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Fund Finance Friday

Turning Off the Taps: Drawstops in Fund Finance

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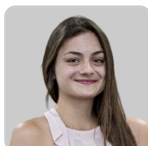

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1. Overview

The term "drawstop" colloquially refers to a provision in a credit facility agreement that entitles lenders to stop advancing loans under a facility upon the occurrence of certain specified events. For most deals, the relevant events would include a default continuing under the facility agreement and any "Repeating Representations" being inaccurate. The list of drawstops is often supplemented by deal-specific events and, in the context of fund finance transactions, various additional events that are explored in further detail below. Given the importance for borrowers of ensuring they have access to liquidity, drawstops are often the subject of intense negotiation.

For obvious reasons, drawstops are most important (and most heavily negotiated) when the facility can be utilised over an extended period of time, i.e. in the context of revolving credit facilities, delayed draw term loans and facilities with an accordion feature that can be exercised at a future date. Lenders rely on drawstops as important guardrails, ensuring that borrowers remain compliant with the terms of the financing (and that the lenders can stop funding where this is not the case).

Drawstops are also seen as an appropriate intermediate means of addressing issues impacting the borrower that may not be sufficiently serious to entitle the lenders to demand early repayment of outstanding loans, but are, nevertheless, important enough for the lenders to stop advancing new loans. On the other hand, borrowers will want to ensure that the availability of the facility, which may be crucial to their on-going operations or investment activities, is not interrupted by defaults that may be seen as insignificant (or so-called "hair-trigger" events).

Indeed, borrowers sometimes view drawstops as a "nuclear option", noting that they are *automatic* (as lenders do not need to take any steps for a drawstop to apply, whereas accelerating existing loans would typically require positive action on the part of the lenders). In addition, sponsors may try to resist drawstops on the basis that the unavailability of the facility can drive borrowers into further defaults - due to a failure to meet investment commitments that were intended to be funded by the facility, for example. This dynamic often creates points of contention, and we outline the points we see most frequently debated in the current market in Section 4 below.

2. Drawstops Specific to Subscription Line Facilities

Drawstops are an important feature of most subscription line facilities, since such facilities are typically structured as revolving credit facilities available for utilisation for one to two years (often subject to further extensions). Given that the lenders' primary recourse on subscription line deals is to the investors' capital commitments to the obligor fund(s), deal-specific drawstops often look to address provisions in the fund documents that would entitle the investors to stop funding (or limit the circumstances in which they may be required to fund), as well as events that may make investors less inclined to fund, even where they may be contractually obliged to do so. The deal-specific drawstops we see most commonly included on subscription line deals are:

a. **Suspension Events / Key Person Events:** Fund documents usually include provisions pursuant to which the investment period of the fund is suspended upon the occurrence of certain issues, and prematurely terminated if such issues are not resolved within a prescribed cure period. The suspension events would almost always include the departure of person(s) key to the management of the fund (i.e. a "key person event"), and are sometimes supplemented by further events upon which an investor may need to revisit its investment in the relevant fund, such as a change of control of the fund manager.

   Typically, the investment period would be suspended immediately upon the occurrence of a "suspension event" or "key person event", and prematurely terminated if such event is not resolved within six to twelve months. As the fund's ability to draw capital from its investors is often limited during a suspension, and following the termination of, the investment period, lenders may feel that the occurrence of any suspension event should constitute a drawstop under a subscription line.

   However, as the subline market has matured, funds have become increasingly focused on ensuring that their fund documents include lender friendly protections, including provisions ensuring that capital calls issued for the purposes of repaying debt are permitted during a suspension period or following the termination of the investment period. Where such protections feature in the fund documents, borrowers may argue that utilisations of subscription line facilities should be restricted following the occurrence only to the extent that the fund would not be allowed to call capital to repay debt incurred following such suspension or termination of the investment period.

   However, often subscription line lenders will push back - arguing that the suspension should still be a drawstop in all cases, noting that the suspension in and of itself signals issues at fund level. A common compromise is that the drawstop only applies a few months after the initial suspension event, but still well before a termination of the investment period.

b. **Senior management withdrawals:** Subscription line facility agreements often include a drawstop upon the withdrawal of senior fund managers where such withdrawal results from allegations of misconduct by the investors or a regulator. Such drawstops are often included regardless of whether such withdrawal would restrict the fund's powers to call capital from the investors under the fund documents, as a withdrawal in such circumstances is likely to make the investors more likely to try to exit the fund or resist funding capital calls.

3. Drawstops Specific to NAV Facilities

Drawstops are an important tool in the context of NAV facility agreements. Although NAV facilities are typically structured as term loans that are drawn in full on closing, they can also be structured with revolving facilities or as delayed draw term loans (with a 1-2 year availability period).

Deal-specific drawstops ensure that the lenders are not required to fund new loans when the value of their collateral may be eroded (or, sometimes, where such value is not capable of being determined at the time), and to ensure that the proceeds of any loans are being applied towards the originally envisaged purpose (e.g. a specific new investment or any deferred consideration due in respect of existing investments). The deal-specific drawstops we commonly see in NAV facility agreements include:

a. **Pro-forma LTV compliance:** Borrowers would typically be required to demonstrate that the loan-to-value ("**LTV**") ratio, *pro forma* for the proposed utilisation (and, sometimes, fulfilment of the purposes for which the proceeds of such utilisation are to be used, such as the acquisition of new investments) is not higher than a specified threshold (which is frequently set slightly lower than the threshold at which the LTV financial covenant would be breached). Such a drawstop makes sense in the context of NAV facilities where the LTV exceeding a specific threshold triggers a cash sweep; lenders will be reluctant to make new money loans available at the same time they are expecting to be repaid via the cash sweep mechanics.

b. **Documents concerning any new investments:** Borrowers are often required deliver certain documents and evidence concerning any investments that are to be funded with the proceeds of a proposed utilisation, such as the documents concerning the relevant acquisition and a master schedule of the investments forming part of the NAV, updated on a *pro forma* basis to include details of any new investment(s).

   Provision of this information enables the lenders to monitor whether any loans are applied towards the originally envisaged purposes, determine whether any new investments qualify as "eligible" and check calculations as to pro forma compliance with the LTV ratio. In addition, where the proposed loan is to be utilised to fund the acquisition of a new investment, the lenders may require evidence that all conditions precedent to such

acquisition under the relevant acquisition documents (other than payment of the purchase price) have been satisfied and evidence that the borrower has received (typically from its parent fund) the amount needed to fund the portion of such investment that is to be funded by way of equity.

c. **Valuation challenge:** Where the facility agreement includes valuation challenge mechanics, lenders will often seek to block utilisations of the facility when a valuation challenge is underway, as the value of the collateral and the accuracy of any computations as to LTV compliance may be uncertain at such times.

4. Points of Contention

In the context of fund finance transactions, various points concerning drawstops and related provisions in the finance documents are subject to intense negotiation. Many such points are beyond the scope of this article, but examples of points we commonly see negotiated include:

a. **Default, Event of Default or Material Event of Default:** Under the different forms of facility agreement recommended by the Loan Market Association (LMA), “new money” loans are restricted following the occurrence of a Default that is continuing, whereas “rollover” loans are only restricted following the occurrence of an Event of Default that is continuing.

   Lenders are typically comfortable allowing rollovers to continue unless an Event of Default is continuing, on the same basis on which they are fine not to require the repayment of money that has already been advanced until an Event of Default (as opposed to a Default) is continuing. In a borrower-friendly market, top sponsors will sometimes successfully argue that the drawstop in respect of “new money” loans should only apply following an Event of Default (rather than a Default), or that the drawstop in respect of rollovers should apply only upon the occurrence of a “Material Event of Default” (usually limited to serious Events of Default such as non-payment, insolvency and insolvency-like events, invalidity or repudiation of the finance documents etc.) or an Acceleration Event.

   Whether such positions are agreed remains a point of constant debate: some lenders may be able to accommodate this position provided they are not required to fund into a financial covenant breach. However, many bank lenders will resist such positions on the basis of strict internal policy requirements.

b. **Repeating Representations & materiality:** As noted above, it is typical to include a drawstop where Repeating Representations are untrue or inaccurate. Borrower counsel will often push for a materiality qualifier such that the drawstop will only apply where such Repeating Representations are not “true and accurate in all material respects”. Where this position is agreed, lender counsel may push to carve out any Repeating Representations that are already qualified by materiality themselves in order to avoid a “double” materiality qualifier. In our experience, borrowers typically accept such carve-outs.

Drawstops remain a crucial protection for lenders in fund finance transactions. The scope, extent and exact formulation of these provisions are key points of negotiation for lawyers and their clients. The interaction between the drawstop regime and the remaining protections set out the financing documents can be complex and clients are advised to think carefully (and consult legal counsel) when negotiating such provisions.