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Fund Finance Friday

Subscription Finance Loan Agreement Series, Part 6 — Included Investors and Exclusion Events

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As we have discussed previously in this series, subscription financings usually adopt a borrowing base approach or a coverage/leverage approach to calculating investors' available commitments. Under the borrowing base approach, lenders calculate the borrowing base by applying different advance rates to different categories of investor (usually depending on internal and external ratings of the investors). Under the leverage/coverage approach, the lenders generally look at the whole investor base and apply a single debt ratio covenant to the total commitments. The borrower must comply with that covenant on an ongoing basis. In both approaches, investors will be excluded from the relevant calculations in certain circumstances, and the events which trigger such exclusion will be similar regardless of which approach is adopted.

Naturally, the terms setting out when an investor and/or its commitments will be included or excluded from the borrowing base or financial covenant calculations are vitally important to both lenders and borrowers. Lenders undertake due diligence on a fund's investors prior to entering into a financing and will agree with the fund if any of the initial investors are to be excluded. However, lenders must also be confident that if the circumstances of an investor changes such that the lenders are no longer willing to lend against that investor, it will be excluded from the borrowing base or leverage calculations. At the same time, from a borrower's point of view, it is important that an investor is not excluded from those calculations at a time when the investor's creditworthiness and reliability are not reasonably in doubt. A borrower will also look to avoid uncertainty as much as possible by ensuring that investors are excluded from any borrowing base or leverage calculation only in clearly defined circumstances.

The extent of the exclusion events that may be included in a facility agreement will depend on the particular circumstances, status and track record of the borrower. Common exclusion events that relate to the status and activities of an investor include the following:

- insolvency
- entry into insolvency proceedings
- being subject to or affected by sanctions
- failure to pay a capital call when due or other breach of the fund's formation documents
- failure to maintain a certain minimum credit rating or net worth
- exercise of rights under a "most-favoured nations" provision in a manner that is materially adverse to the lenders
- withdrawal from the fund
- transfer of its interest in the fund to another person
- excusal from making investments or redemption as a result of the operation of ERISA

A lender will also wish to exclude an investor if there are adverse changes to the investor's obligations under the fund's formation documents or related security. For this reason, exclusion events may also include some or all of the following:

- an investor's obligations under the partnership and subscription documents (in particular, its obligation to make capital calls) cease to be legal, valid and binding
- the investor and the fund enter into agreements which adversely affect the ability of the fund to call or receive

payments of capital
- security over the fund's call-down rights ceases to be effective and enforceable
- the investor repudiates or challenges its obligation to make capital calls
- the lender does not hold up-to-date information to enable it to enforce its security against any investor (*e.g.*, contact details of the investor)

Some of the events listed above will be subject to further refinement in negotiation. To take a couple of the more uncontroversial examples: (i) in respect of a failure to pay a capital call, it is often the case that an investor will not be excluded until a grace period has elapsed beyond the initial due date for the payment and (ii) in respect of a partial transfer, commonly only the amount of the commitment that is transferred will be excluded (rather than the whole of the transferring investor's commitment).

On a separate but related issue, which in practice may lead to a similar result, frequently partnership agreements or side letters allow investors to be excused from participating in certain kinds of investment. This may be for internal policy reasons or to comply with local regulations. Where this applies and excuse rights are exercised by such investors, a lender must ensure that any capital that cannot be drawn down to repay loans is excluded from any relevant covenant calculations.

A final word in relation to transfers and overcall rights: the end result of excuse rights and many exclusion events is that the investor will not ultimately pay in any commitment it was otherwise due to pay. In considering the implications of this, it is important that lenders and their counsel have a full understanding of any limits on a fund's ability to call on other investors to make up any shortfall. Lenders also need to consider carefully at what level (say, as a result of transfers) a reduction in leverage or the borrowing base might become, as a result of reduced commitments, a general concern rather than something that can be managed simply through leverage or borrowing base adjustments.