

Fund Finance Friday



Permitted Indebtedness

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Before a subscription lender can enter into a subscription credit facility with a fund, the subscription lender will need to review the limited partnership agreement (“LPA”) of such fund to confirm the LPA allows for incurrence of indebtedness. Any “bankable” LPA will specifically provide for and allow such fund to incur indebtedness under a subscription credit facility.

Once a subscription lender has determined the LPA is “bankable”, in addition to numerous other considerations, the subscription lender will want to focus on the LPA provisions which discuss any other permitted debt or debt limitations under the LPA. A significant amount of LPAs will allow for additional indebtedness outside of a subscription credit facility to be incurred, such as whether the fund is allowed to enter into derivatives, provide guarantees, whether subsidiaries are permitted to incur debts and other certain types of indebtedness. Alternatively, some LPAs will also include certain debt limitations, which can include limitations that debt cannot be incurred in excess of a certain specific dollar amount, debt not to be in excess of a certain percentage of capital commitments and/or unfunded capital commitments and a host of other limitations depending on the size and type of the fund. The subscription lenders will want to focus on these items in order to determine how to structure the subscription credit agreement, to underwrite and account for any other permitted debt and debt limitations included in the LPA.

Typically, to address subscription lender concerns regarding debt, a subscription credit agreement will include a covenant that the credit parties or the partnership (the “Borrower”) will not incur any borrowings or other indebtedness that is not in compliance with its LPA (the “Standard Debt Covenant”). In many instances, the Standard Debt Covenant may be enough to satisfy the underwriting requirements of the subscription lenders. However, the subscription lenders may also want to consider if further debt limitations should be put in place in the instance the LPA allows for certain incurrences of debt that could be problematic for the subscription lenders. Further, although the credit agreement will already covenant that the subscription lenders have a first priority lien over the uncalled capital commitments of the limited partners (the “Collateral”), by including additional debt limitations beyond the Standard Debt Covenant, the subscription lenders can try to account for and prevent a scenario where lenders outside of the subscription credit facility may look to enforce their rights against the Borrower (or the assets of the Borrower) if the Borrower were to default. Such enforcement could result in potential events of default under the subscription credit agreement depending on how such agreement is structured, or could cause the Borrower to drag the subscription lenders into other potential problems.

For instance, if the LPA allows for subsidiaries of the Borrower to incur indebtedness, then the Standard Debt Covenant would not prevent subsidiaries owned by the Borrower from incurring debt against their assets and/or prevent the Borrower using its equity interests in its subsidiaries as collateral to take on additional debt. In other examples, the Borrower could also provide a guaranty for its subsidiaries or take unsecured additional debt if allowed under the LPA. As noted above, this would not impact the first lien priority over the Collateral, but could create a scenario where Borrower assets are pledged to lenders outside of the subscription facility and thus limit the subscription facility lenders’ ability to collect against assets outside of the Collateral in a default scenario under the subscription credit facility.

Further, even if the Standard Debt Covenant is included and the LPA provides for sufficient debt limitations as originally drafted for purposes of the underwriting requirements of the subscription lenders, a potential issue could occur when

the LPA allows for any committee of the Borrower (the "Management Committee") to change the debt limitations of the LPA without the need for an amendment to the LPA (noting in such instance, the typical covenant in the subscription credit agreement that any material amendment to the LPA requires the Administrative Agent and/or some type of subscription lender consent may not apply in such scenario). If the LPA allows for such modification by the Management Committee, this creates a potential scenario where the original LPA debt limitations can be changed without the need for any Administrative Agent or subscription lender consent.

One way to prevent this potential issue from occurring would be to bake any debt limitations directly into the debt covenant specifically, rather than only including the Standard Debt Covenant (i.e., if the LPA provides for a debt limitation of 25% of the uncalled capital commitments of the limited partners, the covenant should specifically include this limitation). This way, even if the Management Committee were to change the debt limitations included in the LPA, the debt covenant would still prevent the limited partnership from incurring debt in an amount that was not originally underwritten for pursuant to the original LPA debt limitations.

As always, subscription facility lenders will need to review the LPAs to determine the type of debt that is allowed to be incurred under such agreements and tailor the relevant debt covenants accordingly to ensure the subscription credit agreement addresses any subscription lender concerns relating to indebtedness. Although any subscription credit agreement will almost certainly have covenants and restrictions which would prevent incurring indebtedness against any of the Collateral, subscription lenders will still want to be aware and consider the impact of other types of indebtedness incurred by the Borrower(s) (or its subsidiaries), as such indebtedness could restrict the ability of the subscription lenders from collecting on the other assets and/or investments of the Borrower outside of the Collateral in any enforcement scenario.

This is a very broad overview on the concept of how debt limitations can be handled in a subscription credit agreement. There are numerous variations on the covenants lenders might include for any debt limitations. As always, if there are any issues or questions that arise in connection with debt limitations or any other concepts discussed herein, we here at CWT are always happy to assist to provide any such guidance.