

FUND FINANCE FRIDAY

Who's in Front? Structuring Letters of Credit in Europe

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The Loan Market Association form, which is used as the basis for lending and facility mechanics in most European fund financings, contemplates a letter of credit structure where the issuing bank fronts the letter of credit on behalf of the other lenders.

As with other finance markets in Europe, including the leveraged loan market, subscription line lenders are becoming increasingly hesitant to take on the role of fronting issuing bank. In fact, more often than not, the usual LMA letter of credit provisions are amended in one way or another to remove the fronting aspect. Although there are variations on a theme, two main methods of dealing with the letter of credit mechanics are emerging.

The first, and perhaps most straightforward, is to remove the letter of credit provisions entirely and replace them with the LMA ancillary lender concept. This allows a lender to issue a letter of credit bilaterally but with the benefit of the transaction security and, if properly tracked through the document in line with the LMA form, the pro rata sharing between lenders (of commitment obligations and entitlement to repayment) should be preserved.

Although a seemingly straightforward solution, this option has several limitations: an individual lender must be willing to offer its commitment for use in the "ancillary" letter of credit, and there needs to be a lender with sufficient available commitment to issue a letter of credit of the size the borrower requires. Borrowers may also consider it a drawback that the ancillary facility is not committed (at least not on the basis of the LMA language, though this can be adjusted).

The second option that has emerged (which is where we see more variation) is to establish a structure where the day-one (or original) issuing bank issues a single letter of credit with a schedule annexing the participations of the various lenders in the letter of credit. The letter of credit provides that, although issued by the original issuing bank, recourse to the issuing bank is limited to the amount specified in the schedule and that the beneficiary must separately claim from the other lenders in the amounts set out in the schedule.

Again, at least from the lender perspective, this seems a straightforward solution but it also has limitations and, if not properly drafted, can cause issues with the pro rata sharing mechanics. For example, either appropriate adjustments need to be made to the pro rata mechanics or each lender must agree to be an issuing bank and participate in the letter of credit on a proportionate basis.

Issues also arise with respect to the ability to regulate a beneficiary making a claim against some but not all of the lenders and with lender transfers during the term of the letter of credit (which may require the letter of credit to be re-issued with an updated schedule of lender participations). Some lenders, when acting as the original issuing bank, also require exculpatory provisions from the other lenders regarding the beneficiary and underlying transaction to which the letter of credit relates.

A variation on the second method is to have each lender issue its own letter of credit for the amount of its participation, which can solve some of the lender-side issues but at the same time exacerbates others, particularly the risk of a beneficiary claiming against some but not all lenders. It also requires a beneficiary to be willing to receive a number of separate LCs, which borrowers and beneficiaries may find unappealing.

In the absence of a clear alternative to the LMA provisions, there are often variations on these two options, but the key themes of any structure should be that (i) there is no actual or quasi-fronting (for example, quasi-fronting can sometimes arise in the context of the "deemed loan" mechanic seen in some documents) and (ii) pro rata sharing must be preserved or appropriately addressed in the facility mechanics.