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FUND FINANCE FRIDAY

Navigating Capital Call Facilities

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When the fund finance market began to develop in the UK in the early 2000s, it was not uncommon for standard capital call facilities to include various financial covenants regarding the performance of the underlying assets of the fund, including net asset value ("NAV") and loan-to-value ("LTV") tests. Since then, the fund finance market has rapidly evolved, moving away from the use of these provisions in "pure" capital call facilities in favour of their inclusion in genuine hybrid or asset-backed fund finance deals.

Despite this, recent developments in the private equity market have given lenders pause. Increasingly, lenders under standard capital call facilities are placing greater importance on the underlying assets of the fund.

It goes without saying that financial institutions providing capital call facilities will be primarily focused on the uncalled commitments of the investors; for standard subscription lines, the uncalled commitments are the bank's primary source of repayment. The value applied to the uncalled capital by the bank (whether using a borrowing base or coverage model) will therefore determine the amount such lender will make available to the borrower under the facility. That said, subscription line lenders' interests are not confined solely to the uncalled capital commitments of a fund, and the importance of the underlying assets should not be underestimated.

There are various reasons for this. A fundamental one is that, even where a lender has no security over the fund's underlying assets, they may still be available to the lender in an enforcement scenario (notwithstanding that a lender under a standard capital call facility will only be able to make a claim against the underlying assets of the fund on an unsecured basis and will most likely be subordinated to the claims of any asset-backed lender(s) of the fund). Putting the complexities of enforcement to one side, however, it is possible that the assets of the fund may provide additional recourse to a lender if it is unable to recover its debts via its security package (i.e., from the investors and any amounts held in a secured account).

Another important factor for lenders to consider is the impact that the performance of the underlying assets has on investor behaviour. If an investor's perception of its obligations to the fund is that it is "throwing good money after bad," it may seek to avoid or renege on its commitment to provide further capital. Conversely, where an investor is aware the fund has valuable "assets in the ground," the investor has a far greater incentive to comply with its contractual obligations under the fund documents. Of course, none of this is to suggest that any investor will have any legal right to avoid honouring its contractual commitments, but it is clearly preferable for a lender to try avoid any such scenario occurring altogether.

NAV and asset coverage tests can certainly give comfort to lenders, but they are not the only solution available in the subscription line market. There are a range of additional contractual protections that can be included in a capital call facility in order to address concerns regarding investor behaviour and/or the performance of a fund's underlying assets.