

Fund Finance Friday



Letter of Credit Refresher

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Many subscription credit facilities will provide for the issuance of letters of credit in addition to the funding of loans. A letter of credit is an irrevocable undertaking for the payment of money issued by a bank at the request of a borrower in favor of a third-party beneficiary. The inclusion of letter of credit flexibility in loan documents provides borrowers with an instrument for future business with third-parties while avoiding, at times, the need to negotiate a “new” loan or guaranty.

This article will discuss the typical mechanics and elements of letters of credit under a subscription credit facility.

In transactions that include letter of credit optionality, borrowers may submit a request for a letter of credit, which will include a borrowing base certificate and a letter of credit application. Typically, the loan documents will contain language that all letters of credit will be in a form satisfactory to the letter of credit issuer and consistent with the terms of the letter of credit application. The conditions precedent for a letter of credit are usually identical to a standard borrowing request: i.e., a bring down of the representations and warranties in the credit agreement, confirmation that no event of default or potential default has occurred or will occur as a result of the letter of credit, confirmation that the principal obligations will not exceed the available commitment, and confirmation that the letter of credit liability will not exceed the letter of credit sublimit (if applicable).

Letters of credit under subscription credit facilities are usually standby letters of credit, meaning that a third-party beneficiary may draw on the letter of credit on demand. If a letter of credit has been issued to a third-party beneficiary and the third-party beneficiary draws on the letter of credit, the letter of credit issuer will provide the requested funds. The loan documents will include language that the borrower has authorized the lenders to disburse directly, as a borrowing or loan, the drawn amount under such letter of credit, plus all interest and fees due to the letter of credit issuer. As a result, both (i) the aggregate amount of the undrawn stated amount of all outstanding letters of credit and (ii) the aggregate amount drawn under letters of credit for which the letter of credit issuer and the lenders have not yet received payment or reimbursement will be considered as part of the letter of credit liability and a principal obligation under the subscription credit facility.

Most syndicated subscription credit facilities will require that all lenders participate in letters of credit on a pro rata basis, sharing in all rights and obligations resulting from the letter of credit, including (i) the right to receive any reimbursement of the amount drawn under the letter of credit, (ii) the right to receive fees that are payable under the terms of the subscription credit facility, and (iii) the obligation to pay any unreimbursed drawing under a letter of credit. However, some syndicated subscription credit facilities may permit the lenders to determine prior to the issuance of each letter of credit whether to participate in such letter of credit and the amount or percentage of its participation therein.

Letters of credit under subscription credit facilities are customarily secured by the collateral on the same basis as loans. The expiration date of a letter of credit is normally twelve months after the date of issuance with the ability to renew and with the limitation that no letter of credit will expire on a date that is more than twelve months after the maturity date. Most subscription credit facilities will require that any letter of credit that expires more than thirty days past the maturity date will be cash collateralized on or prior to the maturity date. Borrowers may also cash collateralize letters of credit to reduce the letter of credit liability below the available commitment or the letter of credit sublimit (if

applicable). Typically, subscription credit facilities require that letters of credit be cash collateralized with the proceeds of capital calls funded to a cash collateral account separate from the subscription facility collateral account. A segregated cash collateral account allows the borrowers to have access to their subscription facility collateral accounts (absent a default or cash control event) while the lenders retain cash collateral related to the letter of credit liability on a segregated basis. Upon the expiration of all letters of credit and after all obligations related to the letters of credit, including the letter of credit liability, are fully paid, the balance of cash held in the cash collateral account shall be returned to the borrowers.