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Fund Finance Friday

Subscription Finance Loan Agreement Series, Part 16: Covenants

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In our last article, we looked at the first part of a typical clause in an LMA-based subscription/capital call finance facility and particularly at information covenants. In this article, we take a look at the other areas typically covered by the covenants and undertakings in these facilities and, as always, with a focus on those which are more specific to the subscription/capital call finance world.

As with the information covenants covered last time around, a number of the general covenants that are common in other industries are also common to subscription/capital call finance, so any facility document based on an LMA precedent will look reasonably familiar in many respects to those who have also had experience with leverage, real estate or other loan finance products. However, there are also a number of covenants that are much more specific to the fund finance world, along, as always, with some issues that are specific to subscription/capital call finance even in the context of more widely used covenants. This article focusses on these in a little more detail below.

So, dealing first with some of the covenants that are common to many types of facilities in many industries, a very important covenant (and common across all types of facility documents), is the “negative pledge” (or, for those whose first language remains “normal” English, the covenant that restricts or prohibits the obligors from granting security over their assets). Where fund finance differs from other facilities is in the carve-outs allowed or considered to this covenant. Carve-outs may include assets which are not specifically covered by the (limited) security that will be given for the subscription/capital call facility, as well as carve-outs for specific parties to the facility – for example, a manager whose assets may include items entirely unrelated to the fund in question. Also (and again, very common across all types of Facilities), a covenant limiting financial indebtedness, where carve-outs may include, for example, hedging liabilities, indebtedness incurred in the normal course of making investments will or should always include any indebtedness of the fund to its investors where the investors subscribe to the fund by way of loan.

Then we come to a series of covenants that are both particular to subscription/capital call facilities but also (given the significance of the partnership documents) absolutely vital – namely, covenants dealing with the fund’s constitutional documents and the investor commitments. The primary areas of focus here for lenders is to ensure that any changes to the fund’s constitutional documents are severely proscribed (as we have discussed in previous articles in this series, these documents are the cornerstone of any credit and documentary decisions for lenders, so amendments other than those that are very much “administrative” are generally not desirable). Lenders will also want to ensure that, if there are amendments, the lenders are made aware of them immediately and that the fund does not take any action to jeopardise the continuing viability of the fund (for example, by terminating the general partner or manager). In terms of investors, the lenders’ focus will be on ensuring that the fund and its general partner and/or manager do not do anything to reduce or bring into question the level of any investor commitments. As part of this, there will be covenants requiring the fund and other obligors to ensure that those commitments are always paid into the account or accounts over which the lenders have security, that commitments are not reduced or waived in any way and also that commitments are not redirected into other vehicles outside the lenders’ security net (for example, to parallel funds or alternative investment vehicles).

Also in this category, it is worth mentioning a covenant that is sometimes, but not always, included or sought but is useful to consider (and, again, is very specific to fund finance). This is one designed in effect to “oil the wheels” of the structure by requiring the fund to ensure that a proportion (usually a fairly small proportion) of investor commitments are called and paid at intervals over the life of the subscription finance/capital call facility.

Finally, other covenants will cover (assuming that the fund does not come under the definition of “plan assets” and therefore subject to ERISA considerations, which is a whole subject in itself) requirements to ensure that the fund does not constitute “plan assets” and covenants dealing with compliance with sanctions and anti-money laundering measures. Apart from the “ERISA”-related covenants, these are not unique to subscription/capital call facilities, but it is worth pointing out that compliance with some of these covenants (particularly sanctions) can be problematic for funds given the variety and geographical reach of their investments.

As always with this series, this is intended to give a flavour of the types of issues and considerations which come up in particular parts of a facility in the context of a subscription/capital call facility. The above is by no means a complete list of the covenants which are or should be included in such facilities, but it is hoped that this helps to highlight some of the more common ones and the issues that arise. It is important when considering the covenant package overall to understand the fund’s overall structure and (as always) to have carried out full due diligence on the fund’s and related parties’ constitutional and other documents so that any covenants can be properly tailored to the fund in question.