

Fund Finance Friday



Common Events of Default in Subscription Credit Facilities: How Parties End Up Here, and Recommendations for Avoiding Preventable EODs

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Private equity sponsors and their funds benefit from the flexibility of revolving credit facilities and the ability to borrow significant amounts of capital on short notice. But that fast access to liquidity can quickly be paused if an Event of Default (“EOD”) has occurred under the credit facility. This article provides a brief overview of why EODs matter, offers some examples of common EODs in subscription credit facilities and considers ways to help avoid them.

Why EODs Matter

EODs matter first and foremost because a lender needs to ensure the borrower’s ability to repay outstanding amounts under the credit facility and the lender’s interest in the collateral for repayment are not in danger throughout the life of the facility. If a borrower fails to pay outstanding amounts when due under the facility, has a substantial monetary judgment rendered against it, files for bankruptcy or reorganization or has another cataclysmic event, these serious issues could threaten a lender’s ability to recoup principal, interest and other amounts owing under the facility. EODs, particularly recurring instances of the same EOD or a series of EODs over time by a borrower, have the potential to strain the business relationship and trust between fund sponsors and lenders. Lenders generally consider EODs “uncurable” by the borrower, while a potential default – an event that, if not corrected, could lead to an EOD – can be cured by the borrower. That means EODs must be waived by lenders if they decide not to declare all amounts owing under a facility due and payable as a result of the EOD or exercise other remedies available to them at that time.

The occurrence of an EOD under a credit facility may indicate a potentially significant issue and freezes a fund’s ability to borrow so that an admin agent and lenders in a facility may assess the situation and consider the best path forward. This will often entail having legal counsel draft and negotiate a waiver letter detailing (1) the EOD that occurred, (2) the request by the borrower for the lenders to waive the EOD, (3) the lenders granting this request and (4) any remedial steps or waiver fees the borrower agrees to pay to allow it to resume borrowing in the normal course.

Waiver letters cost the borrower both time in having to focus on the EOD issue at hand and money due to legal costs. The borrower may also potentially face default interest rates being implemented by an admin agent as compensation for a lender’s increased risks and time spent remediating the situation. More importantly, EODs could cause a borrower to miss out on time-sensitive business opportunities while the borrower lacks its normal quick access to significant capital.

Common EODs in Subscription Credit Facilities

Truly problematic defaults are extremely rare in fund finance (we’re only aware of two in the history of the industry, each due to fraud). The types of EODs we see in practice are typically “foot fault” defaults that occur because a borrower took action for which it was unaware it would trigger an EOD under the credit facility. Subscription credit facility-related EODs may occur due to a lack of necessary preapproval or notice by the borrower to the admin agent of some event detailed in a credit facility, or the failure to provide the related investor or fund documents in a timely manner. This could happen when a borrower has separate operations and finance teams, or similarly when two separate law firms work on behalf of a borrower as fund counsel and finance counsel (or even two distinct practice groups within the same law firm) that are not in contact with one another about the requirements in the credit

agreement. For example, a borrower might request its fund counsel to take normally innocuous steps like amending the borrower's partnership agreement without realizing that notifying the admin agent under a credit facility and allowing the admin agent's finance counsel to review the draft amendment was a prerequisite for any such amendment.

The borrower could add new investors under its partnership agreement without timely notifying the admin agent and providing executed copies of subscription agreements, side letters, commitment increases for existing investors or related investor documents. Similarly, a borrower might facilitate the transfer of an investor's limited partnership interest in the borrower to a transferee without properly notifying the admin agent or providing executed copies after the transfer has been executed. Or a borrower might allow investors to elect into other investors' applicable side letter provisions via the "most favored nations" election process without the admin agent's awareness or providing executed copies – all potentially jeopardizing a lender's awareness of any risks with the investor pool, in addition to not having the necessary investor information for calling capital from investors to repay a facility, thus leading to an EOD.

Other common subscription credit facility EODs include the following: a borrower (1) misreporting the borrowing base or pool of investors and their commitment amounts in a periodic compliance certificate, (2) directing its investors to fund capital contributions to a bank account that has not been pledged as collateral for the credit facility, (3) calling capital from investors without notifying the admin agent by the required time, or (4) reaffirming representations and warranties and covenants from the credit agreement while an EOD, potential default or cash control event has already occurred and is continuing. Any of these events has the potential to disrupt an otherwise-functioning credit facility.

Ways to Help Prevent Avoidable EODs

A borrower maintaining active lines of communication between its fund and operations teams, as well as with external parties like its fund counsel, finance counsel and the admin agent, is one of the best ways to prevent avoidable EODs from occurring. Previewing for the admin agent and its counsel any planned amendments to the limited partnership agreement, investor transfers, new investor closes, the most favored nations election process, upcoming capital calls and related events will help all necessary parties stay on the same page in satisfying any preconditions before undergoing these types of transactions.

Credit agreements often can be lengthy and seemingly overwhelming legal documents unless someone has spent significant time learning the ins and outs of how they operate and the ongoing requirements of a borrower. A borrower should pay particular attention to the representations and warranties and covenants to ascertain its ongoing obligations over the life of the facility, since breaches of those provisions are generally what lead to EODs. The borrower could request its counsel or the admin agent's counsel to prepare a brief "cheat sheet" for a new credit facility that summarizes some of the key notice and delivery obligations of a borrower in its credit agreement. While this will add to total legal costs when finalizing the legal documents for a facility, if it helps prevent even one EOD, this proactive approach can reduce overall fees and end up being a worthwhile upfront cost – not to mention the saved time and energy for parties and counsel in avoiding EODs that might have otherwise occurred. The borrower should also revisit the representations and warranties and covenants from time to time to refresh its perspective on its continued compliance with the credit agreement.

Final Thoughts

EODs will temporarily freeze a borrower's ability to use the credit facility to facilitate acquisitions, investments or other expenditures and can cause concern for lenders. A borrower could unintentionally trigger an EOD in a subscription credit facility in a variety of ways. That being said, the vast majority of subscription credit facility EODs can be, and often are, quickly addressed by the parties and their counsel. One of the best ways to avoid EODs is the borrower maintaining open and regular communication with its internal finance and operations teams, external counsel, and the admin agent under a facility to help maintain the mutually beneficial and positive business relationship among the parties. Requesting the borrower's or admin agent's counsel to prepare a brief outline of some of the regular and ongoing notice or delivery requirements at the initial close of the credit facility can also help a borrower prevent common EODs from occurring during the life of the credit facility.