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Fund Finance Friday

Who (When) You Gonna Call?

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Traditionally, subscription finance facilities treat investors in two ways. For “regular” investors, they are either included or excluded from the borrowing base or leverage covenants depending on their financial status and/or their behaviour as investors. For investors which are also GPs or managers, the concerns are more around a change of control of the GP or manager or something worse (for example, a voluntary or even compulsory removal of a GP or manger and whether there is an acceptable replacement).

One common feature (whether for regular investors and/or the GP or manager) in traditional subscription facilities is that the focus has been pretty much exclusively on the investors themselves. For a “regular” investor to be excluded from the borrowing base (or the leverage covenant), the relevant event has to occur in respect of the investor itself. For a change of control to apply to a GP or manager, the relevant provisions are often drafted in such a way that the only relevant event will be a change in the direct ownership of that GP or manager. It will not often cover an insolvency of the owner of the GP or manager.

In some situations, these arrangements should be perfectly adequate, particularly where the investor is itself a substantive entity capable of providing the relevant commitments and/or operating in its own right and on its own behalf. But what happens where the investor (including the GP or manager) is not itself a substantive entity and is simply a vehicle for and reliant on another entity?

In that case, the risk becomes somewhat different, because if the investor is reliant on another entity either for funding and/or operations (and that other entity itself suffers from a change in financial status or behaviour) then that will obviously impact significantly on the investor itself. For a regular investor in this position, for example, an insolvency of the entity on which it is dependent for funding commitments could leave that investor clearly unable to fund those commitments (even if the investor itself had not been directly otherwise affected). For a GP or manager, an insolvency at a higher level could impact both on the ability of the GP to fund its own commitments—and that in itself could adversely affect the behaviour of other investors—and/or lead to difficulties in continuing to operate the fund (if the GP or manager is reliant on that entity for providing and paying for the relevant operational and management resources).

In effect, lenders have a choice: They can leave things as they are and wait for whatever happens at the level of an investor’s holding company or entity to impact directly on the investor itself; or they can consider whether they need to make changes to their documentation to ensure that where a significant event occurs at a higher level than the investor which impacts the investor that event will more immediately trigger an exclusion event from a borrowing base or leverage covenant or a change of control. We are increasingly seeing moves towards the latter approach.