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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 noteworthy developments in the subscription credit facility and fund finance markets, including our views on the challenges and opportunities likely to be present over the course of the upcoming year. We also explore evolving approaches to borrowing base calculations, pre-funding rights associated with certain investors and select issues facing an administrative agent in the context of a syndicated credit facility. Finally, we examine the use of repurchase facilities as an alternative source of liquidity for private equity funds.

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Fund Finance Market Update

KIEL BOWEN AND ANN RICHARDSON KNOX

The first half of 2019 continues a long growth rally for the fund finance market, with fund finance deal volume at Mayer Brown significantly up from last year. This growth occurred despite a three-year decline in the number of final fund closings.[1] This apparent contradiction can be explained both by the penetration of traditional subscription credit facilities into a broader range of fund types and the diversification of fund finance product offerings in the market (including a notable uptick in the number of hybrid facility and net asset value credit facility closings).

This perspective has been reinforced by our own experience: in the first half of this year, Mayer Brown has advised clients on numerous subscription credit facilities for both new and established sponsors that have previously not utilized fund-level leverage. Mayer Brown has also served as lead counsel for an increasing number of alternative fund finance transactions as compared to the same time period last year. In addition to a significant increase in deal volume, it is clear to us that the market is embracing fund finance products outside of hybrid facilities and net asset value facilities, including co-invest and partner loan programs, management fee facilities, unencumbered asset facilities and registered fund credit facilities. These facilities, which were historically viewed by lenders as accommodations to larger fund sponsors, are now being marketed alongside traditional subscription credit facilities by many lenders. Additionally, as we note below, collateralized fund obligations ("CFOs") have also reemerged in a meaningful way from levels not seen since the 2008 recession.

In this article, we explore a number of new and developing trends that we expect to shape the fund finance market moving forward, including recent fundraising activity, the effects of broader economic and political factors impacting fund finance deal terms, certain drivers behind product diversification, investor structuring needs and certain other legal developments impacting the fund finance industry.

Fundraising

Since our *Spring 2019 Fund Finance Market Review*, fundraising activity continues to reflect a trend towards fewer fund final closings with larger funds.[2] With investor demand strong through Q2 2019, the largest funds and sponsors continue to capture an outsized amount of investors' attention and equity commitments, even though the number of funds entering the fundraising market continues to rise.[3]

The most active fundraising markets continue to be North America and Asia, with fewer funds focused on Europe. Preqin's investor polling indicates that while investors remain bullish on the North American and Asian markets, the percentage of investors polled that are looking to invest in European-focused funds in the next 12 months has dropped to 49 percent of all investors (as compared to 61 percent of investors in the market in Q2 2018), demonstrating lesser willingness to invest in Europe. We expect Europe's lag is likely a result of the uncertainty around Brexit and signs of a slowing European economy.

In addition to the jurisdictional focus discussed above, fundraising has likely been slowed by the sheer amount of dry powder remaining to be deployed for private equity and private debt. Dry powder has continued to climb the first half of this year, with Preqin reporting September levels relatively high with overall dry powder at just over $2,400 bn versus $2,300 bn in December 2018; and with overall dry powder at high levels as compared to prior years.[4]

Geo-Political and Economic Forces

The current geo-political and economic environment is murky with the ongoing US-China trade war, political unrest in Hong Kong, and broader signs pointing to a slowing global economy. While these factors will likely continue to impact the global economy, we believe that interest rate cuts and Brexit may have a disproportional impact on the fund finance market.

INTEREST RATE CUTS

While the recent Federal Reserve interest rate cut was widely expected and already priced into the broader market, many believe that more cuts will follow this year, especially if the trade wars continue. If cuts succeed in accelerating economic growth and stimulating the broader economy, investors will likely continue their search for higher yields and allocate more capital into alternative assets, including private equity. Accordingly, the fundraising environment (and resulting subscription credit facility market, which largely tracks the fundraising market) is anticipated to remain robust.

On the other hand, while a market disruption would likely slow fundraising, it would also provide a ripe opportunity for funds to capitalize on a down economy and put their stockpile of dry powder to work. As funds convert uncalled capital to invested capital, we expect even greater demand for fund financings keyed off the investments and asset value (as opposed to uncalled capital), including net asset value and hybrid financings. Thus, while it is difficult to predict whether economic unrest will occur in the short-term, we think the fund finance market as a whole is well-positioned to capitalize on both market stability and market disruption.

BREXIT

As Boris Johnson settles into his new role as prime minister and the rhetoric surrounding a "No-Deal" Brexit becomes more plausible in light of the UK government's recent move to prorogue parliament, it is likely that the UK and European markets will react accordingly. While it is entirely possible that Brexit will lead to increased investment opportunities for some funds (dependent on their jurisdictional scope and asset focus), the disruption and uncertainties surrounding the eventual outcome of any Brexit process will make fund sponsors naturally cautious about investing in the current environment (and thereby potentially suppressing deal activity in the short term). Moreover, if a "No-Deal" Brexit occurs, it could be a catalyst for a wider recession in the fund finance market, especially in Europe, and could affect European-based lenders operating in markets outside of Europe (such as the United States and Asia). The Loan Market Association has also recently noted the publication of UK legislation in order to incorporate EU law in the event of such a "No-Deal" situation (where the United Kingdom leaves without a transition period), and has noted that it is not yet planning on making changes to English law documents prior to proposed changes in English law. As a result, the global legal market is not currently anticipating that there will be a significant move away from the use of English law documentation post-Brexit (in circumstances where it would have been a choice of the parties pre-Brexit).

Fund Finance Outlook

No matter whether geo-political and economic forces ultimately serve to quiet the market or expand opportunities in fund finance, we think it is clear that any significant market disruptions will result in tightened deal terms. With that said, we expect two opposing trends to continue so long as a significant market disruption does not occur. The first is more flexible and borrower-friendly business terms as a result of the increased competition in the US and European markets by lenders (as established lenders are increasing allocations to the fund finance industry and new lenders are entering the space). The second is tighter legal structures as lenders both prepare for the possibility of a recession and also adjust their programs to account for the alleged facts and circumstances surrounding the Abraaj Group.[5]

FLEXIBLE AND BORROWER-FRIENDLY BUSINESS TERMS

Subscription credit facility deal terms have started to diversify away from the status quo. Thus far, the diversification has centered on borrowing base availability (and less on pricing or other structural elements). Many lenders that were traditionally tied to a single method of underwriting a borrowing base are offering a wider variety of credit facility structures to better suit a particular fund's borrowing needs and/or investor pool. For instance, certain lenders are offering a variety of subscription facility structures (flat advance rate, coverage ratio, designated investor structures), and/or simply being able to increase the overall effective advance rate within their traditional model (often accomplished by stretching advance rates, including hurdle investors, relaxing borrowing base designations, or adjusting concentration limits).

(For more on such borrowing base structures, see our Legal Update Comparison of Borrowing Base Structures on page 8.)

Additionally, although other key deal terms have remained relatively constant, the uniformity on pricing and tenor are starting to wane. This year, some European market participants have emerged with lower pricing, resulting in enhanced competition in that market. We have not yet seen this trend spread to the US market and expect the US market to resist aggressive downward pressure on pricing (particularly for longer tenor transactions). While every fund will approach this issue differently, if market uncertainty grows, we expect more funds may request facilities with longer committed tenors which will likely stabilize short-term pricing.

TIGHTER LEGAL STRUCTURES

While the insolvency proceedings relating to Abraaj continue to progress, lenders have not had any knee-jerk reactions but are taking a closer look at their documentation and legal structures. Despite aggressively competing on business terms, some lenders have sought to tighten certain aspects of their facilities in light of the Abraaj fact pattern, including the following:

- Increasing scrutiny on investor notice delivery in jurisdictions where notices are commonly delivered in connection with security arrangements (e.g., Cayman, England, Luxembourg, etc.). While borrowers often negotiated the delivery of such notices post-closing or in the course of the next regular communication with investors, most lenders have now instituted portfolio-wide requirements with little-to-no flexibility regarding timing of such notices;
- Enhancing and expanding covenants and events of default that have traditionally applied to the fund's investment manager to the actual sponsor and any other investment manager controlled by the sponsor. These aim to address the fact that sponsors often now have "fund specific" investment managers, and though legally separate, investor confidence in the sponsor is tied to the platform and not a specific legal entity;
- Including termination events and events of default to the extent investors allege fraud, embezzlement or misappropriation of funds, or if sponsors, managers or related entities are convicted of such acts or subject to investigation by governmental officials;
- Including borrowing base exclusion events for investors alleging fraud, embezzlement or misappropriation of funds, including if

such investor makes such allegations with respect to another fund managed by the same sponsor;

- Increasing scrutiny of requests to delay the required delivery of financial statements or to deliver non-GAAP or non-audited financials;
- Shortening grace periods on events of default relating to involuntary insolvency; and
- Enhancing emphasis on affiliate transaction covenants, including prohibitions on non-arm's-length transactions, even where otherwise permitted pursuant to a fund's organizational documents.

Additionally, as more lenders form dedicated fund finance teams that are better educated on the nuances of the risks associated with these products, we have seen a greater emphasis on legal structure and investor pool diligence in general.

Additional Considerations and Legal Updates

In addition to the above trends, we think the following developments will help shape the fund finance market outlook in the coming year.

INSTITUTIONAL LIMITED PARTNER ASSOCIATION ("ILPA") – PRINCIPLES 3.0

The recent publication of "Principles 3.0" has continued ILPA's focus on general requirements for disclosure and transparency to investors of fund-level debt usage, unlevered internal rates of return and cost associated with leverage, rather than requiring hard-and-fast rules applicable to all funds. While investors have requested more standardized reporting and performance calculations from sponsors and ILPA has recommended disclosure of levered and unlevered internal rates of returns, they have not yet recommended standardized disclosure and reporting formats. While the Principles 3.0 do mention certain thresholds for use of subscription credit facilities, such as clean down requirements and general guidelines regarding debt in excess of 20 percent of uncalled capital, it appears that the guidance also recognizes that appropriate use of debt can vary based on the strategic focus of a fund, investor appetite and geography (and therefore a "one-size-fits-all" strategy is not necessarily appropriate).

As facilities may differ in tenor and scope based on the strategy of the fund, ILPA also recognized the need for investor disclosure and engagement and potential limited partner advisory committee approvals in connection with more levered strategies. Principles 3.0 included a recommendation to permit investors to opt out of leverage, which could in the future lead to increased bifurcation of investors through use of parallel funds.

(For more information on this trend and issues related thereto, see page 15.)

INSURANCE INVESTOR STRUCTURES

Insurance company investors are driving significant innovation in the fund finance market. Among other things, the market for CFOs is returning to levels not seen since pre-crisis. Such CFOs borrow securitization techniques popularized in the context of collateralized debt obligations and apply them to portfolios of hedge fund and private equity fund investments. Because regulators currently treat CFOs similar to bonds, rather than equity investments, insurance company investors can take advantage of such technology by exchanging their equity stakes in private equity fund portfolios for such obligations, which permit them to maintain similar exposure to such investments with the benefit of not having to hold as much capital against the investments.

In addition to the use of CFOs to reduce capital requirements in connection with existing portfolios, insurance company investors are increasingly exploring using alternative structures for new investments in private equity in order to reduce their capital requirements. In addition to the creation of particular investment products geared towards insurance company investors (including use of products that mimic the structures of secondary facilities), we have also seen a notable uptick in the use of leveraged feeders to minimize risk-based capital charges. Under this structure, the feeder can fund its capital calls to the main fund in whole or in part through a draw on a facility provided by the feeder's investors (who act as lenders). While the feeder investors still have an equity commitment obligation to the feeder, if the feeder receives proceeds from a draw under the facility, it will satisfy such investor's obligation to otherwise make an equity contribution to the feeder. Lenders have had mixed reactions to including such investors in subscription facility borrowing bases in light of complexity and potential interaction of such feeder leverage with a subscription credit facility, as well as concerns with competing lender claims at the feeder level. We also understand that risk-based capital requirements are also currently under review by insurance regulators.

OTHER LEGAL AND REGULATORY UPDATES

Since our spring market review, certain legal and regulatory developments have rippled through the market—namely the QFC Stay Rules (with respect to facilities that secure derivatives), widespread adoption of the beneficial ownership provisions, a change in the Delaware law which permits limited partnerships to divide (mimicking the earlier change to the Delaware limited liability company framework which also permitted divisions, which was explored in our *Spring 2019 Legal Update*[6]), and the Alternative Reference Rate Committee publication of suggested guidance on LIBOR replacement, which has already been adopted by some market participants.[7] While none of these changes have disrupted the market, they have resulted in some new negotiations and longer amend-and-extend amendment documents than what most market participants are accustomed to reviewing.

Conclusion

For more information about the topics raised in this article, please contact any of the following lawyers and subscribe to our fund finance mailing list by contacting Dena Kotsores at dkotsores@mayerbrown.com.

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Endnotes

1 *Preqin Quarterly Update: Private Equity & Venture Capital Q2 2019* ("Preqin"), p. 5.

2 *Preqin*, p. 5.

3 *Preqin*, p. 6.

4 *Preqin Dry Powder Report*, Sept. 2019.

5 Abraaj was a large investment manager based in the Middle East that has been accused of fraud and misappropriation of funds. The holding company is currently in insolvency proceedings in the Cayman Islands.

6 https://www.mayerbrown.com/en/perspectives-events/publications/2019/03/divisive-mergers-and-impact-on-fund-financings.

7 For more on LIBOR Replacement, please see https://www.mayerbrown.com/en/perspectives-events/publications/2019/06/the-arrcs-final-fallback-language-recommendations-for-new-libor-syndicated-loans.

Subscription Credit Facilities: A Comparison of Borrowing Base Structures

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Subscription credit facilities, which are lines of credit in favor of private equity and similar investment funds primarily secured by the capital commitments of the fund's investors, are most commonly structured using a borrowing base structure similar to other types of asset-backed loans. Many factors will dictate the best borrowing structure for a fund, the most important of which are the make-up of the fund's investor pool and where the fund is in its life cycle (raising capital, harvesting investments, etc.).

Historically, each market lender has been tied to a single borrowing base philosophy that keyed squarely into its unique credit and underwriting requirements. As industry competition has continued to grow, banks have realized that a one-size-fits-all approach may not be the best long-term approach in the market. Accordingly, many lenders have adjusted their credit and underwriting policies to permit more flexibility in structuring borrowing bases to better fit a particular fund's investor pool. Sometimes this has been accomplished by adjusting the borrowing base inclusion criteria, advance rates or concentration limits, while other times, it is accomplished by taking a completely different approach to structuring the borrowing bases.

Prior to discussing the differences between the various borrowing base structures, it is helpful to first outline the common tenants of the various borrowing base structures:

- **Calculation of the Borrowing Base:** A subscription credit facility borrowing base is usually calculated by taking (x) uncalled capital of each Eligible Investor *multiplied by* (y) the Advance Rate with respect to such Eligible Investor and (z) subtracting any haircuts related to Concentration Limits and/or Borrowing Base Deductions.
- **Eligible Investors:** The uncalled capital commitments of some investors will be included in the calculation of the borrowing base ("Eligible Investors") and the uncalled capital commitments of other Investors will not be ("Excluded Investors"). Determining which investors will and will not be included varies greatly in the different market approaches to structuring a borrowing base. Typically, both an investor's creditworthiness and its investor documentation (e.g., the existence of a problematic side letter provision) will be the key factors in determining if an investor will be included or excluded from the borrowing base. As described below, some borrowing base approaches

use bright-line categories of Eligible Investors, meaning the inclusion process, approval rights, and requirements for these categories are explicitly set forth in the loan documentation, while other approaches employ more relaxed standards. It is important to note, that even though Excluded Investors do not contribute to the calculation of the Borrowing Base, their uncalled capital is collateral and, similar to other asset-backed lending structures, provides the lender with "over-collateralization."

- **Exclusion Events:** Upon the occurrence of certain negative events, Eligible Investors will automatically be excluded from the borrowing base and become Excluded Investors. Standard exclusion events include, among others: (a) an investor elects to stop funding its commitment or such investor repudiates or challenges the enforceability of its commitment; (b) an investor fails to fund its capital contribution when due; (c) an investor defaults in any representation or warranty made in any fund document; (d) rated investors fail to satisfy the applicable requirement (or any other inclusion standard) or unrated investors have a significant drop in net worth; (e) an investor transfers its interest or otherwise ceases to be an investor or requests a withdrawal from the fund; and (f) bankruptcy of an investor.
- **Advance Rates:** This is the percentage of uncalled capital commitments of each Eligible Investor that will be used in the calculation of the borrowing base. It is typically less than 100% to provide additional over-collateralization.
- **Concentration Limits:** In order to provide greater risk diversification, concentration limits are often included in subscription credit facilities. Concentration limits are restrictions on how much borrowing base credit will be given to any particular investor's uncalled capital commitments—often calculated as a percentage of an individual investor's uncalled capital commitment against the total amount of all uncalled capital commitments or all Eligible Investor uncalled capital commitments. Additionally, aggregate investor class concentration limits might be included. Like Excluded Investors and Advance Rates, Concentration Limits provide over-collateralization.
- **Borrowing Base Deductions:** Some lenders may also include deductions from the borrowing base that limit the amount available under the facility. For instance, recourse debt outside of the facility is commonly deducted from the borrowing base on a dollar-for-dollar basis. This concept is premised on the lender's understanding that all debt (and not just their borrowings) should be covered by the borrowing base.

With the above background, there are three standard borrowing base approaches common in the US subscription facility market: (1) a borrowing base of only highly-rated included investors with a high advance rate (the "Included Investor Model" or "II Model"); (2) a two-tier approach, which provides for both highly-rated included investors with a high advance rate and a designated investor class, where the latter has a lower advance rate (the "Included/Designated Model" or the "II/DI Model");

and (3) a flat advance rate across all (or most) investors (the "Flat Advance Rate Model"), which may also be structured as a coverage ratio (the "Coverage Ratio Model").

Below we explore these traditional structures and then discuss how these structures are evolving to address increased competition and the particular needs of fund borrowers.

A. Included Investor Model

In the traditional Included Investor Model, only highly-rated investors that meet a pre-defined set of criteria (e.g., a minimum credit rating (typically set at BBB+) and, with respect to pensions, a minimum "funding ratio" (often 90%) or, in some cases, minimum assets (typically $1 billion)) will be designated Eligible Investors ("Rated Included Investors"). For these investors, typically the only approval right is in favor of the administrative agent (and not any facility lenders). Other non-rated investors that, in the determination of all lenders, would be rated investment-grade if they had a rating ("Non-Rated Included Investors") will also usually be Eligible Investors in an II Model.

The Advance Rate for all Eligible Investors in an II Model is typically set between 80% and 100%[1] and Concentration Limits have historically been determined by a static grid ranging from 5-15%, in each case dependent on the Eligible Investor's rating or classification as a Non-Rated Included Investor. Non-Rated Included Investors (and sometimes lower-rated Rated Included Investors) are usually also subject to an aggregate Concentration Limit.

Since the borrowing base only includes uncalled capital commitments of investment-grade investors, lenders typically offer favorable pricing and looser terms compared to other borrowing base structures. Funds that use the II Model usually have a diversified class of highly rated investors and use subscription facilities mostly for bridging purposes—and not long-term leverage. These funds typically don't require high overall effective advance rates against the entire investor pool because they regularly repay borrowings and prefer the less expensive pricing and looser terms that the II Model provides.

B. Included/Designated Model

The Included/Designated Model builds off the II Model's technology. In addition to classifying Rated Included Investors and Non-Rated Included Investors (collectively referred to as "Included Investors") as Eligible Investors, the II/DI model includes a third category of investor that the lenders have determined is less creditworthy than the Included Investors, but still maintains sufficient creditworthiness to include in the borrowing base (these investors are commonly referred to as "Designated Investors"). The inclusion of any Designated Investors typically requires all lender consent and has historically required some evidence of credit-worthiness or credit support, such as publicly available financial information or evidence of a strong relationship with a creditworthy parent.

Advance Rates and Concentration Limits with respect to Included Investors usually mirror the Advance Rates and Concentration Limits typically used in the II Model. The Advance Rate for Designated Investors is typically set at either 60% or 65%. Additionally, Designated Investors are usually subject to both individual and aggregate Concentration Limits. We often see a 5% individual Concentration Limit and an aggregate Concentration Limit of 35% with respect to Designated Investors.

The II/DI approach is currently the most commonly used in the syndicated market. This approach is often used by funds that need larger credit facilities with a borrowing base than a traditional II Model or Flat Advance Rate Model approach would be unlikely to support over the life of the fund, and usually offers the highest overall effective advance rate. To account for the fact that lower-rated investors are included in the borrowing base, pricing may be higher than facilities employing the II Model and these facilities may be tighter on other terms and reporting requirements than the other models.

C. Flat Advance Rate Model and Coverage Ratio Model

Unlike the other two approaches that have highly structured inclusion criteria, the presumption in a Flat Advance Rate Model is that all investors will be included in the borrowing base unless something is problematic about an investor or type of investor (for example, high net worth investors or investors that are affiliated with the fund are often not included in a Flat Advance Rate borrowing base). Accordingly, Flat Advance Rate Model transactions typically include all or almost all investors in the borrowing base at a single "flat" advance rate. The advance rate may vary widely based on the composition of the investor base but typically range from 50-65% (however, we have seen advance rates range from 20-90% depending on the fund and the makeup of the investor pool). Usually, Flat Advance Rate Models do not include concentration limits. Flat Advance Rate transactions are most often bilateral or club deals.

A Flat Advance Rate borrowing base can be structured as a coverage ratio covenant in the loan documents. This requires that the uncalled capital commitments of the investors shall, at all times, cover the amount of outstanding loans under the credit facility at an agreed upon ratio. The Coverage Ratio Model is currently more common in Europe but is also seen in US bilateral deals done as accommodations for sponsors. These Coverage Ratio Model deals will include Borrowing Base Deductions for other indebtedness of the fund (including guaranties of portfolio companies) and equity commitments the fund has made to its portfolio companies or third parties.

Both the Flat Advance Rate Model and Coverage Ratio Model are used in a wide variety of circumstances, including: (1) where a fund does not desire or need a large facility amount and prefers lighter legal documentation and relaxed reporting requirements, (2) when a lender is advancing a small facility as an accommodation to the sponsor (to curry favor with the sponsor), (3) in uncommitted and on-demand credit facilities (where the bank takes comfort in the fact that a decline in the credit quality of the overall investor pool can be rectified by calling the facility or refusing to fund), (4) where the investor pool would not support a borrowing base under the II Model or the II/DI Model, and (5) where the fund's investor pool is highly concentrated, such that traditional concentration limits would be problematic. Depending on the circumstance, the pricing of these facilities varies greatly, but they are often priced similar to or higher than facilities using the II/DI Model.

While the foregoing approaches have been historically rather inflexible—forcing funds to pick one approach—lenders are now blending the aspects of the different approaches and employing tailored variations. While this trend is noticeable (and likely the result of increased competition), in our experience, lenders are altering their approach judiciously and carefully evaluating and structuring around the risks. Listed below are some of the more common variations currently being utilized:

- **Concentration Limit Holidays** – A common accommodation used in connection with the II/DI Model is to not apply any Concentration Limit to the Rated Included Investors in the borrowing base until the earlier of (x) one year after the credit facility closing date and (y) the fund's final closing date. While the Concentration Limits with respect to Non-Rated Included Investors and Designated Investors typically still apply, this variation gives funds flexibility during the early stages of fundraising and when their investor base might be highly concentrated. Lenders cite comfort in the fact that this approach is used at the beginning of the fund's lifecycle before any possible unexpected negative investment performance is likely to surface which may impact investor confidence in the fund.
- **Concentration Limit Waivers** – Similarly lenders are now selectively waiving concentration limits if investors deliver investor letters in favor of the lender. Since these investor letters provide direct contractual privity and reinforce the key aspects of the facility, lenders are more willing to take a greater concentration risk on an investor.
- **Relaxed Concentration Limits** – Although the concentration grids employed in the II Model and the II/DI Model have historically been static and non-negotiable, lenders have slowly started to relax concentration limits—especially in bi-lateral deals with strong borrowing bases. This allows funds to receive an advance rate against greater percentages of the uncalled capital commitments, even with less diversification in the investor pool.
- **Hurdle Investors** – The accommodation that has perhaps gained the most traction in the market is the designation of "hurdle" investors. This approach is often used where investors either have legal or side letter issues (e.g., sovereign immunity concerns, placement agent issues) or other concerns regarding their ability to honor capital contributions to a lender (e.g., insufficient financial information available

to validate the investor's creditworthiness). These investors will initially be excluded from the borrowing base, and after satisfying certain conditions, will "hurdle" into the borrowing base as a Designated Investor. While such "hurdle" designation is always linked to the applicable Investor having funded a certain percentage (often 40%) of its total capital commitment, some lenders are also requiring the fund to maintain a pre-negotiated minimum net asset value. Oftentimes, these "Hurdle Investors" will toggle back and forth between Designated Investor and Excluded Investor status, depending on whether the conditions remain satisfied (i.e., if net asset value declines below the negotiated minimum or if funded capital drops below the threshold as a result of returned capital). The market has generally accepted the use of Hurdle Investors because once the hurdles are satisfied, the investor has "skin-in-the-game" (reflective of the funding requirement), which is subject to loss if the investor fails to make capital contributions when required[2] and, accordingly, the investor has an incentive to maintain its investment since the fund is performing (reflective of the net asset value prong).

- **Hurdle Advance Rates and Hurdle Concentration Limits** – With the market increasingly comfortable with Hurdle Investors, some lenders have started to employ the hurdle technology to Advance Rates and Concentration Limits. Instead of investors "hurdling" from Excluded Investor status to Designated Investor status, under this approach, a pre-defined select group of high-quality investors will "hurdle" into higher Advance Rates and/or relaxed Concentration Limits when the hurdle conditions are satisfied. Like Hurdle Investors, Hurdle Advance Rates and Hurdle Concentration Limits typically toggle to account for net asset value and the amount of capital funded. This approach is seen most regularly as being applied to high net worth investors and other investors that are not investment grade.
- **After-Care Flat Advance Rates** – Many lenders and funds convert transactions formerly based on the II/DI Model to a Flat Advance Rate Model after the investment period has expired (such facilities, "Aftercare Facilities"). While these credit facilities are usually smaller than more traditional subscription facilities, they often have a high Flat Advance Rates (up to 80-100%). Lenders often include additional net asset value covenants and may take a pledge of the other assets of the fund to secure the obligations (thereby converting the subscription facility to a hybrid facility—at least from a collateral perspective). Similar to the analysis underpinning the hurdle concepts explored above, lenders take comfort in the fact that investors have "skin-in-the-game" and the fund is performing.
- **Relaxing Designated Investor Criteria** – As noted above, unlike in Flat Advance Rate Model deals, the default classification in the other models is Excluded Investor. The II/DI Model has historically required that lenders have strong visibility into the creditworthiness of potential Designated Investors and that the lender determine that there is creditworthy value in the uncalled capital commitment of such potential Designated Investors. While

that presumption remains true, many lenders have recently relaxed their criteria on classifying Designated Investors—oftentimes requiring less insight into the investor's financial standing and/or less concrete linkage to a high-quality parent.

- **Short-Term Bridge Facilities** – Instead of entering into a long-term facility in connection with their initial closing, some funds are now entering into short-term bridge facilities during their fundraising period. Such short-term facilities are often structured on an uncommitted/on-demand basis using the Flat Advance Rate Model or a bilateral deal with relaxed concentration limits that could be difficult to support in a subsequent syndication. This approach allows the fund to determine which borrowing base approach will work best for their ultimate pool of investors once fundraising has been completed. The risk of this tactic is that the fund might not be able to lock down favorable pricing or other terms if the market turns for the worse and will likely have to negotiate two separate facilities.
- **Multiple Borrowing Bases** – One of the more creative approaches being used is including multiple borrowing base models into the loan documentation. Under this approach, the fund has a one-time option to switch to an alternative borrowing base approach within a short window following the final investor closing (e.g., starting with a II Model and switching to a II/DI Model). For the fund, this foregoes the expense of negotiating two credit facilities and locks down pricing (even if that pricing toggles upon any conversion of the borrowing base approach) and other terms. For the lender, this approach offers a competitive advantage against other lenders that may not be able to provide such flexibility.
- **Syndicated Flat Advance Rates** – Many funds prefer the simplicity of the Flat Advance Rate Model due to the relatively lax reporting requirements and inclusion criteria associated therewith. While Flat Advance Rate deals have not been historically used for large syndicated facilities in the US, recently lenders have been more open to use a Flat Advance Rate Model with top-tier sponsors. Unlike traditional Flat Advance Rate deals, however, other parts of these transaction remain highly structured.

Unlike pricing and tenor—where the market has been relatively uniform—there has been significant creativity in structuring borrowing base approaches in the subscription credit facility market recently. We expect this trend to continue as more lenders change their longstanding credit and underwriting policies to allow more tailored solutions to a wider range of investor pools.

Endnotes

1. In most syndicated facilities, a flat 90% Advance Rate is typically applied to all Eligible Investors in light of many credit policies prohibiting a 100% advance rate to any investor.
2. Organizational documents of funds typically include a contractual remedy to reduce an investor's capital account and/or sell an investor's interest in the fund at a steep discount if an investor fails to honor its capital commitment or otherwise defaults with respect to its contractual obligations.

Investor Pre-Funding Rights in Subscription Credit Facilities

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I. Introduction

As the market for subscription-backed credit facilities, also known as "capital call" or "capital commitment" facilities ("Subscription Facilities"), continues to mature, we have seen co-mingled private investment funds (each, a "Fund") seek higher advance rates and inclusion of a wider pool of investors in the borrowing base.[1] As such, banks and other credit institutions (each, a "Lender") extending credit to a Fund under a Subscription Facility must carefully determine the eligibility criteria regulating which uncalled capital commitments of investors in the Fund will be included (or excluded) from the borrowing base. One increasingly negotiated point in recent Subscription Facilities is whether to include in the borrowing base the unfunded commitments of investors that have the right to pre-fund their allocable share of borrowings. This article provides an overview of the nature of such borrowing pre-funding rights, the reasons why investors request such rights and some of the ways in which Lenders and Funds have addressed such rights in Subscription Facilities.

II. Borrowing Pre-Funding Rights, Generally

An investor's right to "pre-fund" its capital contribution (such investor, a "Pre-Funding Investor") is typically set forth in an investor's side letter, but may also appear in the Fund's partnership or other operating agreement. Generally, a pre-funding right provides the investor with the option to fund its pro rata capital contribution to the Fund at a point in time (e.g., at the time of or within a short period following the incurrence of debt by the Fund), before a capital call notice is generally delivered to the investors to repay a debt obligation of the Fund.[2]

An investor's pre-funding right is often limited to circumstances in which the Fund intends to borrow money. In such circumstances, the Fund's general partner will typically agree to provide an investor with timely notice of the Fund's intention to borrow, and allow such investor the opportunity to pre-fund its allocable share of any such borrowing. The investor may have the right to elect to pre-fund (or not pre-fund) a capital contribution on a loan-by-loan basis.[3] Alternatively, the general partner may have the right to elect to treat an investor as a Pre-Funding Investor and call capital from such investor in lieu of borrowings being made on behalf of such investor (though other formulations are also seen). The Fund may expressly acknowledge in the partnership agreement or side letter that the amounts pre-funded by such investor will be treated as a capital contribution made by such investor as of a specified date. The general partner may also have broad authority to make adjustments to the provisions of the partnership agreement to accommodate the pre-funding of capital contributions.

III. Purpose of Pre-Funding Rights

There are a number of reasons why investors may seek, and sponsors may agree to, a pre-funding right.

One reason is to avoid potential adverse tax consequences. Tax exempt investors, sensitive to unrelated business taxable income ("UBTI"), may seek such provisions to avoid recognizing unrelated debt-financed income ("DFI"), which is treated as UBTI for federal income tax purposes. Specifically, a portion of such investors' gross income derived from or on account of "debt-financed property" is treated as gross income from an unrelated trade or business, which, after certain deductions, is taxable to such investors in the same manner as UBTI.[4]

Investors in limited partnerships generally recognize their share of the limited partnership's income and deductions,[5] and the tax character of such income and deductions is determined as if such income or deductions were realized by the investor directly.[6] Absent certain exceptions, debt incurred by a Fund could cause its investments to be debt-financed property for UBTI-sensitive tax exempt investors.[7] Accordingly, if a tax exempt investor's share of partnership income is derived from debt-financed property, then a portion of such income may be DFI.[8] Pre-funding or opt-out rights are intended to prevent the allocation of Fund-level debt to the applicable tax exempt investor so as to prevent recognition of DFI.

Another reason for pre-funding or opt-out rights is that some investors, such as certain governmental entities or endowment plans, may have provisions set forth in their constituent documents, side letters or investment policies that restrict or prohibit the use of their capital commitments as credit support to secure the debt obligations of the Fund. We have also seen a variation on such a restriction in side letters specifying that an investor is not obligated to honor a capital call made by a Lender (which typically results in outright exclusion from the borrowing base in our experience).

In addition to addressing tax, regulatory and policy considerations, Pre-Funding Investors may also receive economic benefit on account of pre-funding contributions. To the extent an investor pre-funds a capital contribution in lieu of a borrowing and the Fund agrees to treat such contribution as being made prior to the time the capital contributions of the other investors are required, there is a benefit to such Pre-Funding Investor with respect to calculating the preferred return.[9] The investor also may be spared what would otherwise be its pro rata share of the cost of borrowing. As such, any adjustment made to accommodate a Pre-Funding Investor will be highly negotiated between such Pre-Funding Investor and the Fund, although it is also not uncommon for a Pre-Funding Investor to be treated the same way as the non-Pre-Funding Investor for purposes of preferred return calculations and distributions. Additionally, under the Fund's partnership agreement or the applicable side letter, a Pre-Funding Investor usually does not bear any share of the cost or expense incurred by the Fund in connection with a borrowing with respect to which it pre-funded.

IV. Addressing Borrowing Pre-Funding Rights in Subscription Facilities

There are a number of ways Pre-Funding Investors may be addressed in the borrowing base of a Subscription Credit Facility. Historically, Lenders often excluded the capital commitment of Pre-Funding Investors from the calculation of the borrowing base altogether. More recently, we have seen a trend towards Lenders giving borrowing base credit to the capital commitment of Pre-Funding Investors subject to certain parameters.

One approach is to include the Pre-Funding Investor in the borrowing base until such time as it funds its allocable share of the applicable loan within the time period agreed upon in the Fund's partnership agreement or such investor's side letter (as applicable), and require a dollar-for-dollar repayment of the borrowings under the Subscription Facility to which the pre-funding election relates as the Pre-Funding Investors capital contributions are received (regardless of whether a mandatory prepayment would otherwise be triggered under the Subscription Facility).[10] This prepayment mechanism addresses the fact that the Pre-Funding Investor will not be making a capital contribution at the time capital would be called from the investors generally to repay the borrowing, but permits the Fund to borrow against the Pre-Funding Investor's unfunded capital commitment prior to and during the period between when the Fund draws on the line and the point in time that the Pre-Funding Investor makes its related capital contribution under the Fund's partnership agreement or the applicable side letter (or fails to make such capital contribution and is deemed an excluded investor). A Subscription Facility with these features will typically include enhanced notice requirements whereby the Fund is obligated to alert the Lender if any investor elects to pre-fund or opt-out of borrowings, so the mandatory prepayments and exclusion event may be monitored.

Another way to address a Pre-Funding Investor is to include such investor's unfunded capital commitment in the borrowing base, but then adjust the borrowing base calculation to subtract out the amount of capital contributions that the Pre-Funding Investor elects to pre-fund. This amount is generally calculated as the result of (a) the Pre-Funding Investor's pro rata share (based on unfunded capital commitments) of all outstanding borrowings minus (b) the Pre-Funding Investor's pro rata share (based on unfunded capital commitments) of all borrowings for which such investor has declined to pre-fund in writing. In order for the Fund to receive credit in the borrowing base for the portions of the Pre-Funding Investor's allocation of borrowings that it has declined to pre-fund, the Lender typically requires receipt of written evidence of such election. The Lender may also require that the Fund deliver to each Pre-Funding Investor a notification giving such Pre-Funding Investor the opportunity to pre-fund its portion of the borrowing. With this approach, a Lender may also require more robust ongoing borrowing base reporting, and with each request for borrowing, a detailed listing of which Pre-Funding Investors have elected, declined, or not responded to a request to verify their plans to pre-fund any given borrowing so that the borrowing base and resulting line availability may be properly calculated.[11]

In addition to considering the borrowing base impacts of a Pre-Funding Investor, the Fund's partnership agreement will need to be reviewed to determine how the pre-funding rights and mechanics work generally, and how any overcall provisions may impact the analysis. An overcall provision in a Fund's constituent documents provides the Fund with the right to call capital from non-defaulting (or non-excused) investors to make up for shortfalls resulting from the failure (or excuse) of investors to fund capital contributions. Limitations (or ambiguity resulting from silence) on such overcall rights may restrict the ability of a Fund or a Lender to call capital from Pre-Funding Investors to make up any shortfall resulting from the default (or excuse) of other investors. This issue can be heightened if the Pre-Funding Investor also has the right to opt-out of capital calls to repay borrowings.

V. Conclusion

As the fund finance market continues to evolve, Lenders and Funds continue to explore new and innovative ways to include a wider pool of investors in the borrowing base. Subject to certain parameters, more Lenders are now willing to consider inclusion of the unfunded capital commitments of Pre-Funding Investors in the calculation of the borrowing base. Care should be taken, however, in reviewing and understanding the applicable provisions of a Fund's constituent documents and side letters when considering such an approach.

Endnotes

1 *See "Subscription Credit Facilities: A Comparison of Differing Borrowing Base Structures."* On page 8.

2 In lieu of a pre-funding right, certain investors may have a right to "opt-out" of borrowings pursuant to a side letter provision or the Fund's partnership agreement. Such an opt-out right will customarily provide that the applicable investor will not be required to fund capital contributions to repay Fund-level indebtedness, and as such, the unfunded capital commitment of such investor is typically excluded from the borrowing base in Subscription Facilities.

3 The partnership agreement of some Funds may hardwire in an investor's obligation to pre-fund each borrowing, and as such, the investor dœs not make an election to pre-fund (thus resulting in a more streamlined approach under a Subscription Facility).

4 Sec. 514(a)(1) of the Internal Revenue Code of 1986, as amended (the "Code"). The applicable portion is equal to the average "acquisition indebtedness" with respect to the debt-financed property over the average amount of the investor's adjusted basis in such property during the applicable tax period.

5 Sec. 702 of the Code; Treas. Reg. § 1.702-1(a).

6 Sec. 702(b) of the Code; Treas. Reg. § 1.702-1(b).

7 For example, property is not debt-financed property if the applicable "acquisition indebtedness" is repaid more than 12 months before its disposition. Sec. 514(c)(1); Treas. Reg. § 1.514(b)-1(a).

8 Sec. 512(c)(1) of the Code.

9 There are a number of variations in the market with respect to treatment of the timing of a Pre-Funding Investor's contribution, including deeming the contribution as being made as of a specified date (e.g., 90 or 120 days after the borrowing occurred), regardless of when such investor's contribution is actually pre-funded.

10 The Subscription Facility Documents will typically provide for a specific investor exclusion event that is triggered upon a Pre-Funding Investor's failure to fund.

11 A variation of this approach would be to include an investor (subject to typical inclusion and exclusion criteria) and adjusting the borrowing base to reduce availability to the extent that such investor has given notice of its intention to pre-fund a borrowing.

Issues for Administrative Agent to Consider

BRYAN L. BARRERAS AND DAVID B. KOBRAY

In a typical syndicated credit facility, one of the lenders (or an affiliate of a lender) acts as administrative agent (the "Administrative Agent") for the lender group.[1] There are several reasons for a lender to seek the role of Administrative Agent—agency fees, reflection in various league tables and a deeper relationship with the borrower and/or sponsor that such a role requires. Fund financing credit facilities are typically senior secured facilities, so the role of the Administrative Agent also typically relates to pledged collateral.[2] In each case, the role of Administrative Agent includes responsibilities that may give rise to potential liability and of which lenders should be aware. While market-standard documentation, including the Loan Syndications and Trading Association ("LSTA")'s form agency provisions, address these areas, lenders should understand the purpose of these provisions and the potential risks in order to avoid inadvertently lessening the protections provided by this language through negotiation.

Most banks that regularly participate in the fund finance market as Administrative Agent work from a set of form or template documents that contain provisions developed by the particular institution and designed to address the various issues discussed below. However, there are many situations where a lender may need to work with unfamiliar documents or provisions, and in these situations, the lender and its counsel may need to revise or insert agency language. This may occur when: (i) lenders that have traditionally participated in the market as syndicate members take on the Administrative Agent role; (ii) borrowers require the lender to use precedent documents that are based on another bank's form; or (iii) a bilateral facility with no agent is being converted into a syndicated facility in order to accommodate additional lenders. In addition, many syndicated credit facility markets are seeing an increase in participation by nonbank lenders, such as hedge funds and other similar institutional investors, as well as banks that have not traditionally been active in the space. Newer market participants may be more aggressive in trying to negotiate away many of the Administrative Agent protections provided by market-standard agency language. This article will identify typical agency provisions, primarily in the context of LSTA form provisions, while also considering the fund financing market generally, and discuss the issues addressed by such provisions.

Role of the Administrative Agent and Typical Provisions

Generally speaking, the role of the Administrative Agent is in many respects essentially for convenience and efficiency. More specifically, it provides borrowers with a single point of contact for the day-to-day operation of the credit facility and for borrowing and repaying loans under the facility. The role of Administrative Agent also provides for the creation and perfection of security interests in favor of a single entity for the benefit of the other lenders. While providing convenience for borrowers, the Administrative Agent acts as an agent of the lender's party to the credit facility, and many of the agency provisions are meant to define this role and the authority of the Administrative Agent to act on behalf of the lenders (including any limitations with respect thereto).

Typical provisions relating to the Administrative Agent's role include, but are not limited to, the following:

- **Appointment/Authority; Delegation of Duties.** The lenders formally appoint the Administrative Agent in order to establish the necessary authority for the Administrative Agent to act on behalf of the lenders and to exercise the powers expressly set forth in the credit agreement and other loan documents.[3] The lenders recognize that the Administrative Agent has no duties not expressly set forth in the loan documentation and that the Administrative Agent is not acting in a fiduciary capacity or for any third parties.[4] They also recognize the Administrative Agent's right to appoint sub-agents and to delegate its duties (and typically limit liability to the care taken in the selection of such sub-agents).[5]
- **Exculpation.** In addition to specifying the capacity in which the Administrative Agent acts, a typical Administrative Agent provision includes broad exculpatory language:
  a. Limiting the Administrative Agent's obligations and outlining duties, obligations and responsibilities that the Administrative Agent does not have (unless expressly set forth in the credit agreement), including:
     i. Any fiduciary or implied duties;
     ii. Any duty to take actions not expressly set forth in the credit agreement as directed by the requisite lenders, and note that the Administrative Agent is excused from taking actions even upon the direction of the requisite lenders in certain circumstances, such as actions that may be contrary to law (e.g., delivering a default notice to a bankrupt borrower without court consent if such action may violate an automatic stay); or
     iii. Any duty of disclosure not expressly set forth in the credit agreement;[6]
  b. Stating that the Administrative Agent has no liability in the absence of its own gross negligence or willful misconduct;
  c. Stating that the Administrative Agent is not deemed to have knowledge of a default unless notified in writing; and

d. Stating that the Administrative Agent has no duty to ascertain, inquire, monitor or enforce (unless expressly set forth in the credit agreement).[7]

- **Reliance; Non-Reliance.** The Administrative Agent is entitled to rely on notices, reports, etc. reasonably believed to be genuine, and the Administrative Agent may consult with and rely upon the advice of legal counsel and other experts. Each lender also acknowledges that it makes its own credit decision without reliance upon the Administrative Agent.[8]
- **Individual Capacity.** The parties recognize that the Administrative Agent is entitled to act as a lender, and in any other capacity, as though it were not the Administrative Agent.[9]
- **Indemnification.** The lenders indemnify the Administrative Agent (typically pro rata based upon their exposure under the credit facility), to the extent any borrower indemnity is insufficient.
- **Collateral Matters.** The circumstances under which security interests and/or collateral may be released or subordinated by the Administrative Agent, the release of any guarantor by the Administrative Agent and the sharing of collateral among the lenders are typically specified. The ability of the Administrative Agent to file proofs of claim and/or credit bid may also be specifically set forth in the credit agreement.[10]
- **Resignation; Removal.** The Administrative Agent typically has the right to resign, although in practice this may be difficult to accomplish, unless another syndicate member is prepared to assume the role. A successor Administrative Agent may be required to be a commercial bank, but the increased participation of nonbank lenders may impact the inclusion of this requirement. There may or may not be a removal right with respect to the Administrative Agent, and any such right would typically be event-driven.[11]

Negotiated Provisions

The provisions related to the role of the Administrative Agent in syndicated credit facilities generally fall within the categories mentioned above and, as such, are not generally controversial. However, there are some provisions that are occasionally the subject of comment from parties to the credit agreement, and care should be taken when negotiating these provisions, especially when the Administrative Agent is not working from its form documents. Three such provisions are:

- **Exculpation.** As mentioned above, a typical provision relieves the Administrative Agent from liability absent gross negligence or willful misconduct on its part. This provision provides substantial protection for the Administrative Agent—failure to show gross negligence or willful misconduct on the part of the agent was the basis for the dismissal of claims against the agent in a 2018 case before the New York Supreme Court, where the agent acted at the direction of "Required Lenders."[12] As a result, in considering changes to this provision, individuals negotiating on behalf of the Administrative Agent need to be aware that many banks have specific language requirements relating to exculpation and modifications to such language may require appropriate internal approvals.

- **Resignation/Removal.** The Administrative Agent typically has the right to resign, but the mechanics around replacement of the Administrative Agent sometimes vary (primarily with respect to the consent and/or consultation rights of the borrowers in the selection of a replacement Administrative Agent by the required lenders). In addition, while the right of the required lenders to remove the Administrative Agent is often limited to the situation where the person serving as the Administrative Agent is a defaulting lender, the concept of a minimum holding by the person serving as the Administrative Agent may be proposed (i.e., if such person holds less than a specified percentage of the overall commitment, they may be replaced).[13]
- **Applicable Standard for Administrative Agent Actions.** Borrowers often have a preference to just deal with the Administrative Agent and may propose changes to provide the Administrative Agent with greater discretion to act for the lender group (instead of requiring consent of the lenders or required lenders). While such changes may make administration of the credit facility more efficient, there is a great deal of protection to be gained by the Administrative Agent from acting at the direction of the required lenders and/or all lenders. Even where the Administrative Agent may take actions on its own, consideration should be taken to include provisions permitting the Administrative Agent to seek direction or authority from the lender group upon request (e.g., when releasing collateral that may otherwise be within the defined discretion of the Administrative Agent).

Additional Considerations

Typical contractual provisions related to an Administrative Agent's role in a syndicated credit facility for a fund finance transaction are described above, but there are other potential issues presented by different structures that could impact the provisions relating to the Administrative Agent and/or whether a bank should be willing to take on such a role.[14] One recent no-action letter issued by the US Securities and Exchange Commission ("SEC") highlights the potential complexity around the seemingly straightforward role of Administrative Agent for a particular set of facts. The SEC took the position that, in certain circumstances, an Administrative Agent could have "custody" of the assets of the syndicate members and would be required to comply with the applicable provisions of the Investment Advisers Act of 1940.[15] While a detailed discussion of this no-action letter is beyond the scope of this article, this example illustrates the need to carefully consider the role of the Administrative Agent and the related loan documentation provisions described above.

Conclusion

Even though there is LSTA form language as well as typical market provisions relating to the Administrative Agent's role in syndicated credit facilities, the changing landscape of market participants and potential issues relating to the rights and obligations of an Administrative Agent have resulted in an increased awareness of the importance of these provisions. Consequently, prospective Administrative Agents and lenders will want to carefully consider these provisions and seek guidance from counsel when negotiating such language or when taking on such a role.

Endnotes

1 The same lender may, along with one or more other members of the lender group, also act in other capacities—e.g., arranger, manager and/or bookrunner—but such roles do not typically have any rights, powers or responsibilities pursuant to the transaction documents and are therefore outside the scope of this article.

2 This role may also be labeled as the "Collateral Agent," and in certain circumstances, may be performed by an entity that is not the Administrative Agent.

3 See https://www.mayerbrown.com/en/perspectives-events/publications/2015/03/limitations-on-lender-assignments-to-competitors-i for an example of a specified duty of an Administrative Agent and a general discussion of issues related thereto.

4 One of the exceptions with respect to third parties is the maintenance by the Administrative Agent of a participant register, if applicable, which it does as an agent of the borrower.

5 Note that under New York law, an agent may not be able to delegate its duties without the specific authority from the principal.

6 But see https://www.mayerbrown.com/perspectives-events/publications/2010/10/renewed-concerns-over-administrative-agent-liabili for a discussion of circumstances where an Administrative Agent with "peculiar knowledge" of a borrower may have a duty to disclose under the "special facts" doctrine. See also *Harbinger Capital Partners Master Fund I, Ltd. vs. Wachovia*, 27 Misc 3d 1236(A), for a discussion of these exceptions.

7 See *Stanfield Offshore Leveraged Assets, Ltd., et al., vs. Metropolitan Life Insurance Company, et al.*, 64 A.D.3d 472, dismissing a claim alleging administrative agent liability and citing broad exculpatory language in credit agreement.

8 See ibid, which also cited language in credit agreement regarding non-reliance in dismissing a claim.

9 This provision avoids any general duty of loyalty and/or non-competition the Administrative Agent might otherwise owe to the lenders.

10 The Administrative Agent may be able to file proofs of claim and credit bid without specific language, pursuant to its ability to exercise remedies.

11 E.g., if the Administrative Agent is a defaulting lender under the credit facility.

12 See *Eaton Vance Management v. Wilmington Savings Fund Society*, 2018 NY Slip Op 30727(U), dismissing a claim alleging administrative agent liability and citing exculpatory language in credit agreement and failure to show breach by agent of applicable standard.

13 This is not often seen in widely syndicated credit facilities, but is more prevalent in "club" transactions involving a small group of lenders.

14 One example is a structure with both first and second lien debtholders, which may present conflict between the two debtor groups that may require two separate administrative agents to properly address such conflicts.

15 See https://www.mayerbrown.com/en/perspectives-events/publications/2018/12/sec-grants-conditional-noaction-relief-from-the-cu for a discussion of this no-action letter. While this no-action letter was not applicable to a traditional financial institution acting as administrative agent, it highlights that entities new to the role of administrative agent should consult with counsel before agreeing to act in such capacity.

Utilizing Repurchase Facilities and Related Protected Contracts as an Alternative Source for Fund Liquidity

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I. Introduction

Subscription-backed credit facilities (also known as "capital call" or "capital commitment" facilities, and each a "Subscription Facility") have served as the cornerstone of the fund finance market for the past 20 years. Loan availability under a Subscription Facility is subject to a borrowing base, which is typically tied to the remaining amount of the pledged uncalled capital commitments of investors satisfying certain eligibility requirements, multiplied by an advance rate. However, in connection with the ongoing evolution of the fund finance market, we have seen a growing interest among real estate and other private credit funds (each, a "Fund") for additional fund financing tools to leverage the value of their portfolio assets and optimize investment returns.

In order to meet the financing needs of these Funds, a growing number of banks and other credit institutions (each, a "Buyer") are entering into financing arrangements, commonly known as repurchase agreements or securities contracts, with subsidiaries of these Funds (each, a "Seller") whereby the Buyer provides liquidity by "purchasing" certain portfolio assets with an obligation of the Seller to "repurchase" these same assets on a specified date in the future (each a "Repurchase Facility"). In contrast to Subscription Facilities (which look "up" to capital commitments of investors to determine loan availability), Repurchase Facilities look "down" to assets beneath the Fund level. Repurchase Facilities can also be used effectively in tandem with Subscription Facilities.

Repurchase Facilities are often used to provide temporary financing of an asset until an exit strategy (like pooling into a securitization) can be pursued. In addition to Repurchase Facilities, there are other tools available to Funds for purposes of obtaining liquidity from portfolio assets, including "note on note" financings (whereby a lender provides an advance against a loan asset and in turn takes an assignment of the underlying loan documentation as collateral for repayment) and "CLO light" structures (whereby a lender provides a temporary warehouse line of credit for loan assets meeting certain specified eligibility criteria). Repurchase Facilities, however, include distinct structural elements resulting in an increased appetite from market participants for this type of financing arrangement. In light of this trend, this article will discuss some common features of Repurchase Facilities and certain other related "protected contracts" and the benefits of this alternative source of liquidity associated with Fund assets.

II. Benefits of Protected Contracts

Protected contracts are specific types of contracts designated under Title 11 of the United States Code, as amended (the "Bankruptcy Code") to receive "safe harbor" protections that allow the qualifying party to liquidate and close out the protected contract when its counterparty becomes the subject of a bankruptcy case, and to do so free from the automatic stay and certain other significant restrictions of the Bankruptcy Code.

In most lending arrangements, if a counterparty files for bankruptcy, an automatic stay of actions is imposed which prevents a lender from (i) foreclosing on the property of the debtor, (ii) commencing or continuing certain enforcement actions against the debtor or its property and/or (iii) setting off amounts owed under such arrangements (in each case unless a motion seeking relief from the stay is filed and granted in the related bankruptcy case). In addition, provisions in these lending contracts that allow for the termination or modification of a contract based on the debtor's bankruptcy or financial condition (also known as "ipso facto clauses") are prohibited from being enforced.

In contrast, if a contract is a "protected contract" and the party seeking enforcement is a "protected party" (e.g., in the case of securities contracts, a financial institution or a financial participant as defined within the Bankruptcy Code), then ipso facto clauses that would not otherwise be enforceable can be enforced and the actions taken by the protected party to enforce the protected contract are not subject to the automatic stay. The safe harbor provisions, therefore, enable counterparties to protected contracts to terminate their financial contracts and exercise contractually agreed upon rights of liquidation, termination and acceleration (e.g., enforcement through the netting and setoff of then outstanding obligations) promptly upon the bankruptcy of the debtor. Additionally, each of the Bankruptcy Code's protected contract provisions makes clear that a protected party can freely exercise its rights under any security agreements, guarantees, reimbursement agreements or other credit enhancements that relate to the primary protected contract and that those related contracts are each eligible, in their own right, for treatment as protected contracts. As a result, enforcement actions by the protected parties of these related protected contracts are exempt from the automatic stay and can be undertaken without prior approval of the bankruptcy court.

The Bankruptcy Code also shields protected parties from a variety of avoidance powers that are generally available to a bankruptcy trustee (or debtor-in-possession) with respect to transactions engaged in by the debtor prior to commencement of the bankruptcy case. Most importantly, under Section 546(e) of the Bankruptcy Code, certain payments and other transfers received by the protected party from the debtor in connection with a Repurchase Facility, prior to commencement of the case, may be retained by the protected party. Likewise, because the Bankruptcy Code permits the close-out of the

Repurchase Facility, those post-bankruptcy actions also cannot be "avoided" by the trustee (or the debtor-in-possession).

As a consequence, because a counterparty to a protected contract has more certainty in contract enforcement upon a debtor bankruptcy, the counterparty is able to undertake a different calculus in determining the necessary resources to recover on a claim against the bankrupt debtor, the amount recoverable, the timeframe in which the recovery can be achieved and, equally important, the ability to retain the recovery once achieved. As a result of these changes to the protected counterparty's "calculus," the Seller under a Repurchase Facility or a securities contract (described below) may obtain better pricing as compared to a typical asset-level lending arrangement.

III. Common Characteristics of Repurchase Facilities and Securities Contracts

Protected contracts entitled to safe harbor treatment under the Bankruptcy Code include commodity contracts, forward contracts, master netting agreements, swaps, repurchase agreements and securities contracts. Repurchase Facilities are the most similar to a typical secured lending arrangement and can be used as an alternative to a secured lending arrangement if certain characteristics are met.

A Repurchase Facility is similar to a secured lending facility in that the Buyer (or lender) provides financing to the Seller (or borrower) for a period of time and expects to receive a rate of return on the amount provided to the Seller. The rate of return is typically described as the "price differential" and, similar to interest on a loan, is payable periodically prior to or upon repurchase of the applicable asset(s) by the Seller. In addition, Repurchase Facilities are usually treated by Sellers and Buyers as loans for accounting and tax purposes.

Unlike most other secured lending arrangements, Repurchase Facilities are treated as protected contracts under the Bankruptcy Code and are afforded the safe harbor protections described above. Not every lending contract can be a repurchase agreement. In fact, to fit into the "repurchase agreement" definition under the Bankruptcy Code, an agreement must:

> [provide] for the transfer of one or more certificates of deposit, mortgage related securities . . . mortgage loans, interests in mortgage related securities or mortgage loans, eligible bankers' acceptances, qualified foreign government securities (defined as a security that is a direct obligation of, or that is fully guaranteed by, the central government of a member of the Organization for Economic Cooperation and Development), or securities that are direct obligations of, or that are fully guaranteed by, the United States or any agency of the United States against the transfer of funds by the transferee of such certificates of deposit, eligible bankers' acceptances, securities, mortgage loans, or interests, with a simultaneous agreement by such transferee to transfer to the transferor thereof certificates of deposit, eligible

> bankers' acceptance, securities, mortgage loans, or interests of the kind described in this clause, at a date certain not later than 1 year after such transfer or on demand, against the transfer of funds . . . .[1]

In sum, the underlying asset subject to a Repurchase Facility must be (a) a security, mortgage loan or an interest therein and (b) sold with an automatic obligation to resell such asset within one (1) year.

In addition, there are other protected contracts that can be utilized in a manner similar to secured lending arrangements. "Securities contracts" under the Bankruptcy Code are similar to repurchase agreements, with the notable exception that there is no requirement to transfer the asset back to the counterparty. However, the Buyer in connection with a "securities contract" must be a stockbroker, securities clearing agency, financial institution or financial participant. In other words, such entity must be:

> an entity that, at the time it enters into a securities contract, commodity contract, swap agreement, repurchase agreement, or forward contract, or at the time of the date of the filing of the petition, has one or more [securities contracts, commodity contracts, repos, swaps or master netting agreements] with …any entity (other than an affiliate) of a total gross dollar value of not less than $1,000,000,000 in notional or actual principal amount outstanding (aggregated across counterparties) at such time or on any day during the 15-month period preceding the date of the filing of the petition, or has gross mark-to-market positions of not less than $100,000,000 (aggregated across counterparties) in one or more such agreements or transactions with the debtor or any other entity (other than an affiliate) at such time or on any day during the 15-month period preceding the date of the filing of the petition…" or is a clearing organization (as defined in section 402 of the Federal Deposit Insurance Corporation Improvement Act of 1991).[2]

While under the Bankruptcy Code a "securities contract" is more broadly defined than a "repurchase agreement", the universe of potential "Buyer" counterparties to a securities contracts may be limited. Regardless, structuring asset-level financing as a "protected contract" (whether as a repurchase agreement or securities contract under the Bankruptcy Code) should benefit both parties by providing the Buyer with safe harbor protections for the enforcement of remedies in connection with a bankruptcy of the Seller, and likely providing the Seller with more favorable economic terms.

IV. Conclusion

As the fund finance market continues to mature, both Funds and financial institutions will continue to explore new and innovative ways to generate liquidity from existing pools of assets. In addition to the rise in Net Asset Value Facilities, Hybrid Facilities and Unencumbered Asset Pool Facilities (looking beyond just the capital commitments of a Fund under a Subscription Facility to the underlying assets of a Fund as a source of liquidity), we have seen an increase in the number of Funds entering into Repurchase Facilities to obtain asset-level leverage (particularly for mortgage loans). Since Repurchase Facilities provide Funds with another cost-effective method for satisfying their liquidity needs and optimizing returns for Fund investors, we expect to see continued growth of these financing arrangements in the coming years.

Endnotes

1 11 U.S.C. § 101(47).

2 11 U.S.C. §101(22A).

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