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Subscription Credit Facilities: Continuation Funds

By Kiel A. Bowen and McKay S. Harline*

In this article, the authors discuss the ins and outs of continuation funds and subscription credit facilities and the considerations for implementing a subscription credit facility in connection with a continuation fund.

When using a subscription credit facility for a continuation fund, lenders and borrower funds should keep in mind certain best practices to ensure that the facility is structured appropriately. This article discusses the ins and outs of continuation funds and subscription credit facilities and considerations for implementing a subscription credit facility in connection with a continuation fund.

WHAT ARE CONTINUATION FUNDS?

In a traditional private equity fund, capital contributions are used to make portfolio investments. These investments will be held for a limited period prescribed by the constituent documents of the fund. At the end of this period, the fund's investments will need to be liquated in some way.

Historically, exit options have included an IPO or sale of the asset. A relatively new exit option, however, is for a fund sponsor to establish a new continuation fund that purchases unripe assets from the liquidating fund. In this way, continuation funds provide a valuable liquidity option for investors who want to exit the investment, while also providing an opportunity for the fund sponsor and continuing investors to remain invested in a maturing asset that may have remaining upside – and without the costs of finding a new asset and de novo diligence.

HOW IS A CONTINUATION FUND FORMED?

A continuation fund is usually formed as a new fund (e.g., a completely separate and distinct legal entity) with the limited purpose of acquiring one or more identified assets from an existing private equity fund. Typically, the same fund sponsor manages the continuation fund. The investors in the liquidating fund will be given a disclosure memorandum that explains the continuation fund's formation and strategy and offers investors the option to either exit the fund by selling their interests or roll their investment into the continuation fund.

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New investors can also invest in the continuation fund by making cash contributions to the continuation fund, the proceeds of which are used to pay out the exiting investors.

Sometimes continuation funds also include unfunded capital commitments from investors to acquire or increase follow-on investments. In this case, rollover investors may also end up with increased unfunded capital commitments.

CONSIDERATIONS AND BEST PRACTICES WHEN USING A SUBSCRIPTION CREDIT FACILITY FOR A CONTINUATION FUND

Traditional private equity fund borrowers have historically used subscription credit facilities to bridge capital calls and other types of permanent financings. The defining characteristic of a subscription credit facility is the collateral – the unfunded capital commitments of a fund borrower's limited partners, the related rights to make and enforce capital calls, and the bank accounts into which the limited partners are required to fund their capital contributions.

While a subscription credit facility for a continuation fund will likely contain representations, warranties, covenants, events of default and a collateral package similar to a traditional fund, lenders and fund borrowers can accommodate the unique features of a continuation fund (including the timing of the transfer of assets, the structuring of investor capital commitments and the use of proceeds to make distributions to investors) by keeping in mind a few best practices.

EVALUATE INVESTOR CAPITAL COMMITMENTS AND CREDITWORTHINESS

Subscription facility lenders will generally apply their credit models to determine individual investor advance rates and concentration limits, the financial capacity and stability of the investor pool, and the track record of the investors and fund sponsors. They should also consider additional guardrails, especially for rollover investors whose capital commitments may not be confirmed until the transferring assets are sold to the continuation fund and the sale proceeds are allocated or distributed to the investors, including:

- *Requesting Investor Deliverables*. The lenders may ask for investors to provide investor letters (and related evidence of authority to enter the subscription documents and continuation fund's limited partnership agreement) to, among other things, acknowledge and agree to fund capital contributions without defense, counterclaim or offset, and to direct such capital contributions to the collateral accounts. The lenders may also ask for comfort letters (including from the relevant parent of any investor) that include assurances that the applicable investor will maintain financial assets adequate to meet the investor's capital commitment. These investor deliverables may be more relevant to lenders and their credit underwriting process if a continuation fund's investor pool is smaller or more concentrated or if the capital commitments of the investors (especially rollover investors) may not be immediately known.

- *Excluding Investors Until Commitments Have Crystalized*. The lenders may also elect to deem rollover investors without established capital commitments as "excluded investors" (whose capital commitments will not be counted toward the borrowing base), at least until the lenders have received acceptable documentation confirming the final amount of their capital commitments. This could be in the form of subscription agreement amendments, capital account statements, distribution notices that reflect the value of an investor's prior investment prior to rolling to the new continuation fund, and/or evidence of cash payments made to these investors, and the resulting unfunded capital commitments to the new continuation fund.
- *Including Additional Exclusion Events*. The lenders may also look to include additional exclusion events, including failure to maintain a minimum net asset value and failure to provide investor financial information (especially in the event an investor's financials are not publicly available).
- *Requiring Minimum Funded Capital Commitments*. Some lenders may also require that a minimum percentage of the aggregate capital commitments (net of any returned capital) of the investors be called and funded (and remain invested in the assets) at all times.

INCORPORATE COVENANTS RELATED TO THE ASSETS IN FACILITY DOCUMENTATION

Because continuation funds generally have a more concentrated portfolio of assets (as compared to traditional private equity funds that invest in broader portfolios during their investment periods), subscription facility lenders will often look to build into the facility documentation additional covenants related to the assets, including:

- *Minimum Number of Investments*. The lenders may require that the continuation fund maintain a minimum number of unrelated investments (and in some cases, the lenders may require that each of these investments maintain a minimum net asset value).
- *Cash Sweeps*. The lenders may require that distributions, dividends and other payments from the portfolio of assets (or an agreed percentage of such liquidity events) be applied towards repaying the facility.

- *Fund Net Asset Value*. The lenders may include a covenant that the continuation fund maintain an overall net asset value above a set floor.
- *Material Asset Sales*. The lenders may include limitations on material asset sales (with materiality thresholds set on a fund-by-fund basis) that would result in distributions or sale proceeds being received by the fund.
- *Value to Cost Basis*. The lenders may include a covenant or event of default trigger if the ratio of the fair market value of the fund's investments to the cost of such investments falls below a certain percentage threshold.

Breaches of one or more of the above requirements could result in a mandatory prepayment event, event of default or termination of the facility, given the limited portfolio of assets and to ensure value remains in the fund's investments. To monitor the value of the fund's assets, the lenders may also look to restrict changes to the fund's valuation policies or similar amendments.

REQUEST ADDITIONAL COVENANTS AND COLLATERAL

As lenders structure subscription credit facilities for continuation funds to account for net asset value determinations, asset transfers and investor capital commitment mechanics, they may also look to include additional covenants related to:

- *Loan Proceeds and Distributions to Investors*. The lenders will likely seek to prohibit the loan proceeds from being used to make distributions to the limited partners. However, given the timing of transfer of assets to a continuation fund and the fluctuation of rollover, liquidating and new investors, the lenders may agree that the loan proceeds may be used to issue a distribution to the fund's new limited partners (provided such distribution is subject to recall).
- *Additional Reporting Requirements*. The lenders may ask that the continuation fund provide more detailed or frequent reporting on borrowing bases, investor events, investor composition changes, and net asset values. Given the concentrated asset portfolio, the lenders may look for valuation reports provided to the investors and/or the advisory committee regarding specific assets (including details as to the methodology used to determine values) and any notices of objection from the investors and/or advisory committee.
- *Additional Collateral*. The lenders may also ask continuation funds to provide additional collateral under the subscription credit facility, including a pledge of the fund borrower's equity interests in one or

more holding vehicles that own or hold the underlying assets and the deposit and securities accounts into which distributions from the assets are funded.

- *Facility Tenor*. Similar to a subscription credit facility for a traditional fund, the tenor—or length of time until the facility expires—will likely be aligned to the "investment period" of the new continuation fund (if it has one) or the expected sale of the underlying assets. A facility could also be structured with a 364-day tenor (subject to permitted extensions), allowing the lenders and the fund sponsor to reevaluate their respective needs on an ongoing basis during the continuation fund's life.

BOTTOM LINE: A SUBSCRIPTION CREDIT FACILITY CAN BE A VALUABLE TOOL FOR CONTINUATION FUNDS IF NECESSARY STEPS ARE TAKEN

Subscription credit facilities can be a useful financing tool for continuation funds. However, given the unique structure and timing considerations of continuation funds, lenders and fund sponsors should keep in mind the above best practices to ensure a subscription facility can be appropriately structured to meet all parties' needs.