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Fund Finance Friday

Subscription Finance Loan Agreement Series — Part 3

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After the first two articles in the series, we continue through the form of Loan Agreement, this week focussing on a small but crucial part of the Agreement relating to the definition of "control" or "change of control" and how that applies and is used in a Loan Agreement for subscription/capital call facilities.

In many ways, the considerations that apply to this particular section of the Agreement are similar for a subscription/capital call facility as to any other type of facility. Essentially, the lenders want to know that if they have entered into credit arrangements on the basis that they are contracting with a particular entity, that entity will remain in control of the affairs of the fund or funds that are the borrowers or guarantors of the facility. The difference lies in how and where that control is exercised. Where the borrower is a fund, that borrower can have one or any number of investors. Its affairs will also typically be conducted via a general partner and/or manager rather than by the borrower itself.

So given these structural considerations, how should lenders approach the issue (and to what extent should lenders consider the investors themselves in the fund in the context of "control")? To answer the second question first, lenders will look at the fund's investors and their make-up. If the fund consists of a single investor (or of only two or three investors), or if there is a "cornerstone" investor or investors crucial to the continued viability of the fund, then lenders should consider including those investors in the definition of "control" and any change in any of those investors as a "change of control." However, if the fund has a wider multiple investor base (and particularly if, as is often the case, those investors can change over time) then this approach will generally be both impractical and unnecessary (since there is never a specific investor or group of investors that can be said to be crucial to remain in "control") and lenders will look to rely on alternatives.

Fundamentally, though, the most important "control" questions are who controls the general partner and/or manager of the fund (as it is these entities that will in practice run the fund and will be largely responsible for its success or failure). In making decisions as to whether to provide facilities to a fund, lenders will therefore look hard at the track record of the manager in particular and at who controls/owns the manager and the general partner, and they will expect that ownership/control to remain in place through the life of the facility. So any "change of control" provisions should precisely define what is envisaged by "control" of the manager and the general partner. Care should be taken to ensure that the "control" definition is extended far enough "up" the structure to identify those who in fact ultimately control the entities (and on whose control the lenders ultimately rely). Lenders (and their counsel) should also focus carefully on the nature of that "control." For example, in a corporate structure, reference to ownership or control by "shareholders" would normally be a sufficient definition, but in a fund structure (and some general partners or managers are themselves structured as funds) the "control" may be through investors or even a series of investors in that fund.

A related question (and one which lenders should be asking themselves specifically after recent events in the subscription finance/capital call market) is whether there is any need to add any further elements to the question of "control." Given the way in which these facilities have developed, the focus has traditionally been very much on the ultimate "ownership" of (or interests in) the general partner and the manager. However, in an insolvency situation, it is quite possible that while the ownership position will not change, the way in which that ownership is conducted may change fundamentally (in particular, if a liquidator or trustee in bankruptcy is appointed to the ultimate "controlling" entity). Such an event could in some circumstances have potentially significant knock-on effects on the ability of the general partner and/or the manager to continue to operate the fund and (or in the case of the general partner, which might also be an investor in the fund) to continue to fund investments. Where that is a concern, consideration may be given to whether an insolvency event should trigger similar consequences to any other change in control or ownership.

Once “control” and “change of control” have been properly defined, the usual convention is that a change of control will (as with any other type of facility) result in a draw stop (usually immediate or within a very short period) and/or a requirement to repay the facilities in full (usually referred to as a “mandatory prepayment”). The mandatory prepayment will usually be an option exercisable by the lenders, rather than an absolute requirement, and there will usually be a grace period allowed between the change of control occurring and any requirement to make a prepayment.

Finally, it is worth commenting on a couple of related issues. First, a fund will often want to retain an ability to change general partners and/or managers through the life of a facility for a mix of internal, tax or regulatory reasons. In the context of “control” and “change of control” only (other consequences will be discussed in subsequent articles in this series), that will generally be something lenders can consider permitting, provided the replacement general partner or manager remains in the ultimate “control” of the same entity or entities. Next is the question of “key person” provisions. For now, though, while the lenders (and indeed the investors) may rely on specific “key” individuals remaining actively involved in the management of a fund (so to that extent it is a similar “reliance” issue to that raised in this article on “control” and “change of control”), the treatment of it will be different. Again, we look forward to addressing this in a subsequent article or articles in this series.