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Spring 2019

# Fund Finance Market Review

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

In this edition of our *Fund Finance Market Review*, we discuss issues arising from current developments in the subscription credit facility and fund finance markets, including certain protections against the unauthorized release of capital commitments, enforcement methods for various forms of credit support in fund finance transactions and divisive mergers under Delaware law and their impact on fund financings. We also provide a summary of model LPA provisions commonly associated with subscription credit facilities and other fund financings. Finally, concerning the continued globalization of fund finance products, we examine the evolution of facilities for separately managed accounts in Europe.

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# Fund Finance Market Review

ANN RICHARDSON KNOX AND KIEL A. BOWEN

Looking forward in 2019, we are optimistic that the market for fund financing remains robust. In 2018, Mayer Brown noted a significant uptick in the number of traditional subscription credit facility (each, a "Subscription Facility") closings and a record number of alternative fund financings such as net asset value facilities, hybrid facilities, secondaries transactions, management fee facilities and partner loans (together with Subscription Facilities, "Facilities"). Counterintuitively, this occurred even though fundraising in 2018 did not exceed the prior year's numbers and in light of the recently publicized events relating to the insolvency proceedings of a Cayman Island domiciled fund that was sponsored by a Middle Eastern sponsor. In general, given investor ("Investor") expectations for continued investment and the reaction of both private equity and other investment funds (each, a "Fund") and lenders, we continue our optimism for 2019 with respect to both the Facility market and that of the Fund asset class. Below, we expand our views on the state of the fund finance market as well as current trends likely to be relevant in 2019.

## 2018 Fundraising and Effect on Fund Finance Market

While final reports on fundraising for private capital in 2018 are still coming in, it appears that fundraising in 2018 did not match the banner year experienced by the market in 2017. As compared to 2017, a year in which the largest amount of investor capital commitments ("Capital Commitments") were raised in recent memory (exceeding more than $925 billion) preliminary data suggests that just over $757 billion of Capital Commitments were raised in 2018.[1] This drop suggests a slowing of Fund closings from 2017, but likely better than 2016 fundraising numbers and, if so, would make 2018 the second best year ever for new capital commitments.

The trend of Investors flocking to a smaller group of preferred sponsors continues with familiar US and European sponsors on the list of the largest Funds closing in 2018.[2] Moreover, increased interest in Asia was a clear trend throughout 2018, and, according to Preqin, for the first time Asia saw more funds closed than Europe.[3] We expect this trend to continue into 2019 given Investor appetite seems to be focused on Asia more than any other emerging market (including Central and Eastern Europe).[4]

Because both the appetite and the need for Facilities often follows fundraising activity, it would be natural to think that fund financing activity would have dropped in 2018 given the most recently released Preqin data. However, anecdotal evidence and Mayer Brown's own experience in this area suggest that the Facility market as a whole was as robust as ever in 2018. We think a number of factors may account for this including the following:

The often-cited Preqin data on fundraising activity used for year over year comparisons captures only Funds that had a final close in a given year. So, while the data provides for Funds that had a final close in 2018, Subscription Facilities are often put into place in connection with or shortly after an initial close but prior to a final close. Therefore, we would expect that in addition to Funds that had a final close in 2018, the market is seeing robust activity from Funds that are currently still fundraising. Other information supplied by Preqin supports this argument as it provides for a substantial uptick in the number of Funds in the market as of January 2019 (5,147) compared to January 2018 (3,484). There is a much larger amount of capital being raised compared to the comparative periods as well ($1.634B vs. $1.263B)[5].

Penetration of the market with respect to Facilities has also grown. Long gone are the days where only real estate and buyout Funds used Facilities. Recently we have witnessed an uptick in debt and private credit Funds wanting Facilities, as well as infrastructure Funds, that have become larger consumers of Facilities than in years past.

Finally, 2018 continued to prove that fund finance is much larger than just Subscription Facilities. The continued diversification in fund finance product offerings tilts towards Funds that are further along in their life cycle, including net asset value, hybrid and unsecured or "second lien" facilities. Unlike the typical Subscription Facility, such Facilities would have a lower correlation to fundraising in the same year because such Facilities are premised upon the investments and investment activity of a Fund. As a result, one would expect that these types of Facilities would depend upon Funds having their final closing in or prior to the banner years of fundraising in 2016 and 2017 (rather than 2018). We believe that these factors explain, at least in part, the solid 2018 for Facilities.

## Onward to 2019

Based on the number of term sheets and proposed transactions coming our way, 2019 is off to a strong start, with robust activity both in the Subscription Facility market and the market for other Fund Financings. As noted above, while fundraising does not perfectly correlate to the volume of new Fund Financings, it does appear that with a 40-percent increase to Funds in the market fundraising in January 2019 versus the prior year, we expect 2019 to see a similar number of Fund Financing originations.

With respect to the Investor perspective, while sponsor performance track record is key to Investors, we also note that some changes in sentiment among Investors may mean that the flight to a smaller number of larger sponsors of Funds that has been recently experienced may be diminishing. A majority of Investors in private equity seems to be interested in looking to increase its fund manager relationships rather than maintain or reduce them.[6] Moreover, the vast majority of Investors in private debt, real estate and infrastructure are seeking to either maintain or increase the number of sponsors they work with.[7]

## Recent Trends and Developments

### SPONSOR-LED RESTRUCTURINGS AND SPONSOR SECONDARIES

Another development in the market is that general partners are increasingly restructuring old Funds to move assets into new vehicles. This generally will occur where a general partner seeks to liquidate investments in an appropriate manner and for the right price. Multiple techniques have been implemented to achieve such results, including Fund recapitalizations permitting a cash-out or a roll into a new Fund with new terms. Additionally "strip" transactions that involve Funds or third-party investors have also developed.

In general, it would appear that while Investors involved with such restructurings have generally felt that adequate opportunities had been given to them to decide whether to cash out or roll into the new entity, they were not necessarily of the view that costs were fairly divided between the general partner and the Fund.[8] This is despite the fact that many such transactions will seek a fairness opinion as to the consideration paid by new investors.

We think this will continue to be a trend as Funds age and investments for one reason or another are not yet realized. We also note that Mayer Brown has seen an increasing number of Funds specializing at providing financing either to permit continued time to realize investments, to assist with custom solutions relating to a general partner restructuring or to offer additional management support to enhance asset values.

Another interesting topic of discussion we've heard is whether Funds may look to the secondaries market in order to sell interests in management companies. Whether this materializes in 2019 remains to be seen.

## HURDLE BORROWING BASES

In response to Funds requesting greater borrowing base capacity in the later stages of their lifecycle, many Subscription Facility lenders are now more regularly using the "hurdle" concept. Traditionally, hurdles were used sparingly to include Investors that would have otherwise been excluded from the borrowing base due to cease funding rights, sovereign immunity or other issues. Under a hurdle approach, these previously excluded Investors would be eligible for borrowing base credit after certain financial hurdles were satisfied (e.g., a percentage of capital commitments funded and a minimum net asset value of the Fund). Lenders grew comfortable with this approach based on the theory that the Investor's "skin in the game" would outweigh any negative economic incentive to exercise their cease funding right or immunity. Until recently, the concept was usually reserved for limited circumstances where an excluded Investor had a large commitment to the Fund and such Investor's exclusion would severely impact the usefulness of the Subscription Facility. Recently, however, hurdle conditions have become part of many borrowing bases and are a key feature of the overall borrowing base structure. In addition to including previously excluded Investors, hurdle conditions are now used to also increase concentration limits and advance rates applicable to a subset of Investors already included in the borrowing base. We expect this trend to continue to grow over 2019.

## DIVERSITY IS ON THE AGENDA

The Institutional Limited Partners Association ("ILPA") recently released a new form of due diligence questionnaire ("DDQ"), which includes questions relating to diversity and inclusion. Given many of ILPA's members are themselves being held to best practices in this area, it is a natural progression for ILPA's members to encourage best practices among the sponsors in which they choose to invest. In fact, a recent survey revealed that almost half of Investors include pay disparity at the sponsors as part of their due diligence efforts.[9]

ILPA's proactive approach to diversity and inclusion includes queries in their DDQ, as well as including a template for sponsors to measure and report the diversity of their teams. Such information is fairly granular, requiring reporting of whether individuals are on the investment team or in operations and highlighting what seniority they hold in their role.[10] Moreover, ILPA has included particular forms for certain jurisdictions (United States, United Kingdom, Canada or Australia) so as to more appropriately capture the breadth of underrepresented groups in each country.

The DDQ also includes questions designed to respond to issues that many firms are already choosing to address given the current "Me Too" movement. This includes requests regarding sexual harassment and discrimination claims and codes of conduct. It also seeks to elicit information regarding hiring and promotion policies and data at the sponsor level, in addition to the board composition of portfolio companies. Such information can provide Investors with more transparency in choosing a sponsor and emphasizes that diversity is good business.

### OTHER TRENDS AND DEVELOPMENTS

As you would expect, this market review also covers in more detail very timely issues that we are seeing, including updates on Delaware LLC technology regarding divisive mergers, financing of single managed accounts in Europe and, in light of recent events, cancellation of Capital Commitments.

## Industry Conferences

### MAYER BROWN EUROPEAN MARKET UPDATE

As a global service provider within the Fund Finance market, we will be hosting a European Market Update in London on March 6. This event will feature panelists from the lender, sponsor and investor communities and will address developments in the European Fund Finance market and trends taking shape for 2019 and beyond.

### FUND FINANCE ASSOCIATION GLOBAL FUND FINANCE SYMPOSIUM IN MIAMI

Once again, Mayer Brown will be a platinum sponsor at the Global Fund Finance Symposium. To avoid the snowstorms that plagued the New York City conferences the past two years, the symposium's ninth annual conference will be held this year in Miami, Florida. As the founding institution of the symposium that spurred the Fund Finance Association ("FFA"), Mayer Brown is proud to support the symposium. We expect this year's symposium to again bring together leading market participants to share their insights on the trends affecting the Fund Finance industry.

### WOMEN IN FUND FINANCE

Mayer Brown is also a proud sponsor of Women in Fund Finance, which will be holding a networking boat trip in connection with the Miami conference. To register for the Miami event and learn about other planned events in the United States, London and Asia, please go to www.womeninfundfinance.com/events.

### MAYER BROWN MID-YEAR MARKET REVIEWS

As we have done in prior years, Mayer Brown will again host Mid-Year Market Reviews during the late summer. 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.

## Endnotes

1. *Preqin Private Capital Fundraising Update Q4 2018*, January 2019.
2. *Id.*
3. *Id.*
4. *The Complete LP View: Perspectives 2019*, Private Equity International, January 2019.
5. *Prequin.*
6. *PEI.*
7. *Id.*
8. *PEI*
9. *Id.*
10. The DDQ and templates can be found at: https://ilpa.org/due-diligence-questionnaire/.

# Statutory Protections against the Unauthorized Release of Capital Commitments in a Subscription Credit Facility

KIEL A. BOWEN, CHRISTINE T. CARTER AND KRISTIN M. RYLKO

The market for subscription-backed credit facilities, also known as "capital call" or "capital commitment" facilities ("Subscription Facilities"), was recently unsettled by reports that an international private equity fund had allegedly released its investors' capital commitment obligations in violation of covenants under its Subscription Facility, potentially leaving the Subscription Facility lender exposed without sufficient collateral coverage with respect to the loan amounts outstanding. While most lenders have always been aware of this risk, many market participants have re-focused their attention on this issue and are now looking to better understand a lender's protections against a fund-borrower (the "Fund") and its investors following the unauthorized release of the investors' obligations to fund their capital commitments to the Fund.

A key to understanding the risks of a Fund releasing its investors' capital commitment obligations without lender consent is to examine the jurisdiction in which the Fund is organized. Jurisdictions differ on the statutory and common law protections available to lenders that might find themselves in this situation. Accordingly, prior to entering into a Subscription Facility (or allowing a new Fund to join an existing Subscription Facility), lenders should be comfortable with the Fund's governing law and understand any jurisdiction specific risk with respect to the enforceability of capital commitments.[1] Fortunately, from a US perspective, statutory law in jurisdictions in which Funds are frequently formed (e.g., Delaware and New York) provides some helpful protections to Subscription Facility lenders that find themselves in a situation where a Fund has released capital commitment obligations in violation of its contractual obligations under a Subscription Facility.

Under Delaware limited partnership law, Subscription Facility lenders can take comfort in the fact that even when a general partner releases the Fund's investors from the obligation to fund their capital commitments, so long as the lender reasonably relied on the capital commitment obligation when making a loan to the Fund, the capital commitment obligation will likely survive with respect to the repayment of that loan. Specifically, Section17-502(b)(1) of the Delaware Revised Uniform Limited Partnership Act (the "DRULPA") provides that notwithstanding any "compromise" of a capital contribution obligation, "a creditor of a limited partnership . . . may enforce the original obligation to the extent that, in extending credit, the creditor reasonably relied on the obligation of a partner to make a contribution or return."[2] It is reasonable to infer that a release of capital commitments will likely constitute a "compromise," and thus a Subscription Facility lender should be able to reasonably rely on such statutory protections. Similarly, the Delaware statutory framework for limited liability companies provides for similar protections for Subscription Facility lenders that reasonably relied on the capital commitments.[3]

DRULPA Section 17-502(b)(1) was applied to a Subscription Facility dispute in 2004 in *In re LJM2 Co-Investment, L.P.*[4] There, the chief financial officer of Enron established a $400 million Fund that invested in businesses related to Enron. The Fund entered into a $120 million credit facility with a lender, which included an undertaking that if the Fund defaulted, the lender had the right to compel the general partner to issue capital calls to cure any payment default, up to the unfunded balance of the investors' commitments. When Enron filed for bankruptcy, the Fund defaulted on the credit facility. Accordingly, the general partner and, subsequently, the lender issued capital calls to repay the credit facility. The investors rebuffed the capital calls and purported to amend the Fund's partnership agreement to rescind the pending capital calls and require all future capital calls be subject to the consent of a majority in interest of the limited partners. Without enough funds to repay the credit facility, the Fund filed for bankruptcy. The bankruptcy trustee then issued an additional capital call and, upon the investors' refusal to fund, commenced litigation against the investors to enforce their capital contribution obligations. The investors petitioned the court to dismiss the statutory cause of action based on numerous arguments, including that the creditors could not demonstrate "reliance" on their unfunded capital commitments as required by the statute. While the court did not directly rule on whether or not the lenders actually relied on the unfunded capital commitments, the court denied the investors' motion to dismiss, holding that there was sufficient detail in the complaint to demonstrate reliance.[5] Thus, this case supports the proposition that it is reasonable to apply DRULPA Section 17-502(b)(1) to a typical Subscription Facility of a Fund organized as a Delaware limited partnership.

New York law has similar statutory protections. Under the New York Partnership Law, a "waiver or compromise" with respect to an investor's liability to fund its unpaid capital commitment "shall not affect the right of a creditor of a partnership, who extended credit . . . to enforce such liabilit[y]."[6] Additionally, US federal courts applying New York law have upheld this duty with respect to investors under New York statutory provisions. In *In re Securities Group 1980,* the US Court of Appeals for the Eleventh Circuit examined whether investors that were released from the partnership in connection with a tender offer remained obligated to fund their unfunded capital commitments to repay office lease obligations entered into by the Fund prior to such release. The released investors argued that although the lease was signed prior to the tender offer and resulting release, the obligation to make the lease payments at hand arose after they were released. The court required the released investors to make capital contributions to settle the lease obligations holding that "even if a debt to a partnership creditor 'arises' after the limited partner's withdrawal, the withdrawn limited partner is nevertheless liable for the debt if the creditor 'extended credit' before the amendment of the limited partnership certificate."[7] The court went even further than the plain language of the statute, stating that the obligation of the investors to make capital contributions to the Fund's creditors should survive a release because "the limited partner, not the creditor, should bear the risk that the partnership's assets could become worthless."[8]

The elements under these statutory protections have shaped many Subscription Facility lenders' underwriting standards. Accordingly, many lenders require or will offer better terms to Funds that include specific language in their governing documents with respect to these elements, including specific acknowledgments by the Fund and its investors that any Subscription Facility lender is relying on the investor capital commitment obligations as their primary source of repayment.[9]

In addition to these statutory protections, Subscription Facility lenders facing an unauthorized release of capital commitment obligations of investors in a US-domiciled Fund may be positioned to pursue remedies against the Fund and its investors based on additional legal theories, including breach of contract, unjust enrichment, promissory estoppel and other theories of liability.[10]

While no Subscription Facility lender would enter a Subscription Facility expecting that the investors' capital commitments would be released in violation of the Fund's contractual obligations, lenders can take comfort that even in such an extreme scenario, Delaware and New York statutory law contain creditor protections, so long as the lender can demonstrate that it reasonably relied on the capital commitments when it extended credit. While these protections exist in Delaware and New York, Subscription Facility lenders should also keep in mind that these protections vary from jurisdiction to jurisdiction. Accordingly, prudent Subscription Facility lenders should work with experienced counsel to understand both the statutory framework and other protections (or lack thereof) relating to the enforceability of capital commitments in the relevant jurisdiction.

## Endnotes

1 We also recommend that, in addition to examining a jurisdiction's protections against an unauthorized release of capital commitments, lenders should evaluate other jurisdiction-specific risks, such as whether the capital commitments would be enforceable in a Fund's bankruptcy.

2 Del. Code Ann. tit. 6 § 17-502(b)(1) (2010).

3 See Del. Code Ann. tit. 6 §18-501 (2010).

4 *In re LJM2 Co-Investment, L.P.*, 866 A.2d 762 (Del. Ch. 2004).

5 *Id.* at 782 – 83.

6 N.Y. P'ship Law § 106(3) (McKinney 2018). Additionally, New York Limited Liability Company Law provides similar protections with respect to New York domiciled limited liability companies, providing that notwithstanding a compromise of a capital commitment "a creditor of a limited liability company who extends credit in reliance on the obligation of any member may enforce the original obligation to the extent he or she reasonably relied on such obligation after the member signed a writing which reflects the obligation and the creditor extended credit before the compromise." N.Y. Ltd. Liab. Co. Law §502(b) (McKinney 2018).

7 *In re Sec. Group 1980*, 74 F.3d 1103, 1110 (11th Cir. 1996).

8 Id. at 1111 (citing *Kittredge v. Langley*, 252 N.Y. 405, 169 N.E. 626 (1930)).

9 For more information on these requirements, see our article "Model LPA Provisions for Subscription Credit Facilities" in this *Fund Finance Market Review Spring 2019* on p. 30.

10 For additional information on some of these other possible protections, see our July 2011 legal update, "Enforceability of Capital Commitments in a Subscription Credit Facility" (available at: https://www.mayerbrown.com/publications/enforceability-of-capital-commitments-in-a-subscription-credit-facility-07-07-2011/.)

# Enforcement of Forms of Credit Support in Fund Finance

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Private investment funds ("Funds") employ a variety of financing structures to improve liquidity and/or obtain leverage, and lenders similarly rely on a variety of collateral and credit support packages for repayment in connection therewith.[1] Three types of credit support commonly used in the fund finance market are (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").[2] In the event a Fund and/or a lender must attempt to monetize any of these forms of credit support for purposes of repaying a credit facility, the unique characteristics of each will dictate how the parties can effectively realize the applicable credit support. This article will discuss the enforcement of a Capital Commitment, Guaranty or ECL by the applicable party in connection with a credit facility.

## Capital Commitments

Capital Commitments may be used as credit support in a credit facility that is not a standard subscription-backed credit facility or a capital call facility ("Subscription Facility"), whereby 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.[3] In such a credit facility, the loan documents may include representations, warranties and covenants related to the amount of unfunded Capital Commitments that must be reserved 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 and the lender may rely upon. Following a default by the Fund under a Subscription Facility, a lender may directly 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 by the limited partners pursuant to the terms of the limited partnership agreement and in accordance with the Subscription Facility documents.

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. When Capital Commitments are used as credit support as opposed to collateral, the lender will not have the ability to directly enforce the payment of Capital Commitments by limited partners. Instead, the Fund will need to exercise its rights to enforce payment of the Capital Commitments. The limited partnership agreement of a Fund will likely require limited partners to make capital contributions within 10 to 15 days following a capital call and may provide an excuse right for certain investors with respect to such capital call. If a limited partner fails to pay its capital contribution pursuant to the terms of the limited partnership agreement, only then will the Fund be allowed to pursue additional enforcement tools at its disposal pursuant to the limited partnership agreement, including the ability to designate any limited partner that fails to make its capital contribution as a "defaulting limited partner" under the limited partnership agreement. Such designation permits the Fund to apply remedial measures with respect to such limited partner's limited partnership interests, including, without limitation, charging default interest, reducing the value of such limited partner's limited partnership interests and potentially even forcing a full divestment thereof. The various punitive rights available to a Fund under the terms of its limited partnership agreement in respect of a defaulting limited partner are likely to encourage a limited partner to comply with its Capital Commitment before the Fund is forced to seek recourse beyond what is permitted under the terms of the limited partnership agreement.

It is generally accepted that a Fund can enforce the Capital Commitments of the limited partners under two separate theories of liability: state statutory law and general contract law. Delaware statutory law, for instance, contains specific provisions that obligate a limited partner of a Fund to contribute cash and property pursuant to the terms of the Fund's limited partnership agreement.[4] Under general contract law, a Fund may also rely on breach of contract and material breach tenants of law to enforce the Capital Commitments.

## BREACH OF CONTRACT

Under a theory of contract liability, a limited partner's obligation to fund its Capital Commitment is an enforceable contractual obligation pursuant to the terms of the limited partnership agreement. To rely on a theory of contractual liability, the Fund's limited partnership agreement should contain affirmative language evidencing the right of the Fund or its general partner to make capital calls on the limited partners and the obligation of the limited partners to fund their related Capital Commitment. If the Fund's limited partnership agreement provisions create this contractual obligation, the Fund will be well-positioned legally to enforce each limited partner's Capital Commitment.

## MATERIAL BREACH

Under contract law, a limited partner may argue that it should be excused from further performance of its obligations to a Fund in instances where the Fund or its general partner has committed a material breach of its own obligations. The ability to extinguish a limited partner's Capital Commitment in such instance, however, will generally not extend to obligations owed to creditors of the Fund. Courts have emphasized protecting the right of outside parties who rely on the Capital Commitments of limited partners in extending credit to the Fund. Without such assurance that a limited partner will be obligated to honor its Capital Commitment, creditors would be unlikely to enter into a credit facility with the Fund. Even when Capital Commitments are not directly pledged to a lender as collateral under a credit facility, a lender will still rely on the

Fund's ability to enforce each limited partner's Capital Commitment in order to repay any loan made to the Fund. This reliance by a lender is evidenced when the credit facility documents specifically contemplate the use of Capital Commitments as credit support through certain representations, warranties and covenants related thereto, as discussed above. While case precedent provides strong authority supporting the enforceability of Capital Commitments, even in the case of a material breach by the Fund, requiring language in the limited partnership agreement that capital contributions will be funded by the Investor "without set-off, counterclaim or defense" may further weaken any material breach defense.

Finally, a Fund's rights to the Capital Commitments of the limited partners should not be materially impaired by a Fund's bankruptcy proceeding, and the causes of action entitling a Fund to enforce the Capital Commitments should not change in bankruptcy—they will still be based on the same statutory and contractual theories discussed above. A Fund should be able to enforce the terms of the limited partnership agreement and the Capital Commitments of the limited partners following a default by the Fund under a credit facility, and ultimately the Capital Commitments should continue to be enforceable against the limited partners, notwithstanding any bankruptcy or insolvency of the Fund.

## Guaranties

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. When a Guaranty is used in the fund finance market, 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. 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. 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.[5] 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.[6]

A Guaranty will ideally include a waiver of defenses, counterclaims and offset rights (including with respect to those rights arising under the US Bankruptcy Code that may pertain to a bankrupt primary obligor) by the Guarantor in respect of the primary obligor's obligations to the lender and other suretyship defenses available to a Guarantor under applicable law. Suretyship defenses available to the Guarantor may include, without limitation, a lack of validity or enforceability of the underlying agreement between the primary obligor and the lender, failure of the lender to assert any claim or demand against the primary obligor, and any change in the payment terms by the primary obligor in respect of the primary obligation. Another optimal feature of a Guaranty from the lender's perspective is the requirement that the Guarantor subordinate any claims it may have against the primary obligor arising from payments made by the Guarantor on behalf of the primary obligor pursuant to the Guaranty to the claims of the lender against the primary obligor for repayment of the primary obligations in full. A Guaranty may also include other representations, warranties and covenants by the Guarantor, creating contractual obligations between the Guarantor and the lender that are independent of the guaranteed obligations of the primary obligor. The ability of a Guarantor to issue a Guaranty may be restricted, however, by such Guarantor's organizational documents and will necessitate a careful review by experienced legal counsel of such organizational documents to ensure that the issuance of the Guaranty is not prohibited.

Due to the fact that a Guaranty is a contract between two parties, under a theory of contract liability, a Guarantor's obligation to pay the lender pursuant to the terms of the Guaranty should be an enforceable contractual obligation, subject to certain defenses discussed above. Upon a breach by the Guarantor of the contractual obligation established under and pursuant to the Guaranty, the lender may immediately enforce any remedies available to it in respect of such breach, including seeking specific performance thereunder. The lender to which the Guaranty is issued is in direct contractual privity with the Guarantor and there should be no need to further establish standing to assert a claim for breach of the Guaranty (as may be necessary with respect to an ECL, discussed below). Assuming the various waivers of defenses and other supporting provisions discussed above are included in the Guaranty (and there are not concerns regarding receipt of adequate and fair consideration), a lender should be able to enforce the terms of the Guaranty following a default by the primary obligor and ultimately the Guaranty should continue to be enforceable against the Guarantor, notwithstanding any bankruptcy or insolvency of the primary obligor.

## Equity Commitment Letters

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 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. 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 directly 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. 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.

Due to the fact that an ECL is a contract between two parties, under a theory of contract liability, an ECL Provider's obligation to contribute capital to the ECL Recipient is an enforceable contractual obligation. Upon a breach by the ECL Provider of the contractual obligation established under and pursuant to the ECL, the ECL Recipient (or a lender on its behalf) may immediately enforce any remedies available to it in respect of such breach, including seeking specific performance thereunder. If the lender wants to enforce the terms of the ECL, it must rely on a theory of contractual liability and will require the lender to have standing to assert a claim for breach of the ECL. To do so, the ECL and the related credit facility documents should contain affirmative language evidencing (i) the right of the ECL Recipient to require the ECL Provider to honor its obligation to provide capital and (ii) a pledge by the ECL Recipient of its rights to receive such capital and the enforcement thereof to a lender. Assuming the ECL includes the waivers of defenses and other supporting provisions discussed above, the lender should have standing under the terms of the ECL to enforce its provisions following a default by the ECL Recipient under the credit facility, and ultimately such ECL should continue to be enforceable by the lender, notwithstanding any bankruptcy or insolvency of the ECL Recipient.

## Comparing Enforcement of Capital Commitments, Guaranties and ECLs

The nuances specific to Capital Commitments, Guaranties and ECLs will dictate the means of enforcing the applicable credit support in connection with a credit facility.

The use of unfunded Capital Commitments as credit support will run in favor of the Fund, and the Fund itself will have the ability to enforce the payment of the unfunded Capital Commitments when used simply as credit support (as opposed to collateral that is pledged to the lender under a Subscription Facility). In contrast, a Guaranty runs in favor of the lender and allows the lender to seek payment directly from the Guarantor. An ECL will run directly in favor of the ECL Recipient, however, the use of a collateral assignment of an ECL will permit the lender to enforce the terms of the ECL on behalf of the ECL Recipient.

## Conclusion

Capital Commitments, Guaranties and ECLs should all be enforceable forms of credit support that can be enforced by a Fund and/or a lender, even in a primary obligor/Fund bankruptcy context. Notwithstanding the generality of the foregoing, it is important that experienced legal counsel is consulted in connection with employing any such form of credit support under a given credit facility to review the relevant documentation evidencing the related credit support obligation to ensure that the duties and obligations thereunder are clear and that a Fund and/or a lender can reasonably expect to rely on the same for purposes of repaying a credit facility. Following such a review, each party should be confident that enforcing Capital Commitments, Guaranties and ECLs is not a prohibitive undertaking that would deter their use in connection with finding creative solutions to provide credit support in the fund finance market.

## 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 2019* on p. 1

2 For a more detailed review of the use of Capital Commitments, Guaranties and ECLs as credit support, please see our article, "Forms of Credit Support in Fund Finance," in Mayer Brown's *Fund Finance Market Review Spring 2018* (available at: https://www.mayerbrown.com/en/perspectives-events/publications/2018/03/forms-of-credit-support-in-fund-finance).

3 For a more detailed explanation of the use of Capital Commitments in connection with a subscription facility 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* (available at: https://www.mayerbrown.com/en/perspectives-events/publications/2016/09/subscription-credit-facility-market-review).

4 Del. Code Ann. tit. 6, § 17-502(a)(1) (2018).

5 N.Y. Gen Oblig Law § 15-701 (2018).

6 *See* Restatement (Third) of Suretyship and Guaranty § 9.

# The Evolution of Subscription Credit Facilities for Separately Managed Accounts in Europe

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There has been a strong surge in recent years of large institutional investors such as state retirement plans and sovereign wealth funds making use of separately managed accounts ("SMAs") as an investment vehicle. Tailored commercial terms and documentation have become increasingly attractive to such investors (each, an "Investor") and, in addition, sponsors see a benefit in meeting some of their largest and most loyal Investors' demands through the establishment of SMAs. Investments have been made with or in private equity firms, credit firms and private equity real estate firms, both in the United States and, more recently, in Europe. This has, in turn, led to an increased number of credit facilities backed by capital commitments of applicable Investors ("Subscription Credit Facilities") being sourced and provided to SMAs.

## Separately Managed Accounts—An Overview

An SMA comprises a legal entity established for the purpose of executing usually a single Investor's investment agenda, under the management of an experienced investment advisor (or similar role) (each, a "Sponsor"). Typically these entities are structured as limited partnerships whose only limited partner is a single Investor. The Sponsor, in turn, assumes a non-equity (or *de minimis* equity) role—i.e., acting as general partner—which entails the day-to-day operations and management of the entity.

SMAs have steadily gained market share, both in the United States and in the European market (as compared to pooled funds and other investment structures) for several reasons. One, the structure affords the ability to implement bespoke, flexible investment strategies responsive to the Investor's risk appetite, desired asset classes and industries, and to suggest the Investor's investment policies, as well as tailored reporting requirements specifically negotiated to capture the Investor's own internal reporting needs. Two, when assets under management are high enough to realize efficiencies of scale, management fees tend to be lower for an SMA than for a pooled fund. Finally, a fund with a single Investor does not expose the Investor to the risk that other limited partners may default, thereby avoiding negative impacts on the profitability and overall creditworthiness of the fund. While the single Investor feature is a major driver for the growing popularity of the SMA investment structure, it is this aspect in particular that creates some of the key points to consider in relation to Subscription Credit Facilities entered into by such SMAs. To be clear, SMAs do not come without complexities, as Sponsors are often required to explore any potential conflicts of interest that may arise between investments funded by the SMA and other pooled funds generally included in the particular Sponsor's fund structure. The negotiation and documentation of the SMA may also be as costly and time-consuming as establishing a pooled fund.

## Subscription Credit Facilities for SMAs

Both pooled funds and SMAs alike rely on the capital commitments of their respective investors to fund investments, and Subscription Credit Facilities are generally regarded as a valuable tool for an investment vehicle to deploy such capital in alignment with its operations strategy.[1] Among other benefits, Subscription Credit Facilities provide an attractive source of quick liquidity (even providing next-day or same-day funding) and can minimize the need to issue capital calls to finance investments, thereby avoiding burdening the Investor as part of the closing process for an investment.

The issues a lender must consider in relation to SMAs in Europe and related facility documentation are in many respects similar to the issues impacting separate accounts and single investor vehicles in the United States.[2] And as the popularity of SMAs for European Sponsors and their Investors has increased, Sponsors are frequently exploring financing options for their SMAs from their lenders. Like their US counterparts, European lenders have generally demonstrated an appetite to provide facilities for SMAs subject to a more stringent credit analysis given the concentration risks inherent in reliance on a single Investor. Lenders take into account a number of factors such as familiarity and relationship with the underlying Investor and/or the Sponsor itself; for certain European lenders, whether the bank and Investor operate in similar jurisdictions with an institutional understanding of the culture and local economy in which each operates; and, finally, the pricing of the facility, both in terms of up-front and ongoing costs to the SMA. While certain European lenders are more active than others in providing Subscription Credit Facilities to SMAs, many have indicated that viability for a particular fund is typically considered on a case-by-case basis in light of the above factors.

## Documentation Considerations for Subscription Credit Facilities Provided to an SMA in Europe

The documentation posture taken by most market lenders in Europe differs in a few ways from the approach taken for pooled funds where a larger diversified investor pool supports the facility. In pooled funds, should an Investor default or fall out of the borrowing base, the commitments of the other Investors remain as a source of repayment for Subscription Credit Facility obligations. In an SMA structure, the single Investor's capital commitments are the primary credit consideration for the lender.

Generally, European lenders will seek to ensure that the fund documents appropriately address authorization of the general partner or investment manager to enter into Subscription Credit Facilities on behalf of the SMA and to pledge the fund's assets (which include, in the case of a Subscription Credit Facility, the Investor's agreement to advance capital when called). Fund documents generally include detailed borrowing provisions addressing lenders' requirements[3] and other language relating to the ability to call capital typically required by lenders. As such, most European transactions with pooled investment vehicles do not require investor consent letters

("Investor Consent Letters") whereby investors separately enter into an agreement in favor of a lender, acknowledging and making representations regarding the investor's commitments to the fund and the security created in favor of the lender.

Documentation for a Subscription Credit Facility to an SMA typically follows the standardized forms used in the European market (as applicable for the governing law of the facility agreement) and incorporates a well-known suite of documents—including a facility agreement, charges and account charges. The traditional approach in Europe to Subscription Credit Facilities of applying a coverage ratio (being the ratio of uncalled capital commitments of certain investors to aggregate financial indebtedness of the borrower)—as opposed to the US-style convention of formulating a borrowing base with investor concentration limits—is also well suited to Subscription Credit Facilities for SMAs, given the single Investor feature. However, because an SMA usually only has a single Investor, European lenders typically seek to bolster the standardized documentation with additional documentation in order to both deepen the lender's knowledge of and comfort with the underlying Investor and establish contractual privity between the lender and the Investor notwithstanding the adequacy of the fund documentation for the SMA. As such, European lenders to SMAs will in most cases require an Investor Consent Letter from the single Investor. As mentioned above, Investor Consent Letters have not been commonplace in European Subscription Credit Facilities, and so the recent increase in Subscription Credit Facilities for SMAs in Europe has created additional focus on Investor Consent Letters amongst European lenders, Sponsors, Investors and their applicable legal advisers.

Nevertheless, in the context of a Subscription Credit Facility for an SMA, the Investor Consent Letter is important from a lender's perspective for a number of reasons. First, the Investor Consent Letter creates a direct agreement between the lender and the Investor (which for many lenders that provide this product is a key credit requirement given that the creditworthiness of the single Investor is the primary source of repayment for Subscription Credit Facility obligations). Second, sovereign immunity, which may apply to Investors that will invest in SMAs, will often not be adequately addressed in fund documentation, and lenders will require this to be dealt with in the Investor Consent Letter.

The scrutiny on the single Investor applies not only at a credit level for the lender and in relation to the diligence undertaken on the fund documents (as discussed above) but also impacts key provisions documented in the facility agreement and ancillary documents. Typical exclusion events that would exclude a particular Investor in a pooled fund from the borrowing base in a Subscription Credit Facility may be less flexible in certain aspects, including cure and grace periods. In addition, certain major exclusion events in relation to investors where there are multiple investors in a fund are typically re-drafted in SMA Subscription Credit Facilities as events of default. The remaining exclusion events trigger a mandatory prepayment, which, if not waived within an agreed timeframe (usually 30 days), would result in an event of default. Furthermore, transfers by the single Investor will generally require strict levels of approval from the lender. Lenders will also seek tighter reporting requirements given that the Sponsor is only reporting itself to, and managing the commitments of, a single Investor, and lenders will expect more timely delivery of information than Sponsors are often given when they are managing a large pool of investors. These terms are a few examples of the approach taken in Europe to the documentation as a result of the reliance placed on the single Investor by the lender providing a Subscription Credit Facility to the SMA.

## Additional Product Offerings for SMAs in Europe

The rise in SMAs and financings being provided to SMAs in Europe has led to some innovative products and documents being offered by European lenders, particularly for Sponsors that manage a number of SMAs. In these instances, Sponsors have often sourced financing for multiple SMAs from a single lender or club of the same lenders. Where this is the case, the use of umbrella facilities (one documented facility agreement entered into with a number of fund borrowers that each have access to a Separate Subscription Credit Facility under the single document on a non-cross-collateralized basis) ("Umbrella Facilities") is often considered. These types of facilities may be viewed as efficient across the platform and reduce the required documentation for a number of separate facility agreements that have substantially similar terms.

Other technologies that have been used for SMA financings include common terms agreements (each a "CTA"). Similar to Umbrella Facilities, a CTA agreed between the lender and the Sponsor contains the key legal documentation provisions found in a standard facility agreement for a Subscription Credit Facility (including, by way of example, repayment, interest provisions, tax, representations, undertakings, events of default and lender and agency mechanics). The CTA may then be appended to any number of short form facility agreements for a Subscription Credit Facility for any number of SMAs. The short-form facility agreements will include the relevant parties, facility amount, commercial terms (such as pricing and fees) and any other terms applicable for the specific SMA and the Subscription Credit Facility being provided to such SMA. As the CTA will be in an agreed form for each facility agreement required, execution of each facility agreement (once the CTA is agreed) can be very efficient.

One benefit of the CTA in contrast to an Umbrella Facility is that a CTA can be agreed upfront and can then be appended to short-form facility agreements required by SMAs over time at the relevant points at which the Sponsor required the Subscription Credit Facility for such SMA (with any amendments required to the CTA being made as applicable). An Umbrella Facility, by contrast, is typically entered into by all applicable borrowers at the same time albeit additional borrowers may accede as required. Although Umbrella Facilities and CTAs are not new to the European market, the increase in financings being provided to SMAs in Europe has resulted in increased consideration of these products by Sponsors.

## Conclusion

European Sponsors and Investors alike are likely to continue seeking opportunities for SMAs, and this will in turn drive demand for financing products to be sourced and made available to these fund structures. As the types of Investors investing through SMAs potentially diversifies, further lender scrutiny could lead to more developments in the approach to the diligence undertaken on fund documentation and protections sought in the facility agreement and Investor Consent Letters. For larger sponsors with multiple SMAs, there could also be an increasing appetite for Umbrella Facilities and CTA documentation processes. Despite the bespoke nature of the SMA structure, we anticipate that European lenders and Sponsors alike will continue to work on creative structural and documentation solutions for Subscription Credit Facilities to SMAs in order to provide liquidity to this growing segment of the market.

## Endnotes

1 See "The Advantages of Subscription Credit Facilities" in the *Fund Finance Market Review Spring 2017* (available at: https://www.mayerbrown.com/en/news/2017/03/the-advantages-of-subscription-credit-facilities).

2 See "Separate Accounts vs. Commingled Funds: Similarities and Differences in the Context of Credit Facilities" in the *Fund Finance Market Review Summer 2013* (available at: https://www.mayerbrown.com/en/perspectives-events/publications/2013/07/separate-accounts-vs-commingled-funds-similarities) and "Lending to Single Investor Funds: Issues in Connection with Subscription Credit Facilities" in the *Fund Finance Market Review Fall 2016* (available at: https://www.mayerbrown.com/en/perspectives-events/publications/2016/09/lending-to-single-investor-funds-issues-in-connect).

3 See "Model LPA Provisions for Subscription Credit Facilities" in this Fund Finance Market Review Spring 2019 on p. 30.

# Divisive Mergers and Impact on Fund Financings

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## Introduction

Private equity and other types of investment funds ("Funds") often utilize financing to more quickly access funds for investments, working capital and other purposes. Such financing products include both facilities secured by a Fund's investment assets or the net asset value of the equity in such assets ("NAV Facilities") and subscription-backed credit facilities. Subscription-backed credit facilities, sometimes referred to as "capital call" or "capital commitment" facilities (each a "Subscription Facility" and together with NAV Facilities, "Facilities"), are secured by pledges of the contractual rights of the Fund to require its investors to pay in capital to the Fund from time to time, which rights arise from the Fund's organizational documents. The ability of a Fund to utilize such Facilities and the extent to which the contemplated security for a particular Facility is feasible requires careful review and consideration of the Fund's governing agreement, usually a limited partnership ("LP") or limited liability company ("LLC") agreement.

While prior issues of the *Market Review* discussed updates in technology relating to Series LPs and LLCs and their impact on Facilities, this article focuses on recent changes in the laws relating to business entities that permit such entities to consummate transactions informally known as divisive mergers (each, a "Divisive Merger"). Such Divisive Merger statutes permit business entities to divide into multiple entities and to allocate liabilities and assets of the dividing entity amongst surviving entities. While other states were first in passing Divisive Merger statutes, this article focuses mainly on the recent changes in Delaware law, as most Funds organized in the United States are formed in Delaware.

Because Divisive Mergers permit business entities to restructure their assets and liabilities more easily, they can create problems for lenders ("Lenders") in Facilities if the effect of Divisive Mergers is not properly considered and accounted for in Facility documentation. In particular, Divisive Mergers may impact Lenders in existing Facilities, as obligors thereunder could potentially allocate liabilities relating to a Facility to other successor entities. Additionally, this could affect the status of capital commitments or asset security for Facilities should such assets be re-allocated to entities that are not obligors. Accordingly, it is important for Lenders and Funds to understand this new technology in order to assess the impact on existing Facilities and to properly conduct due diligence and document new Facilities. This article includes a summary of the changes in law surrounding Divisive Mergers, a discussion of the impact of this new technology on existing credit agreements and a review of considerations for improved diligence and loan documentation moving forward.

## Background of Divisive Mergers

The first Divisive Merger statute was passed in Texas in 2006 and related to limited liability companies, limited partnerships, corporations and any other business entity organized in Texas.[1] Divisive Mergers, initially unique to Texas but which were also implemented by Arizona and Pennsylvania in 2016,[2] permitted such entities additional, flexible restructuring options. For example, such statutes permit business entities to reorganize their assets and liabilities for a number of purposes. Such purposes may include efficient division of entities to end a partnership where equity holders are unable to effectively work together, to spin off certain assets or liabilities so as to restructure an entity's balance sheet or to assign contracts that may otherwise be unassignable. Where used to facilitate asset transfers, such statutes permit LLCs to achieve such objectives without having to execute numerous transfer agreements and potentially without violating transfer restrictions included in the contracts that the dividing LLC may wish to reallocate.[3] Not to be outdone, in August 2018, Delaware followed suit by enacting changes to the Delaware Limited Liability Company Act (the "LLC Act"), which permit limited liability companies organized in Delaware (a "Delaware LLC") to divide and allocate assets and liabilities to one or more newly formed Delaware LLCs (such amendments, the "Amendments").[4]

## Plan of Division

Pursuant to the Amendments, an existing Delaware LLC (the "Dividing Company") may divide its "assets, property, rights, series, debts, liabilities and duties" among itself (if the Dividing Company is intended to survive the Divisive Merger) and any new Delaware LLCs that are created in connection with such Divisive Merger ("Resulting Companies," and together with any Dividing Company that survives, the "Division Companies").[5]

The Amendments provide that a Dividing Company may only affect a division through a plan of division (a "Plan").[6] A Plan is required to set forth the terms and conditions of the Divisive Merger, including information as to how the limited liability company interests of the Dividing Company will be treated in connection with the Divisive Merger (e.g., conversion, exchange or cancellation of such interests) and the allocation of "assets, property, rights, series, debts, liabilities and duties" of the Dividing Company among the Division Companies.[7] The Plan is also required to include the names of each entity that survives the Divisive Merger, the name and business address of a division contact who maintains a copy of the Plan (a "Division Contact") and other matters which the Dividing Company chooses to include.[8] A Plan is not required to list each individual asset and liability of the Dividing Company that is to be allocated, so long as such assets and liabilities are "reasonably identified" by any method where the identity of such assets and liabilities is "objectively determinable."[9] While the Plan is not filed with the State of

Delaware and, therefore, would not be obtained through a search of the company records, a certificate of division ("Certificate") is required to be filed by "the surviving company" if there is one, or any other Division Company.[10]

A Certificate is more basic than a Plan and provides only limited information about the Division Companies, such as the names and addresses of the surviving Division Companies, any prior names of the Dividing Company and a statement that the Plan is on file at a place of business of a specified Division Company, with such Division Company's address.[11] The Certificate also provides the name and business address of the Division Contact.[12] The Amendments require that such Division Contact be a resident of Delaware (or an entity organized in Delaware), maintain a copy of the Plan for six years post division and provide copies of the Plan to "any creditor" of the Dividing Company during such six-year period upon 30 days' notice.[13] Additionally, the Division Contact must provide the name and address of the Division Company to which a claim of a creditor of the Dividing Company was allocated pursuant to the plan of division.[14]

The Amendments also provide default rules for what types of consents must be obtained in connection with a Divisive Merger and adoption of a Plan, to the extent that such consent requirements are not specified in the limited liability company agreement of a Dividing Company.[15] If a limited liability company agreement specifies consent or other requirements with respect to mergers or consolidation, then a Divisive Merger and a Plan shall be authorized in the same manner.[16] If the limited liability company agreement is otherwise silent, a Plan must be authorized by the approval of "members who own more than 50 percent of the then current percentage or other interest in the profits of the dividing company owned by all of the members."[17]

## Allocation of Assets and Liabilities and Potential Risks to Lenders

The LLC Act provides that the "debts, liabilities and duties" (collectively, the "Liabilities") of the Dividing Company will be allocated to and be the Liabilities of the Division Company as allocated in the Plan.[18] Additionally, the statute provides a default rule, such that in the event that a particular Liability of the Dividing Company is not specifically allocated by the Plan, post division such Liability is considered to be a Liability of all of the Division Companies on a joint and several basis.[19]

A Dividing Company could therefore fully pass along its obligations under a Facility to a Division Company and would no longer be liable under such Facility, unless the allocation constituted a fraudulent transfer. Due to the fact that liabilities of the Dividing Company are not automatically joint and several obligations of all of the Division Companies, a Lender in a default scenario might have to institute multiple enforcement actions against multiple entities that are each severally liable for a portion of the Liabilities in favor of the Lender. The LLC Act also provides that Liabilities allocated under the Plan will be enforceable against the Division Company to which they are allocated unless the Plan would constitute a fraudulent transfer under applicable law.[20] If a court of competent jurisdiction determines that the related allocation under a Plan constitutes a fraudulent transfer, a similar default rule provides that the Liabilities will be the joint and several obligations of, and enforceable against, all of the Division Companies.[21]

The collateral that is at the heart of a Facility could be impacted by a Divisive Merger. Because a Dividing Company can allocate its assets to new Division Companies, the portfolio investments, portfolio company equity and bank accounts that secure a NAV Facility could be allocated to a new entity through a Divisive Merger. Since the Amendments provide that assets subject to an allocation shall "not be deemed, as a result of the division, to have been assigned or transferred," general transfer restrictions in a NAV Facility credit agreement may not be violated by a Divisive Merger.[22] Similarly, if ownership interests are canceled or converted into cash or other property as the Amendments contemplate, the rights of a Lender in a NAV Facility to collateral consisting of equity interests in portfolio companies could also be fundamentally altered.

Divisive Mergers may also impact Subscription Facilities given the ability to broadly reallocate "rights," "powers" and "interests" of a Dividing Company, including the various contractual rights that a Fund has through its constituent documents and subscription agreements to call capital from investors and exercise remedies against investors.[23] Moreover, the Amendments also allow the "rights or securities of, or interests in" the Dividing Company to be canceled or "exchanged for or converted into cash, property, rights or securities of, or interests in" a Division Company or even in "any other business entity which is not a division company."[24] It appears that LLC interests of investors in a Dividing Company can therefore be reorganized through a Plan in such a way as to adversely affect Lenders. For example, a reallocation of the equity in a Fund to one or more Division Companies may also mean that the investor's obligations to make capital contributions in relation to their equity interests may be diminished or eliminated or do not carry over to the entities to whom the Liabilities under the Facility are allocated.

We note that, while the Amendments do not permit actions that would cause a fraudulent transfer and may limit the ability of a Plan to adversely affect Lenders, Lenders should nonetheless be concerned with the effect of asset allocations that can be effectuated as it is possible that such allocations may not rise to the level of a fraudulent transfer.

## Updates to Diligence/Liens

Another area in which Lenders could be negatively affected by a Divisive Merger would be with respect to the preservation of Liens. Here the Amendments do seem to have Lenders in mind as they provide that "all liens upon any property of the dividing company shall be preserved unimpaired," and all Liabilities of the Dividing Company "shall remain attached" to the Division Company to which such Liabilities have been allocated in the plan of division (the "Lien Clause").[25]

While the Amendments provide that a Lender's security interests will be unimpaired following a Divisive Merger, it does not appear that any revisions to the Delaware Uniform Commercial Code (the "UCC") were made in connection with the Amendments. Therefore, it remains to be seen how the Lien Clause and the UCC's provisions will work together in practice. In this regard, both existing security interests and the due diligence a Lender would perform for new transactions involving a Delaware LLC should be considered.

Properly conducted UCC searches should reveal the existence of prior liens against most types of collateral pledged by a Delaware LLC. However, if an entity has undergone a Divisive Merger or is newly formed as a result of a Divisive Merger, unless new UCC financing statements were filed in connection with a Divisive Merger, typical UCC searches would not reveal liens that continue pursuant to the Lien Clause. Therefore, Lenders conducting due diligence may need to inquire of the borrower whether any LLCs are Division Companies and also perform searches of any filings of a Division Company relating to a Fund that are on file with the State of Delaware ("Delaware Searches") as early as possible in the diligence process. Delaware Searches may reveal the filed Certificate in the event that a Fund was a Dividing Company or, if the Dividing Company did not survive, that it is a Division Company created from a Divisive Merger. We note that the wording of the Amendments suggests that the Certificate may not be filed by all Division Companies.[26] Accordingly, it is important for lenders to request a full certified history of a Delaware LLC's filings with the State of Delaware and not just a certified copy of a Delaware LLC's certificate of formation. A full certified history should include a copy of any Certificate that may be on file for any Division Company, however the certificate of formation may not necessarily include the Certificate. In each case, if an LLC is a Division Company, the Lender should obtain a copy of the Plan to understand the precise division of assets and liabilities relating to such potential obligor. As the Amendments only contemplate the Division Contact being required to provide a copy of the Plan to "any creditor of the dividing company,"[27] it is possible that the Division Contact may not be required to provide such information to a potential Lender. Therefore, it would also be prudent for prospective Lenders to require the potential obligor to make representations as to its status as a Division Company and provide a copy of the Plan that it should represent is the Plan filed with the Division Company (which Plan may be verified by the Division Contact once the Lender becomes a creditor).

A prudent lender will perform UCC searches against the Dividing Company and all Division Companies.[28] We note that, although it is unclear whether new UCC financing statements would need to be filed or current UCC financing statements would need to be amended to account for the changes made by a Plan, the UCC also provides that unless released, a filed financing statement will remain effective with respect to collateral that is "sold, exchanged, leased, licensed or otherwise disposed of," even if the secured party knows of or consents to the disposition. However, if the name of the debtor on a filed financing statement becomes inaccurate so that the financing statement becomes "seriously misleading," the financing statement will only be effective to perfect a security interest in collateral acquired by the new debtor before, or within four months after, the filed financing statement becomes seriously misleading.[29] This uncertainty means that to the extent an existing obligor for a Facility is a Division Company, it would be prudent to make appropriate amendments to UCC financing statements or file new UCC financing statements to clarify the collateral for a Loan.

## Updates to Credit Agreements and Loan Documents

The Amendments provide a safe harbor for written contracts in existence prior to the Amendments' effective date. If the applicable contract by its terms "restricts, conditions or prohibits the consummation of a merger or consolidation by the dividing company with or into another party, or the transfer of assets by the dividing company to another party," then such restrictions are also deemed to apply to a Divisive Merger.[30] While this safe harbor should provide protection for older Facilities, new Facilities going forward should be updated to account for Divisive Mergers. Lenders should review and consider the following provisions in Facility documentation taking effect following the Amendments:

### MERGERS/CHANGE OF CONTROL PROVISIONS/ASSET TRANSFERS

Divisive Mergers may affect a Lender's rights against an obligor as well as its rights in respect of collateral, the effect of which would be different than a typical merger, whereby the successor company succeeds to the liabilities of the companies being merged. However, most restrictions on changes of control and transfers of assets in Facilities relate to a traditional merger scenario, restricting only mergers or similar transactions where the original credit party is not the surviving entity. Such restrictions may not apply to transactions relating to a Divisive Merger, and the applicable events of default or mandatory prepayments might not be triggered. It is important for Lenders to review their forms and to incorporate tailored provisions to restrict Divisive Mergers. Restrictions on asset transfers and disposals and changes in control in new credit agreements will need to be updated to specifically reference transactions occurring by way of Divisive Mergers.

### NOTICE PROVISIONS/FURTHER ASSURANCES

Notice covenants should be updated to require prompt notice to Lenders in the event that a Divisive Merger is contemplated and provide for necessary Lender approvals (and/or the addition of new Division Companies as obligors) to prevent adverse effects upon a Lender. Further assurance provisions should also be updated to ensure that the Fund will allow the Lender to file any necessary financing statements to ensure that the Lender is kept in the same position from a security standpoint prior to any Divisive Merger. While not covering all of the suggestions above, the Loan Syndications and Trading Association has published model credit agreement language aimed at clarifying that assets, rights and liabilities passed to a different entity through a Divisive Merger shall be deemed to have been transferred.[31]

### MATERIAL AMENDMENTS

Facilities also often include provisions relating to material amendments to the constituent documents of a Fund and related entities that may be subject to review and consent of the requisite Lenders. Such material amendments might typically include amendments that affect the rights and duties of a Fund's investors in Subscription Facilities to make capital contributions and the valuation of a Fund's portfolio investments in NAV Facilities. The Amendments state that a plan of division may affect any amendment to the limited liability company agreement of the Dividing Company if it is a surviving company in the division.[32] Material amendment provisions in a credit agreement may (or may not), as drafted, also cover changes that would need to be effectuated post division to effectuate a Plan. It may also be prudent to specify in a Facility credit agreement that any changes to constituent documents relating to a Divisive Merger that could adversely affect Lenders shall be considered to be material amendments to the constituent documents of a Fund and would therefore require Lender review and approval. The Amendments also state that any amendment to a limited liability company agreement or adoption of a new limited liability company agreement for a Dividing Company shall be effective notwithstanding any provisions in the Dividing Company's operating agreement that restrict amendments of the operating agreement, unless such restriction specifically contemplates amendments in connection with a "division, merger or consolidation."[33] The Amendments, therefore, allow for the limited liability company agreements of Dividing Companies to disallow the consummation of a Divisive Merger. Lenders in Facilities conducting due diligence may, in the future, begin checking whether a Fund's organizational documents specifically state that the Fund may not engage in a Divisive Merger.

### JOINDER OF DIVISION COMPANIES

In addition, due to the fact that assets may be allocated to Division Companies that are not party to the security agreements in a Facility, in order to ensure that a Lender will have a security interest in any after-acquired assets of such a Division Company, Lenders should also consider whether to add covenants requiring that such Division Companies will become party to the security documents in a Facility if such Facility documents do not otherwise address this issue.

## Conclusion

While the ability to divide their assets and liabilities will provide welcome flexibility for Delaware LLCs that wish to restructure in the manner that is most efficient for them, this flexibility provides challenges for Lenders in Facilities. Lenders should ensure that credit agreements are updated to account for Divisive Mergers so that they are adequately protected. Additionally, while Delaware so far has limited this ability to divide to entities formed as limited liability companies, other states that allow Divisive Mergers, such as Texas, Arizona and Pennsylvania, have permitted a broader set of entity types to take advantage of this right.[34] The changes to the LLC Act should therefore be considered in light of the fact that similar changes may be instituted in the future for Delaware limited partnerships, which are even more commonly utilized by borrowers in Facilities than Delaware LLCs.

# Endnotes

1 See Texas Business Organizations Code §1.002(55)(A).

2 See 29 Ariz. Rev. Stat. §2601 et seq. and 15 Pa. Cons. Stat. Subchapter F.

3 See Delaware LLC Act §18–217(l)(8) and §18–217(o) (providing that an allocation of assets as part of a Divisive Merger will not be deemed a "transfer" and that a contract that a Delaware LLC is party to that restricts transfers of assets will only be deemed to apply to a Divisive Merger as if it was a transfer of assets if such contract was entered into prior to August 1, 2018).

4 See Delaware LLC Act §18–217.

5 Delaware LLC Act §18–217(g)(1)(b).

6 Delaware LLC Act §18–217(g).

7 *Id.*

8 *Id.*

9 Delaware LLC Act §18–217(l)(7).

10 Delaware LLC Act §18–217(h).

11 *Id.*

12 Delaware LLC Act §18–217(h)(4).

13 Delaware LLC Act §18–217(g)(3).

14 *Id.*

15 See Delaware LLC Act §18–217(c).

16 *Id.*

17 *Id.*

18 Delaware LLC Act §18–217(l)(4).

19 Delaware LLC Act §18–217(l)(6).

20 Delaware LLC Act §18-217(l)(4).

21 Delaware LLC Act §18-217(l)(5).

22 Delaware LLC Act §18-217(l)(8).

23 *Id.*

24 Delaware LLC Act §18-217(e).

25 Delaware LLC Act §18-217(l)(4).

26 Delaware LLC Act §18-217(h).

27 Delaware LLC Act §18–217(g)(3).

28 Delaware Uniform Commercial Code § 9-507(a).

29 Delaware Uniform Commercial Code § 9-506(c).

30 Delaware LLC Act §18-217(o).

31 See LSTA Publishes Divisions by Delaware LLCs Market Advisory (available at: https://www.lsta.org/news-and-resources/news/lsta-publishes-divisions-by-delaware-llcs-market-advisory).

32 Delaware LLC Act §18-217(f)(1).

33 Delaware LLC Act §18–217(f).

34 See Texas Business Organizations Code §1.002(55)(A); and 29 Ariz. Rev. Stat. §2601 et seq. and 15 Pa. Cons. Stat. Subchapter F.

# Model LPA Provisions for Subscription Credit Facilities

KIEL A. BOWEN AND CAITLIN E. WOOLFORD

The first step in determining if a subscription credit facility, often called a capital call facility (a "Subscription Facility"), is a viable option for a private equity or similar investment fund (a "Fund") is to diligence the limited partnership agreement or other organizational document of the Fund (the "LPA"). Subscription Facility lenders usually require that specific concepts and language be included in an LPA in order to provide a Subscription Facility without additional credit support, such as investor consent letters. Below, we provide model LPA Subscription Facility language, examine some of the most important LPA provisions that lenders may require and discuss certain obstacles that may arise depending on the language included in LPAs.

## Subscription Facility Provisions and Model Language

An ideal LPA from a Subscription Facility perspective will include the following:[1]

- Explicitly permit the incurrence of indebtedness by the Fund in connection with a Subscription Facility as a borrower and/or guarantor.
- Specifically contemplate a Subscription Facility and the related pledge of collateral and corresponding acknowledgments from the Fund's limited partners (the "Investors") of the Fund's pledge to a lender of the uncalled capital commitments to the Fund, the general partner's related right to call capital and the collateral account.
- Authorize the joint and several borrowings (or cross-collateralization) with alternative investment vehicles and parallel funds. This is key in order to provide one Subscription Facility to an entire Fund complex.
- Acknowledge that Investors will be obligated to fund their capital contributions into a collateral account of the Fund that will be pledged to the lenders as security under the Subscription Facility loan documents.
- Include an explicit agreement by the Investors to fund their capital contributions without setoff, counterclaim or defense, including certain defenses under bankruptcy. This is a key provision for lenders because their underwrite is primarily based on the creditworthiness of the Fund's Investors—and thus disputes between Investors and the general partner should not be a risk that is allocated to the Subscription Facility lender.
- Acknowledge that the lenders are relying on the capital contributions as their primary source of repayment. This language is important to lender analysis, as such language was referenced by one of the key court decisions that has examined Subscription Facilities.[2]
- Acknowledgement by the Investors that their capital contribution obligations are legal, valid, binding and enforceable.

- Acknowledgement by the Investors that they are obligated to fund their capital contributions into a collateral account of the Fund that will be pledged to the lenders as security under the Subscription Facility loan documents.
- Acknowledgement by the Investors that its investment is a commercial act and that any immunity the investor may have will not apply to the making of capital contributions.
- Subordinate any claim an Investor might have against the Fund to the lenders.
- Provide for an Investor's delivery of financial information, confirmation of uncalled capital commitments, an investor consent letter and, with respect to certain pension plan Investors, certain representations or confirmations relating to ERISA requirements.
- Specifically carve out any overcall limitations in the LPA relating to management fees, defaulting Investors or excused Investors with respect to the Subscription Facility. Note that such debt carve-outs should also be included in the overcall provision directly in order for the LPA not to internally conflict.
- Provide that any Investor transfer or withdrawal from the Fund may result in a capital contribution to repay obligations under the Subscription Facility.
- Establish that the lenders are third-party beneficiaries of the LPA, and if there is "no thirdparty beneficiary" language in the LPA, the lenders should be adequately carved out of such limitation.

Below is model language addressing each of these points:

> The Fund and General Partner shall be authorized to incur Indebtedness under such terms as they may elect, including, but not limited to, on a joint and several basis with Parallel Funds, Alternative Investment Vehicles and other affiliates of the Fund. In connection therewith, the Fund and General Partner shall be authorized to pledge, charge, mortgage, assign, transfer and grant security interests to a lender in (i) all Capital Commitments of the Partners, the General Partner's right to initiate Capital Calls and collect the Capital Contributions of the Limited Partners and to enforce their obligations to make Capital Contributions to the Fund; (ii) the Subscription Agreements and in the Partners' obligations to make Capital Contributions thereunder; and (iii) a Fund collateral account (the "Collateral Account") into which the payment by the Limited Partners of their uncalled Capital Commitments are to be made (any such financing, a "Subscription Facility").
>
> Each Limited Partner understands, acknowledges and agrees, in connection with any Subscription Facility, that (i) it shall remain absolutely and unconditionally obligated to fund Capital Contributions duly called by the General Partner or by the lender (as collateral assignee) under a Subscription Facility (including, without limitation, those required as a result of the failure of any other Limited Partner to advance funds with respect to a call for a Capital Contribution), without setoff, counterclaim or defense, including without limitation any defense of fraud or mistake, or any defense under any bankruptcy or insolvency law, including Section 365 of the Bankruptcy Code, subject in all cases to the Limited Partners' rights to assert such claims against the Fund in one or more separate actions; provided

that, any such claims shall be subordinate to all payments due to the lenders under a Subscription Facility; (ii) its Subscription Agreement and this Partnership Agreement constitute such Limited Partner's legal, valid and binding obligation, enforceable against such Limited Partner in accordance with their terms, subject to applicable bankruptcy, insolvency, reorganization, moratorium or other laws affecting creditors' rights generally and to general principles of equity; (iii) the lender under the Subscription Facility is extending credit to the Fund in reliance on such Limited Partner's funding of its Capital Contributions as such lender's primary source of repayment; (iv) so long as the Subscription Facility or obligations thereunder remain outstanding, all payments made by such Limited Partner pursuant to this Partnership Agreement or its Subscription Agreement shall be made to the Collateral Account, and any payments not made to the Collateral Account will not satisfy such Limited Partner's obligation to fund its Capital Commitment; (v) the making and performance of the obligations under the Partnership Agreement and the Subscription Agreement constitute private and commercial acts rather than governmental or public acts; (vi) neither it nor any of its properties or revenues has any right of immunity from suit, court jurisdiction, execution of a judgment or from any other legal process with respect to its obligations under the Partnership Agreement or the Subscription Agreement, including the obligation to make Capital Contributions; (vii) any termination, reduction or release of its Capital Commitment may require the consent of the lenders under and pursuant to a Subscription Facility; and (viii) all claims it may have against the Fund, the General Partner or any affiliate thereof shall be subordinate to all payments due to the lenders under a Subscription Facility.

Each Limited Partner hereby represents and warrants that (i) it has the power and requisite authority to execute, deliver and perform its respective obligations (including the Capital Contribution obligations) under this Partnership Agreement and its Subscription Agreement and (ii) its Subscription Agreement and this Partnership Agreement (including the Capital Contribution obligations) constitute such Partner's legal, valid and binding obligation, enforceable against such Partner in accordance with their terms, subject to applicable bankruptcy, insolvency, reorganization, moratorium or other laws affecting creditors' rights generally and to general principles of equity.

Each Limited Partner further agrees to deliver, if requested by the General Partner for provision to the third-party lender, (i) its most recent financials; (ii) a certificate confirming the remaining amount of its uncalled Capital Commitment; and (iii) an investor letter and/or authority documentation relating to its entry into its Subscription Agreement and this Partnership Agreement, and such other instruments as the General Partner or such lender may reasonably require in order to effect any such borrowings by the Fund or any of its Subsidiaries. In addition, in connection with any Subscription Facility, each ERISA Partner confirms that a fiduciary of such ERISA Partner has confirmed that (A) it made its own determination that such ERISA Partner's investment in the Fund and execution of this Partnership Agreement were made on terms that are no less favorable to such ERISA

Partner than those that could be obtained in arm's-length transactions with unrelated parties; (B) the decision to invest in the Fund and to execute and deliver this Partnership Agreement was made by such fiduciary; (C) such ERISA Partner (or commingled funds of related plans): (x) has no less than $100,000,000 of assets and (y) not more than five percent (5%) of the assets of such ERISA Partner (or commingled fund) have been invested in the Fund; and (D) no Subscription Facility lender (1) has had any influence, authority or control over such ERISA Partner's investment in the Fund or (2) has rendered investment advice with respect to such ERISA Partner's investment in the Fund.

Notwithstanding anything in this Partnership Agreement, its Subscription Agreement or any Side Letter to the contrary, each Limited Partner acknowledges and agrees that (i) any excuse right or other limitation with respect to any Capital Contribution (including the payment of any management fee) shall not be applicable with respect to any Capital Call the purpose of which is to repay amounts due under the Subscription Facility, regardless of whether the related Capital Call is issued by the General Partner or the lender (as collateral assignee) under the Subscription Facility; and (ii) in the event such Limited Partner is entitled to transfer its interest or withdraw from the Fund pursuant to any provision of this Partnership Agreement, its Subscription Agreement or its Side Letter, prior to the effectiveness of such transfer or withdrawal, as applicable, such Partner shall be obligated to fund such Capital Contributions as may be required under the terms of the Subscription Facility as a result of such transfer or withdrawal; provided, that in no event shall any amounts funded by such Limited Partner exceed its uncalled Capital Commitment.

Notwithstanding anything herein to the contrary, including Section [Insert Third Party Beneficiary Provision], each lender and other secured party under a Subscription Facility shall be an express and intended third-party beneficiary.

## Commitment Period and Key Person Events

In addition to the foregoing Subscription Facility provisions, lenders will examine the Fund's commitment period to determine whether capital calls for the purpose of repaying indebtedness (including principal, interest and fees) are explicitly authorized during the commitment period, any suspension (i.e., after a key person event) or after the termination of the commitment period. Many LPAs will explicitly address interest and fees through the definition of "Partnership Expenses" but will not explicitly address principal. Clarifying this ambiguity or otherwise providing that Subscription Facility indebtedness may be repaid following any suspension or termination of the commitment period will provide the most flexible terms under the Subscription Facility.

## Debt Limitations

Of course any limitations on the incurrence of indebtedness are scrutinized by lenders, including any limits on the amount of debt and/or guarantees that may be incurred and the amount of time debt may remain outstanding (commonly known as "clean-down" provisions). Many LPAs carve out Subscription Facility debt from their debt limitations, especially if the debt is short term, in order to give the Fund maximum flexibility in using the Subscription Facility to bridge asset purchases quickly and effectively.

## Remedies

Subscription Facility lenders will also look to see if the LPA provides adequate predefined remedies if an Investor fails to comply with the terms of the LPA, including failing to make capital contributions. Market remedies include, among other things, an ability to charge default interest, reduce the Investor's capital account and sell the Investor's interest in the Fund at a reduced price. Additionally, as noted above, it is key that the LPA explicitly provides that nondefaulting investors may be called on (up to their uncalled capital commitments) to make up any deficiency caused by a defaulting Investor.

Adequately addressing the foregoing concepts directly in the LPA will help a Fund obtain more competitive bids that provide the greatest amount of flexibility for its Subscription Facility needs and most likely avoid the need for investor consent letters.[3]

## Endnotes

1 While some of these provisions may not be necessary in order to authorize and/or structure a Subscription Facility, they provide Subscription Facility lenders desired clarity and comfort on key points. Accordingly, even though a Fund might be authorized to incur indebtedness and pledge assets generally via the broad authorizing terms of the LPA and/or by virtue of relevant governing law, adding specific Subscription Facility provisions will assist the Fund in obtaining the most advantageous structures and pricing.

2 See In re LJM2 Co.-Investment, L.P., 866 A.2d 762 (Del. Super. Ct. 2004).

3 Investor consent letters are typically required by the market for highly concentrated investor pools (including single-investor Subscription Facilities) even with ideal LPA provisions.

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