
Partner
London
+44 20 3130 3610
carnold@mayerbrown.com

Bryan L. Barreras
Partner
New York
+1 212 506 2571
bbarreras@mayerbrown.com

Jason S. Bazar
Partner
New York
+1 212 506 2323
jbazar@mayerbrown.com

Sandy Bhogal
Partner
London
+44 20 3130 3645
sbhogal@mayerbrown.com

Daniel B. Blackburn
Staff Attorney
Charlotte
+1 704 444 3695
dblackburn@mayerbrown.com

Linda E. Boss
Associate
Charlotte
+1 704 444 3519
lboss@mayerbrown.com

Kiel Bowen
Partner
Charlotte
+1 704 444 3692
kbowen@mayerbrown.com

Jennifer L. Bruni
Counsel
Chicago
+1 312 701 7490
jbruni@mayerbrown.com

Jeffrey M. Bruns
Partner
Chicago
+1 312 701 8793
jbruns@mayerbrown.com

Todd N. Bundrant
Partner
Chicago
+1 312 701 8081
tbundrant@mayerbrown.com

Doo-Soon "Doos" Choi
Partner
Hong Kong
+852 2843 2201
doos.choi@mayerbrownjsm.com

Christopher M. Chubb
Associate
Chicago
+1 312 701 8477
cchubb@mayerbrown.com

Leslie S. Cruz
Counsel
Washington DC
+1 202 263 3337
lcruz@mayerbrown.com

Mark C. Dempsey
Partner
Chicago
+1 312 701 7484
mdempsey@mayerbrown.com

Douglas A. Doetsch
Partner
Chicago
+1 312 701 7973
New York
+1 212 506 2370
ddoetsch@mayerbrown.com

Christopher Ellis
Associate
Charlotte
+1 704 444 3637
cellis2@mayerbrown.com

Frank A. Falbo
Partner
Chicago
+1 312 701 7485
ffalbo@mayerbrown.com

Frederick C. Fisher, IV
Partner
Chicago
+1 312 701 8545
ffisher@mayerbrown.com

Simon Fisher
Partner
London
+44 20 3130 3411
sfisher@mayerbrown.com

J. Paul Forrester
Partner
Chicago
+1 312 701 7366
jforrester@mayerbrown.com

Michael P. Gaffney
Partner
Charlotte
+1 704 444 3527
mgaffney@mayerbrown.com

Wendy Dodson Gallegos
Partner
Chicago
+1 312 701 8057
wgallegos@mayerbrown.com

Martin W. Goodlett
Associate
Chicago
+1 312 701 8729
mgoodlett@mayerbrown.com

Erika Gosker
Partner
Chicago
+1 312 701 8634
egosker@mayerbrown.com

Dominic Griffiths
Partner
London
+44 20 3130 3292
dgriffiths@mayerbrown.com

Karen F. Grotberg
Counsel
Chicago
+1 312 701 7923
kgrotberg@mayerbrown.com

Haukur Gudmundsson
Partner
Chicago
+1 312 701 8622
hgudmundsson@mayerbrown.com

McKay S. Harline
Associate
Chicago
+1 312 701 8695
mharline@mayerbrown.com

Carol A. Hitselberger
Partner
Charlotte
+1 704 444 3522
New York
+1 212 506 2662
chitselberger@mayerbrown.com

John A. Janicik
Partner
Chicago
+1 312 701 7323
jjanicik@mayerbrown.com

Mary Elise Johnson
Associate
Chicago
+1 312 701 7043
mejohnson@mayerbrown.com

Paul A. Jorissen
Partner
New York
+1 212 506 2555
pjorissen@mayerbrown.com

Adam D. Kanter
Partner
Washington, DC
+1 202 263 3164
akanter@mayerbrown.com

Jeremy Kenley
Partner
London
+44 20 3130 3030
jkenley@mayerbrown.com

Catherine T. Kiwala
Associate
Chicago
+1 312 701 8287
ckiwala@mayerbrown.com

Nadav C. Klugman
Partner
Chicago
+1 312 701 8433
nklugman@mayerbrown.com

Ann Richardson Knox
Partner
New York
+1 212 506 2682
aknox@mayerbrown.com

Anne Marie Konopack
Partner
Chicago
+1 312 701 8467
akonopack@mayerbrown.com

Andreas Lange
Partner
Frankfurt
+49 69 7941 1941
alange@mayerbrown.com

Karin Lee
Associate
Chicago
+1 312 701 7509
karinlee@mayerbrown.com

Stuart M. Litwin
Partner
Chicago
+1 312 701 7373
New York
+1 212 506 2389
slitwin@mayerbrown.com

Michael N. Loquercio
Associate
Chicago
+1 312 701 8904
mloquercio@mayerbrown.com

David A. Love
Associate
Chicago
+1 312 701 7651
dlove@mayerbrown.com

David Malinger
Partner
Chicago
+1 312 701 8662
dmalinger@mayerbrown.com

Brian T. May
Partner
Chicago
+1 312 701 8990
Los Angeles
+1 213 229 5113
bmay@mayerbrown.com

Matthew A. McDonald
Partner
Chicago
+1 312 701 8321
mmcdonald@mayerbrown.com

George K. Miller
Partner
New York
+1 212 506 2590
gmiller@mayerbrown.com

Stephanie M. Monaco
Partner
Washington, DC
+1 202 263 3379
smonaco@mayerbrown.com

Michael V. Morelli
Partner
New York
+1 212 506 2564
mmorelli@mayerbrown.com

Russell E. Nance
Partner
New York
+1 212 506 2534
rnance@mayerbrown.com

Joanna C. Nicholas
Counsel
Chicago
+1 312 701 8215
jnicholas@mayerbrown.com

John W. Noell
Partner
Chicago
+1 312 701 7179
jnoell@mayerbrown.com

Tim Nosworthy
Partner
London
+44 20 3130 3829
tnosworthy@mayerbrown.com

Keith F. Oberkfell
Partner
Charlotte
+1 704 444 3549
koberkfell@mayerbrown.com

Lennine Occhino
Partner
Chicago
+1 312 701 7966
locchino@mayerbrown.com

Matthew D. O’Meara
Partner
Chicago
+1 312 701 8815
momeara@mayerbrown.com

Nikolas R. Ortega
Associate
Charlotte
+1 704 444 3559
nortega@mayerbrown.com

# Mayer Brown's Fund Finance Team *continued*


Tristan E. Propst
Partner
Houston
+1 713 238 2657
tpropst@mayerbrown.com

Dennis M. Quinn
Counsel
Chicago
+1 312 701 7885
dquinn@mayerbrown.com

Claire K. Ragen
Counsel
Chicago
+1 312 701 7984
cragen@mayerbrown.com

Jonathan R. Rosaluk
Associate
Chicago
+1 312 701 8096
jrosaluk@mayerbrown.com

Laura K. Rosiecki
Counsel
New York
+1 212 506 2348
lrosiecki@mayerbrown.com

Kristin M. Rylko
Partner
Chicago
+1 312 701 7613
krylko@mayerbrown.com

David Sahr
Partner
New York
+1 212 506 2540
Washington, DC
+1 202 263 3332
dsahr@mayerbrown.com

Priscilla Santos
Counsel
Tauil & Chequer Advogados
São Paulo
+55 11 2504 4269
ppsantos@mayerbrown.com

Sean Scott
Partner
Chicago
+1 312 701 8310
New York
+1 212 506 2573
stscott@mayerbrown.com

Monica J. Steinberg
Associate
Chicago
+1 312 701 7676
msteinberg@mayerbrown.com

Mark Uhrynuk
Partner
Hong Kong
+852 2843 4307
mark.uhrynuk@mayerbrownjsm.com

Jeffrey A. Usow
Partner
Chicago
+1 312 701 8612
jusow@mayerbrown.com

Jon D. Van Gorp
Partner
Chicago
+1 312 701 7091
New York
+1 212 506 2314
jvangorp@mayerbrown.com

Donald S. Waack
Partner
Washington, DC
+1 202 263 3165
dwaack@mayerbrown.com

Laura M. Watson
Associate
Chicago
+1 312 701 8504
lwatson@mayerbrown.com

Michael W. Weigel
Associate
Chicago
+1 312 701 8567
mweigel@mayerbrown.com

Keith J. Willner
Partner
Washington, DC
+1 202 263 3215
kwillner@mayerbrown.com

Adam C. Wolk
Partner
New York
+1 212 506 2257
awolk@mayerbrown.com

Robert Woll
Partner
Hong Kong
T +852 2843 2454
robert.woll@mayerbrownjsm.com

Caitlin Woolford
Associate
Charlotte
+1 704 444 3557
cwoolford@mayerbrown.com

Vincent R. Zuffante
Associate
Chicago
+1 312 701 7573
vzuffante@mayerbrown.com

## About Mayer Brown

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