Fund Finance

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Common ground: Achieving a commercial result for borrowers and lenders

Mary Touchstone & Julia Kohen
Simpson Thacher & Bartlett LLP

Introduction

Initially, subscription facilities were most commonly seen as bilateral, relationship loans to real estate funds for the purpose of bridging capital calls to a diverse group of large, highly rated, institutional investors for a short period of time. Such facilities were typically put in place after the final closing of a fund and terminated at the end of its investment period. As the subscription facility market has evolved, a wider range of funds (with varying investment strategies, investor bases and borrowing needs) have sought access to financing at the fund level. Not only are a wider range of funds and fund sponsors accessing the fund finance marketplace, but they are seeking subscription facilities that may be used at any time during the life of the fund and for any purpose permitted under the fund's partnership agreement. As fund borrowing needs have increased, so too have facility sizes, tenors, available currencies, the number of lenders in a facility syndicate, the range of lenders participating in the market, and the complexity of the loan documentation.

Despite these significant changes, at their core, subscription facilities remain relationship deals where borrowers and lenders have a common goal of implementing a facility that accommodates the fund's borrowing needs while at the same time protecting the lenders. Even when syndicated, these facilities tend to be club deals where the lenders have close relationships with the borrowers. This article aims to highlight how subscription facilities can be structured to accommodate fund borrowing needs, address lender concerns and sensitivities, and achieve a commercial result that works for all participants.

Flexibility

Subscription facilities offer fund sponsors and investors a variety of administrative, operational and economic benefits. Administrative benefits to the fund and its investors include bridging capital calls and other sources of capital that may not be available at the time of an investment, avoiding the need to rebalance during the period between the initial and final closings of the fund, quicker access to cash (as compared to the time it takes to call capital from investors), and not having to call capital in advance of an investment or return that capital to investors if the investment falls through or is significantly delayed.

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Investors further benefit from an operational standpoint as the fund may use its subscription facility to smooth out investor capital calls by grouping them on a periodic basis (rather than calling capital multiple times for each investment and fund expense). Economic incentives include mitigating the J-curve effect, enhancing the fund's internal rate of return, providing loans and letters of credit for portfolio companies, with a fund-level guarantee, at cheaper rates than might otherwise be available at the portfolio level, and obtaining more favorable pricing on hedges to the extent that the hedging exposure is secured by the pool of uncalled capital commitments that secures the subscription facility obligations. When exploring whether a subscription facility will provide these benefits to a particular fund and its investors, sponsors will focus on the flexibility that a lender can offer, especially as it relates to borrowing base calculations, facility size and tenor, types and currencies of credit extensions and which entities are permitted to borrow under the subscription facility.

Borrowing base capacity

When considering a subscription facility, the first question a fund sponsor should ask a potential lender is what the fund's borrowing base will look like. Most subscription facilities measure availability against a borrowing base of eligible investor commitments. In determining eligibility, a lender may diligence the fund's investors (including their subscription agreements, side letters, ratings and available financial information) and assign advance rates to the uncalled capital commitments of only those investors that are deemed by the lender to be the most "creditworthy". In some cases, a lender will impose concentration limits so that no single investor, or type of investor, comprises more than a certain percentage of the borrowing base.

While advance rates are often 90% for the highest rated investors (and, if necessary to achieve the desired borrowing base, 60% to 65% for certain other investors), lenders may have differing viewpoints on specific investors, including whether they should be in the borrowing base at all, which advance rate should apply and whether a concentration limit should be imposed. For example, one lender may be unable, as a credit matter, to lend against the uncalled capital commitment of an investor whose side letter contains withdrawal rights or a reservation of sovereign immunity, whereas another lender may be able to lend against the uncalled capital commitment of such investor. As a result, different lenders may look at the same investor base and yet arrive at different borrowing base calculations. Given the possibility of divergent lender views with respect to an investor base, once a potential lender has signed a non-disclosure agreement but prior to entering into extensive credit facility negotiations, it is critical that a fund sponsor share the fund's investor documentation and request that the potential lender provide an indicative borrowing base.

Although it is important to request indicative borrowing base calculations from potential lenders, there are a number of things a fund sponsor can do, during both fundraising and initial discussions with lenders, to maximize its borrowing base. Those actions include the following:

- First and foremost, ensure that investor side letters include top-of-market language to give lenders comfort from a legal perspective that uncalled capital may be called by the fund (and, in the event of enforcement, by the lender) to repay subscription facility obligations. For example, if an investor requests a side letter provision entitling the investor to withdraw from the fund and/or cease making capital contributions upon the occurrence of a triggering event, ask that the withdrawal and/or cease-funding right be conditioned on the repayment of debt incurred prior to the triggering event.

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Similarly, if an investor requests that its identity be kept confidential, ask that there be an exception for disclosure, on a confidential basis, of such information to lenders.

- Draft the relevant partnership agreements to authorize a main fund and its parallel fund to cross-collateralize each other's obligations under a credit facility. By providing authority under the partnership agreements to cross-collateralize, lenders have the comfort that, regardless of whether loans are made to the main fund or its parallel fund, both pools of capital support the loans. As a result, lenders should be willing to loan to both fund borrowers, on a several basis, against a single borrowing base that is comprised of the uncalled capital commitments of the investors in the main fund and the investors in the parallel fund. From a reporting standpoint, it is simpler for borrowers to calculate a single borrowing base than to calculate separate borrowing bases for each of the main fund and its parallel fund. In addition, a combined borrowing base may result in greater borrowing capacity for a smaller parallel fund with a more concentrated investor base than it would have had with a separate borrowing base calculation.
- If a lender seeks concentration limits, consider whether those limits should be relaxed: (a) during the fundraising period when the fund has fewer investors and, hence, greater investor concentration than it will at the completion of fundraising; and (b) later in the life of the fund when investors will have funded enough capital such that they have "skin in the game" and have more of their investment to lose should they fail to fund capital.
- Consider a "hurdle investor" concept to allow for investors that might not otherwise be included in the borrowing base (whether as a result of sovereign immunity, problematic side letter provisions or otherwise) to be included after they have funded a certain minimum percentage of capital.
- Seek lenders that offer credit for investors who historically may not have been included in a borrowing base but who have a good track record of funding capital contributions, such as high-net-worth investors or investors with sovereign immunity.

Historically, it was challenging for funds-of-one, and funds with significant investor concentrations, to find lenders willing to provide subscription financing. However, as the market has evolved, more lenders are willing to provide financing to these funds. In these scenarios, given the lack of investor diversity, the fund and its counsel will need to ensure that the fund's partnership agreement and side letters contain robust language to address a potential lender's underwriting needs. Also, it is important to note that some lenders will not lend to a fund-of-one without an investor consent letter. As a gating item, the fund sponsor will want to discuss with the investor the potential need to deliver such a consent letter if the fund is to have a credit facility. From an efficiency perspective, it may be helpful to negotiate such a consent letter with the investor during negotiations of the fund's partnership agreement and any related side letter with the investor.

Financing for open-ended funds may also be challenging because the investor composition changes as new investors are added in subsequent closings and existing investors may have the option, subject to the terms of the partnership agreement, to exit the fund. When marketing an open-end fund and drafting its partnership agreement, consideration will need to be given to balancing the flexibility for investors to enter and exit the fund against preserving the flexibility for the fund to enter into a financing. As a result, the fund sponsor may seek to build into the partnership agreement appropriate notice periods and other conditions that must be satisfied before an investor may exercise its withdrawal right from the fund.

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Facility size, currencies and tenor

In addition to making sure that the borrowing base is sufficient to support a fund's borrowing needs, fund sponsors also seek flexibility on the credit facility terms, including the ability to increase the facility size (whether on a permanent or a temporary basis), extend the stated maturity of the facility, and borrow in dollars and foreign currencies. This emphasis on flexibility is a departure from older lines that often had a 364-day tenor, were renewable annually in the lender's discretion, terminated at the end of the fund's investment period, and were available only up to a stated amount in dollars.

In light of the trend toward putting a subscription facility in place as soon as possible after the initial closing of the fund, it can be advantageous for a sponsor to close a credit facility at a lower amount and build in the ability to upsize the facility on a permanent basis as fundraising progresses and the investor base grows. Facility increases may be requested by the borrowers from time to time, often in minimum increments and subject to delivery of an increase request, the absence of credit facility defaults and the payment by the borrowers of an agreed increase fee. Increases are typically subject to the consent of increasing lenders, though some credit facilities provide for a committed increase, at the option of the borrowers, up to a specified amount. To the extent that a requested upsize is not provided by existing lenders, the credit agreement may provide for the ability to join additional lenders that are willing to provide all or a portion of the increased commitment amount.

Similarly, there may be times during a fund's investment period when its borrowing needs may be quite high, such as in anticipation of a particularly large investment. In those cases, it can be helpful to the fund to temporarily increase the facility to accommodate the increased short-term borrowing needs. Such temporary increases are generally uncommitted and, like permanent increases, subject to the delivery of an increase request, the absence of credit facility defaults and the payment of a fee for the temporary increase. Temporary increase loans are also usually subject to the same terms and conditions as other loans under the facility, other than the maturity. Due to the earlier temporary increase maturity date, the credit agreement will need to permit the non-*pro rata* payment of the temporary increase loans at their maturity.

Incorporating flexibility for both permanent and temporary upsizes into the loan documentation can allow for streamlined, cost-efficient and faster execution as and when increased borrowing capacity is needed. A further benefit to providing these features in a credit facility is that, by timing permanent and temporary increases in the facility size to the fund's investment needs and borrowing base, the fund can avoid paying upfront and unused commitment fees on a larger facility size than either its borrowing base can support or its borrowing needs warrant.

As the subscription facility market has evolved, facilities are now commonly offered with longer tenors and with the flexibility to extend the stated maturity date for one or more additional periods. Similar to the upsize features, these maturity extension options are subject to the absence of defaults and the payment of an agreed fee and are often subject to the consent of the extending lenders. However, some facilities offer a committed extension feature or a combination of committed and uncommitted extensions. Whether the fund chooses to extend the full amount of its facility, or only a portion, will depend on its borrowing base and borrowing needs. For example, if a fund is later in its life, has already deployed significant capital and is nearing the end of its investment period, it may request that only a portion of its facility be extended. Additionally, a fund borrower may want the flexibility to extend

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the maturity of its facility even after the fund's investment period has terminated, so as to finance follow-on investments and any fund expenses. The key in such a circumstance is to ensure that the fund's partnership agreement permits the fund to call capital after the end of the investment period to repay any such new borrowings as well as borrowings incurred prior to the end of the investment period.

Additionally, providing capacity in the loan documents for borrowings and letters of credit to be made available in multiple currencies can be an essential element for fund sponsors with global investment strategies. With a multi-currency option, a fund can borrow and repay in foreign currencies and thereby better manage its foreign currency exposure. At the same time, however, lenders will want to protect against currency movements by reducing the borrowing base by an agreed foreign currency reserve to the extent that there are foreign currency loans and letters of credit outstanding under the subscription facility. The amount of the reserve and the frequency with which it is calculated should be carefully negotiated by the borrower and its lender. For example, although it is reasonable to calculate the foreign currency reserve at the time an alternative currency loan is made, and on a periodic basis while such alternative currency loan is outstanding, it is not reasonable to recalculate the borrowing base daily or with each currency fluctuation. Also, in the event that a borrowing base deficiency were to result from a significant currency fluctuation, as with any mandatory prepayment, the borrower should be given sufficient time to call capital to cure such deficiency. Borrowers should also be cognizant that borrowing requests in alternative currencies may require additional time for lenders to process and that not all lenders have capacity to lend in all currencies.

Types of credit extensions and timing of credit extension requests

For certain funds, particularly those that make investments in the infrastructure, real estate and energy sectors, it is helpful if the subscription facility provides flexibility for the issuance of letters of credit in order to support those investments and advance the fund's investment strategy. If there is such a letter of credit sub-facility, the fund sponsor will want to consider the rating of the letter of credit issuer to ensure that a proposed beneficiary will accept a letter of credit issued under the subscription facility. Also, in the event of a drawing under a letter of credit, the borrower will want the credit facility to include a mechanic whereby any such drawing may be repaid or automatically converted into a loan without the need to submit a notice of borrowing or satisfy any minimum borrowing amounts.

A fund may also want the flexibility to borrow on a same-day basis under its credit facility. Although loans under a subscription facility are typically made available in one to four business days (which is far less than the 10 to 15 business days necessary for the fund's general partner to call capital from investors), having same-day borrowing capacity can be a particularly helpful feature for some funds. Even if not all lenders can offer same-day borrowings, or cannot offer same-day borrowings in certain foreign currencies, the borrower will want to discuss with its lenders whether a portion of the subscription facility can be made available on a same-day basis, which lenders are able to make same-day loans, and the currencies in which such same-day loans will be available.

Other fund sponsors may wish to build in secured hedging capacity. Hedge providers benefit because the hedges are secured by the same collateral that secures loans and letters of credit under the subscription facility. At the same time, the fund may benefit because the pricing for the secured hedge will be more favorable than would be available without such collateral security. In discussing a secured hedging option, the borrower and its lenders will want to

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consider whether to impose caps such that neither the aggregate hedging exposure, nor any single lender, receives a disproportionate benefit from such collateral sharing.

Borrowers under the subscription facility

As fund sponsors have broadened their investor base, fund structures have grown increasingly complex. Funds that used to operate as a single limited partnership now encompass various entities, including parallel funds, alternative investment vehicles, and funds-of-one. As a result, fund sponsors want flexibility to join many of these other entities as borrowers under a single subscription facility as well as holding or portfolio companies (i.e., "qualified borrowers") that sit below the fund level.

In order to address the preferences of certain investors, including, for example, tax sensitive investors, a fund sponsor may offer investors the option of investing in a parallel fund. Such parallel fund has a separate pool of investor commitments and typically invests on a *pro rata* basis with its related main fund. The fund sponsor will want flexibility to add these parallel funds as borrowers, on a several basis, so that they may borrow under the subscription facility to pay for their share of a particular investment. Lenders are generally amenable to parallel fund joinders, subject to customary loan and security documentation and deliverables such as authorizing resolutions and legal opinions.

The limited partnership agreement of a fund will often contemplate that, whether due to tax, regulatory or other reasons, investments may be made through one or more alternative investment vehicles ("AIVs"). Each AIV has the same ability to call capital as its related main fund or parallel fund and may have the same borrowing needs. If the subscription facility is secured by uncalled capital, lenders may want AIVs to join the credit facility as borrowers so as to avoid collateral leakage. Similarly, the fund will often want the flexibility to join its AIVs as borrowers, each on a several basis, so that each AIV can borrow to make its investments. However, in some cases, the fund may not need an AIV to join as a borrower. For example, an AIV may have been formed to make a single investment that will be funded with capital contributions, rather than borrowings. In such a case, having the flexibility not to join an AIV as a borrower benefits the fund by avoiding the unnecessary expense of a joinder and the attendant security documents and deliverables. Given the tension between the possibility of collateral leakage against the expense of joinder, a possible compromise is to agree on a "non-borrower AIV basket" such that the aggregate amount of capital contributions that can be made to non-borrower AIVs does not exceed an agreed percentage of total capital commitments to the fund borrowers.

A qualified borrower does not have the ability to call from the fund's uncalled capital and, as a result, does not provide collateral to secure its obligations as a borrower under the subscription facility. Instead, the lenders look to the applicable fund-level borrower (whether the main fund, a parallel fund or one of their respective AIVs) to guarantee the qualified borrower's loans and letter of credit exposure. That fund-level guarantee is secured by the same collateral that secures the guarantor's direct obligations as a borrower under the subscription facility. Due to this secured, fund-level guarantee, lenders are willing to extend loans and letters of credit for the benefit of qualified borrowers under the fund's subscription line, often at more favorable pricing than the qualified borrowers could have obtained outside of the subscription facility. The ability to add a qualified borrower can also be especially useful as a bridge to a more permanent financing at the portfolio company level.

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Efficiency

Subscription facilities are not a one-size-fits-all product, and each fund will need a tailored subscription facility to address the specific features of that fund, including its investor base, investment strategy, and borrowing needs. Similarly, what a lender can offer a fund sponsor will vary greatly depending on the particularities of the fund borrower and the terms necessary for the lender to obtain internal credit approvals. However, by starting with an agreed form of loan documentation as a precedent, fund sponsors and lenders can facilitate the timely execution and implementation of a subscription facility and streamline the negotiation process as well as ongoing compliance.

Agreed precedent

For sponsors with multiple funds, each with its own subscription facility, it is important from an efficiency perspective to standardize, as much as possible, the ongoing reporting requirements and other covenants included in the facilities. It is in all parties' interests to ensure that, once a subscription facility is implemented, the fund borrower complies with all of its obligations thereunder. Using the same template for loan documents across multiple funds will not only ease the administrative burden on the sponsor, it will also help to facilitate compliance across different fund subscription facilities and thereby avoid a "foot-fault" that could result in a technical event of default. The ramifications of an event of default under a subscription facility are significant. During an event of default, the fund borrower will not be permitted to borrow or make distributions to its investors. Further, the fund's investment activities will be limited, as it will only be able to call capital and withdraw funds from the pledged collateral account in order to repay its outstanding obligations under the subscription facility.

Along these lines, the key for fund sponsors and lenders is to focus on how to streamline reporting obligations under a subscription facility so that the lenders receive useful information in a timely manner while not imposing an undue burden on the credit parties to provide such information. If aggregate investor commitments are substantially larger than the subscription facility size, the parties may wish to consider limiting fund reporting regarding changes in the fund's investor base to a quarterly obligation unless there has been a significant change during such quarter. For example, the fund would report investor transfers on a quarterly basis with the delivery of its financial information but, if during such quarter more than an agreed percentage of the fund's investor capital commitments were transferred, the fund would promptly report such transfers to the lender.

In the unlikely circumstance that the fund's lender elects to exercise its remedies during an event of default, it is in all parties' interests to incorporate a standstill period so that, following notice from the lender that it intends to issue a call capital notice, the fund's general partner is given the first opportunity to do so. During the standstill, the fund's general partner would be permitted to issue a capital call notice, collect investor capital contributions into the collateral account that has been pledged by the fund to the lender, and apply those amounts to the fund's outstanding subscription facility obligations. This approach is more efficient because the fund's general partner has the processes in place to issue capital calls expeditiously, and investors are accustomed to receiving capital call notices from the general partner on a regular basis. Moreover, all parties want to avoid the possibility of spooking investors with a capital call issued by the fund's lender. Notwithstanding a brief standstill before the lender may issue a capital call to investors, there would be no limitation during the standstill period on the lender's authority to take control of any pledged collateral account during an event of default.

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In addition to facilitating compliance by starting with an agreed form of credit agreement, negotiating certain forms of exhibits up front can help to keep legal costs down during the term of the subscription facility and allow for easier and quicker execution. For example, fund sponsors and lenders may consider negotiating forms of loan documents at the initial closing of the subscription facility that can be used for: (1) future temporary and permanent upsizes, (2) extensions of the stated maturity date, and (3) joinders of parallel funds, AIVs and other entities as new borrowers. If the resolutions and legal opinions that are delivered at the initial closing of the subscription facility authorize and cover future facility increases and tenor extensions, fund sponsors can save some costs and streamline the documentation needed to implement such changes to the subscription facility. Similarly, lenders may be willing to forego legal opinions for AIV borrower joinders if the jurisdiction of formation and fund structure of the new AIV borrower is identical to, and the partnership agreement is substantially consistent with, that of an existing borrower for which a legal opinion was previously delivered.

Other creative solutions

Umbrella documentation may be another creative solution for a fund sponsor that is focused on limiting costs associated with implementing separate subscription facilities for similarly situated funds that do not invest in parallel. With an umbrella facility, the initial fund borrower and its lender, together with their counsel, negotiate a base credit agreement that sets forth the borrowing mechanics, representations, covenants and defaults that apply to the initial borrower and each other fund entity that may be added as a borrower. As future funds are formed, each may adopt the same base credit documentation, together with a loan addendum that provides for the economic and other terms that are specific to such new fund borrower, including its facility size, pricing, tenor and borrowing base. This approach can facilitate execution for future funds as the base credit agreement and exhibits are not re-negotiated for each new fund, and can be adapted to address different lender syndicates for each new fund. At the same time, to the extent the lenders require modifications to take into account changes in law or operational requirements, the lenders and borrowers may agree to an amendment to the base credit agreement that will be effective for all or any subset of fund borrowers thereunder.

Another concern of fund sponsors is minimizing the time and expense associated with adding offshore entities as borrowers under their subscription facilities. As funds have broadened their investor bases to European, Asian and other foreign investors, it is common for a fund structure to include one or more Cayman, Canadian, Luxembourg or other offshore entities, all of which may have borrowing needs. In those cases, local counsel are engaged to review the loan and security documents (which, in US deals, are often governed by New York law), prepare customary authorizing resolutions and provide legal opinions as to the offshore entities. In addition, to the extent that a lender feels strongly that local law pledges are necessary in a particular jurisdiction, local counsel will need to be involved in the preparation and negotiation of that security documentation as well. These additional agreements should be considered "belt-and-suspenders" for lenders to ensure the creation and priority of their security interests under the applicable local law as well as the ability to enforce locally in the unlikely event of an exercise of remedies.

Absent any specific local law requirements for the creation and perfection of the security, the collateral package, covenants and reporting obligations in any local law security agreement should not extend beyond what has been negotiated in the credit agreement or New York

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law governed security documentation. For example, if the parties have agreed during the subscription facility negotiations that investors are not required to provide investor consent letters to lenders, any notice to investors that is sent out to comply with local law perfection requirements should not require countersignature by investors. In order to simplify and streamline the preparation and execution of these local law security documents, and facilitate fund compliance, it may be more efficient to use the negotiated New York law documentation as the base for such local law documentation. That base document would then be revised to change the governing law and incorporate such other changes as are necessary to address applicable local law collateral requirements. In that way, the parties may avoid inadvertently agreeing, in a local law document, to a substantive provision that is inconsistent with the negotiated, business arrangement.

Conclusion

Fund sponsors want subscription facilities with terms that take into account each fund's unique investor base, investment objectives, structure and borrowing needs. Fund sponsors also seek efficiencies, across fund types and facilities, in order to streamline execution, minimize costs, avoid undue administrative burdens and facilitate compliance. As a result of ongoing dialogue among fund sponsors, lenders and their counsel, subscription facility terms have continued to evolve to take into account these objectives. Subscription facilities now routinely include features to add new borrowers, extend tenors and increase facility sizes using pre-agreed forms, thereby giving borrowers the flexibility and efficiencies they require. At the same time, lenders have broadened their relationships with fund sponsors as they are now lending to multiple fund entities and related borrowers, in larger amounts and over a longer tenor. As it adapts to these changes, the subscription facility market remains a relationship-centered business where all parties can find common ground as they craft creative solutions to address the complexities of fund structures and financing needs while achieving a commercial result that works for both borrowers and lenders.

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Mary and her team regularly work on a wide variety of fund level financings, including secured and unsecured subscription (or capital call) facilities, with borrowing capacity for the fund as well as its parallel funds, alternative investment vehicles and portfolio companies. Mary serves as Vice Chairman, and member of the Board, of the Fund Finance Association and as Co-Chair of the U.S. Committee of Women in Fund Finance.

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