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Fund Finance Friday

Side Letter Diligence: Considerations for Subscription Lenders

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As the subscription credit market continues to mature, side letter diligence has remained a key component of both underwriting and credit agreement negotiation. Investor side letters often address matters specific to an investor's legal, regulatory, tax or policy requirements, but certain provisions can directly affect a lender's borrowing base analysis and the practical administration of the facility.

For lenders and administrative agents, the central question is whether a side letter provision could impair the fund's ability to call capital from investors to repay outstanding facility obligations. Some provisions, such as cease funding rights, raise this issue directly. Others, such as most favored nations provisions, may raise it indirectly by allowing a problematic right granted to one investor to spread. Additionally, other provisions may not eliminate an investor's funding obligation, but can affect capital call mechanics, overcall flexibility, borrowing base eligibility or enforcement strategy.

Cease Funding Rights

Cease funding rights are often among the most important side letter provisions reviewed by subscription lenders. These provisions may permit an investor to suspend or terminate its obligation to fund future capital contributions upon the occurrence of certain events, including a change in law, regulatory issue, violation of internal policy or other investor-specific trigger.

For lenders, the key analysis is whether the investor remains obligated to fund capital contributions to the extent attributable to indebtedness incurred prior to the exercise or effectiveness of such right. This savings language, which is becoming more commonplace, preserves the lender's expectation that commitments supporting existing borrowings remain available for repayment, even if the investor is excused from funding future investments or obligations.

Where this language is included, lenders are generally more comfortable analyzing the investor for borrowing base inclusion. Where an investor has a broad cease funding right without a carve-out for prior indebtedness, lenders will often require that investor to be excluded from the borrowing base. The concern is not necessarily the investor's credit quality, but the mismatch between the lender's reliance on the uncalled commitment and the investor's ability to decline future funding.

Certain investors may not be amenable to lender-friendly revisions, particularly where the provision is tied to statutory, regulatory or policy requirements. If the investor has a sizable commitment or is otherwise important to the borrowing base, lenders may consider whether the risk can be addressed through the credit documentation. Potential mitigants include clean-downs, concentration limits, exclusion events, investor-specific advance rates or other tailored borrowing base mechanics.

Most Favored Nations

Most-Favored-Nations provisions ("MFNs") are another important focal point. MFNs generally permit an investor to elect the benefit of more favorable rights granted to other investors, subject to the applicable fund documents and side letters. While common in private fund structures, MFNs can create concerns for lenders if problematic rights are capable of spreading across the investor base.

The key issue is whether a provision that may be manageable when granted to one investor becomes more significant if elected by multiple investors. For example, a cease funding right, excuse right, sovereign immunity-related provision or other investor-specific protection may be underwritten differently if it applies only to one investor with a limited commitment. If that same right is broadly available through an MFN election process, it could have a materially greater impact on the borrowing base and the lender's collateral analysis.

Lenders therefore focus on whether the MFN framework contains limitations designed to prevent investor-specific or otherwise problematic provisions from being elected by other investors. Common mitigating language may include carve-outs based on commitment size, so that only similarly situated investors with equal or greater commitments may elect certain rights. Lenders also look for exclusions covering rights specific to the type, status or jurisdiction of a particular investor, including rights arising from regulatory requirements, tax considerations, sovereign immunity concerns, governmental status, ERISA or public pension considerations, sanctions policies or other investor-specific legal or policy constraints.

In the credit documentation, lenders may negotiate rights to review and consent over material side letter amendments, including MFN elections that could adversely affect the borrowing base, lender remedies or the enforceability of capital contribution obligations. This material amendment process gives lenders a mechanism to monitor future side letter changes and prevent problematic provisions from expanding without lender input.

Other Side Letter Provisions

Lenders and administrative agents also review a number of other provisions that may affect their credit analysis or borrowing base treatment. These provisions may not raise the same direct enforceability concerns as a broad cease funding right, but they are important considerations during the diligence process.

One common example is an overcall limitation. Overcall provisions may limit the fund's ability to call capital from an investor in excess of a specified percentage of what otherwise was called, or may prohibit overcalls for specified purposes, such as management fees. Lenders focus on whether the limitation could impair the fund's ability to cover shortfalls created by other investors that fail to fund. Overcall limitations also raise MFN-related concerns because a limitation that is acceptable for one investor becomes a different analysis if a substantial portion of the borrowing base can elect the same protection.

Another side letter consideration is particular capital call mechanics since some investors require capital call notices to be delivered by an authorized signatory of the general partner, manager or other specified fund party, and may require evidence of incumbency. These provisions are generally administrative, but can become important in an enforcement scenario if the administrative agent is issuing capital calls on behalf of the fund. The issue is often addressed by including the administrative agent in the relevant incumbency certificate or otherwise acknowledging the lender as an authorized party in the event of an exercise of remedies.

Excuse, withdrawal and transfer-related rights are also important considerations. As the market has matured, these rights have become expected features of investor side letters. They are generally manageable, but can have borrowing base implications. If an investor may be excused from participating in certain investments or obligations, lenders will consider whether available uncalled capital may be reduced. Similarly, if an investor transfers its interest, lenders will focus on whether the replacement investor satisfies applicable eligibility criteria. These events are typically addressed in the credit documentation through borrowing base adjustments, excluded investor concepts, mandatory notices and ongoing reporting requirements.

Sovereign immunity provisions present their own unique set of issues, something **this newsletter examined on a state-by-state basis in its 13-part *Sovereign Immunity Series***. These provisions often arise with sovereign wealth funds, governmental entities, public pension plans and other investors connected to governmental bodies. The primary concern is whether sovereign immunity reservations could impair the enforceability of such investor's capital contribution obligations.

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One well-known example involves certain Texas governmental or public pension investors, which may raise diligence considerations due to Texas sovereign immunity principles and related limitations on contractual remedies against governmental entities. Where the concern is material, lenders may exclude the investor from the borrowing base. However, if such investor's commitment is important for the borrowing base, lenders may negotiate a hurdle investor

concept into the credit documentation. Once the hurdle investor has funded a meaningful portion, it has demonstrated performance under the fund documents and has sufficient “skin in the game” to provide additional comfort.

Concluding Thoughts

Side letter diligence is ultimately an exercise in identifying which investor-specific rights matter for facility purposes and determining how those rights should be treated within the borrowing base and credit agreement framework. Not every side letter provision presents a material lender issue, and many are expected features of modern private fund documentation. However, provisions affecting an investor’s funding obligation, the fund’s ability to overcall, capital call mechanics, MFN elections or enforceability of remedies are important considerations for lenders in the subscription credit context.

The market has developed numerous tools to manage these risks, including but not limited to investor exclusions, concentration limits, hurdle requirements, investor-specific advance rates, reporting requirements, clean-down provisions and Material Amendment protections. The value of side letter diligence is identifying key issues early in the deal process so that the lenders can adequately assess risk and negotiate mechanics in the credit documentation to meet their specific needs.