A subscription credit facility (a “Facility”), also frequently referred to as a capital call facility, is a loan made by a bank or other credit institution (the “Lender”) to a private equity fund (the “Fund”). The defining characteristic of such Facilities is the collateral package, which is composed not of the underlying investment assets of the Fund, but instead by the unfunded commitments (the “Capital Commitments”) of the limited partners in the Fund (the “Investors”) to make capital contributions (“Capital Contributions”) when called from time to time by the Fund’s general partner.

The loan documents for the Facility contain provisions securing the rights of the Lender, including a pledge of (i) the Capital Commitments of the Investors, (ii) the right of the Fund’s general partner to make a call (each, a “Capital Call”) upon the Capital Commitments of the Investors after an event of default accompanied by the right to enforce the payment thereof, and (iii) the account into which the Investors fund Capital Contributions in response to a Capital Call.

The number of Facilities is rapidly growing due to the flexibility they provide to Funds (in terms of liquidity and consolidating Capital Calls made to Investors) and the reliability of the Capital Commitment collateral from the Lender’s perspective. As the Facility market continues to grow and evolve, both Lenders and Fund sponsors seek to put in place Facilities for fund structures that vary from the typical closed-end Funds that have historically dominated the Facility market. As recovery from the financial crisis continues, Investors are increasingly investing in open-end Funds due to the Investors’ interest in increased liquidity due to the availability of voluntary Investor redemptions in open-end Funds. Historically, Lenders have not pursued open-end Funds for Facilities because of concerns surrounding the transient nature of the Capital Commitments in those Funds. As discussed below, however, with a few structural tweaks, Facilities can be provided to open-end Funds, offering Lenders the same comforts of a traditional Facility while providing Funds convenient and cost-effective fund-level financing. Such financing can be used for leveraging investments, liquidity and bridging Capital Calls. This newsletter provides background on how open-end Funds generally differ from a typical closed-end Fund, and proposes solutions for structuring a Facility for open-end Funds.

**Background**

While there are many types of open-end Funds, there are a number of common characteristics that generally distinguish an open-end Fund from a typical closed-end Fund. These include: the long-term fund-raising period during which it can accept additional Capital Commitments and close in new Investors, the extended or perpetual investment period during which it can make Capital Calls, and most important and potentially...
concerning for purposes of Facilities, the increased flexibility for Investors to redeem their interests. Unlike a closed-end Fund, where redemption and withdrawal rights are generally not available to Investors, or, to the extent that they are available to Investors, are generally limited to specific legal or regulatory issues, Investors in an open-end Fund are generally free, subject to notice and timing restrictions, to redeem their interests in the Fund. True open-end Funds by their nature permit redemption of equity at the election of the Investor (and, in some circumstances, the remaining unfunded Capital Commitment of the redeeming Investor may be cancelled). It is important to note that some open-end Funds require Investors to fully fund all Capital Contributions concurrently with closing into the fund and, thus, do not retain the concept of an unfunded Capital Commitment. A traditional Facility would not be feasible for such a Fund. For purposes of this newsletter we will focus on structuring issues related to the expanded redemption and withdrawal rights of Investors in open-end Funds that retain unfunded Capital Commitments.

Structuring and Documentation Concerns

A Facility for an open-end Fund should contain a representation, warranty, covenant and an event of default package that is generally consistent with that seen in Facility documentation for a closed-end Fund. The collateral package would also be similar, if not identical, to that for a closed-end Fund. As a gating issue, it is important to review the constituent documents of the open-end Fund to ensure that the timing of requests for redemption and the timing for satisfying redemptions allows for Capital Calls to be made and the proceeds thereof applied to make any mandatory prepayment that would result from any such redemption. Notwithstanding the generality of the foregoing, there are a few structural changes that should be noted in a Facility for an open-end Fund.

COLLATERAL ISSUES

As discussed above, the collateral and expected source of repayment in a Facility is the Capital Commitments of the Investors. Given the nature of open-end Funds, the potential fluidity with respect to the Investors and, therefore, the collateral for the Facility raise potential concerns. Notwithstanding the issues related to a changing pool of Investors, with a careful review of the Fund’s constituent documentation and attention to the redemption timing and mechanics, a Facility could be structured to address a Lender’s concerns while still providing flexibility (in terms of liquidity and consolidating Capital Calls made to Investors) to an open-end Fund. As described in more detail below, the Facility documentation can address the foregoing concerns with some minor changes, including additional exclusion events, mandatory clean-up calls, additional events of defaults and/or additional covenants.

An exclusion event tied to any request by an Investor to redeem its interest in the Fund must be structured so as to remove any such requesting Investor from the borrowing base while also allowing sufficient time to make a Capital Call to cure any resulting borrowing base mismatch in the time period between receipt of such request from an Investor to the time the Investor has been redeemed from the Fund. Tying the exclusion event to a request for redemption, rather than to an actual redemption, is important not only for timing concerns, but also because an Investor that has redeemed its equity in a Fund, even if it is not also seeking to cancel its unfunded Capital Commitment, may not be as concerned by the defaulting investor penalties in the constituent documents of the open-end Fund as an Investor that still has equity at stake.

Additional Lender protection can be obtained by requiring cleanup calls (to reduce amounts outstanding under a Facility) in advance of each regularly occurring redemption window under the constituent documents of the open-end Fund. An event of default can be added that is triggered upon a threshold percentage of Investors
requesting redemption of their interests in the Fund. Such event of default can be structured to be cumulative or with respect to any redemption window. A net asset value covenant can be inserted to provide additional early warning of any Fund problems.

ADDITIONAL REPORTING
Because of the potential for changes in the Investor base and the collateral package associated with an open-end Fund, Facilities should be structured to provide additional reporting as to borrowing bases and Investor events, including notice of redemption requests, cues of Investors seeking admission to the Fund and net asset values. Additional delivery of borrowing base certificates and notices of redemption requests should coincide with the time periods under the constituent documents of the open-end Fund such that the Lender can properly monitor borrowing base changes and anticipate any necessary mandatory prepayments resulting from Investor redemptions, while maintaining time to issue any necessary Capital Calls before the effectiveness of any requested redemptions. Tracking redemption requests and Investor cues should provide a Lender with an early indication of underlying problems with a Fund.

We note that reporting and documentation required in connection with a Facility for an open-end Fund may be more administratively burdensome than a Facility in a typical closed-end Fund. Beyond the additional reporting with respect to borrowing bases and Investor redemptions discussed above, deliverables (such as constituent document changes, new side letters and subscription agreements) with respect to additional Investors can continue for a longer period than in a typical closed-end Fund. Moreover, given the increased potential for Investor turnover, it may be burdensome for both Lenders and Fund sponsors to negotiate and obtain investor letters and opinions from Investors. Lenders may want to consider addressing any additional administrative burden related to an open-end Fund Facility by increasing the administrative fees under the Facility. Even with an incremental increase in fees or the interest rate, a Facility still likely provides cheaper liquidity than many asset-level financings.

FACILITY TENOR
Because of its long-term nature, there are a number of options to structure the tenor of a Facility for an open-end Fund. Since open-end Funds typically are not subject to limited investment periods during which they may make Capital Calls for investments and repay Facility obligations, there are more options available to Lenders and Fund sponsors in terms of the tenor of the Facility. Some open-end Funds prohibit initial Investors from redeeming their interests and/or withdrawing from the Fund for a predetermined period of time (often one or two years). Such lock-out periods help the Fund achieve and maintain a critical size during its ramp-up period. During the early stages of such an open-end Fund, a Facility could be structured with a tenor equal to any applicable redemption lock-out period for the Investors. A Facility of this type would look very similar to a Facility for a typical closed-end Fund. Secondly, a Facility could have a longer tenor, even in excess of five years or more, to match the long-term investment period and life-span of an open-end Fund. Although rare in this market, such a long-term tenor is regularly seen in other leveraged lending products. Lastly, a Facility could be structured with a 364-day tenor, subject to any number of one-year extensions, allowing the Lender and Fund sponsor to re-evaluate their respective needs on an ongoing basis during the life of the Fund.
Conclusion

While Facilities for true open-end Funds have to date been relatively rare, the opportunity is ripe for new market entrants. With a careful review of an open-end Fund’s constituent documentation and some modifications to the Facility documentation, a Facility can be structured to provide the traditional benefits of a Facility for an open-end Fund while still addressing a Lender’s standard Facility credit criteria. Please contact any of the authors with questions regarding open-end Funds and the various structures for effectively establishing Facilities for such entities.

Endnotes

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