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Fund Finance
Friday

Time to Stitch Up Those Legal Documents: Common Mistakes, Misunderstandings and Oversights that Every Fund Finance Lawyer Should be Aware of — Part I

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Legal documentation governing subscription credit facilities has certainly improved for both lenders and funds alike since the product first came to market. Funds have effectively negotiated for more flexibility where needed, and lenders have effectively negotiated for more protections where perceived risks may exist. However, as with many other corporate or financial transactions between two or more parties, and especially given the relationship-nature of subscription finance lending, provisions in legal documentation often get replicated from one transaction to the next, including errors and inconsistencies as a result of the fast-paced world in which practitioners find themselves or, in some cases, a failure to connect the dots. Thus, we are presenting a multi-part series on common mistakes, misunderstandings and oversights we have noticed throughout the legal documentation governing subscription credit facilities over the years.

1. Whose obligations are intended to be secured by which assets?

With the introduction of borrowing groups and umbrella facilities that include separate fund families (which we have explained **here**) and even with regard to certain simpler structures that require certain fund entities to pledge assets to the administrative agent even though such fund entities do not have any borrowing capabilities (and thus will not incur any loan obligations), it is critical that attention be paid by lender and borrower's counsel to the lead-in in the granting clause of the security documentation. An example of a typical granting clause is the following:

"*In order to secure the prompt payment and performance in full when due, whether by lapse of time, acceleration, mandatory prepayment or otherwise, **of the Obligations**, each Pledgor, to the extent of its respective interests, hereby grants to the Administrative Agent and pledges and creates a security interest in, all of its right, title and interest, in, to and under the following, whether now existing or hereafter acquired or arising and wherever located, for the benefit of the Secured Parties (the "Collateral"):…*"

As you can see, in this granting clause the assets being pledged by the applicable entity secure all of the "Obligations." This is ideal for a lender but could be overly broad and problematic for a fund if your transaction includes borrowing groups where the intent is that assets pledged by an entity only secure obligations incurred by members of such entity's borrowing group. Likewise, you may have a granting clause drafted too narrowly. For example, if the entity who has pledged assets will not incur any obligations under the credit facility as discussed above, you would want to ensure that the granting clause does not provide that such entity's assets secure "its Obligations," as that particular entity will not have any obligations. Rather, the granting clause should provide that its assets secure "all Obligations" or such other appropriate subset thereof.

As counsel for either the administrative agent or the borrower, you will want to work closely with your client to make sure you understand the business arrangement with respect to whose assets are securing whose obligations and document it properly. To the extent the security arrangement is explained across multiple documents, you will want to make sure this concept is treated the same way across all documents.

2. Does your material adverse effect clause actually have teeth?

This next topic isn't necessarily specific to subscription credit facilities, but we felt it was worthy of being raised, given the number of instances where we've seen it come up as administrative agent's counsel. The issue is related to material adverse effect clauses often contained in loan documentation governing credit facilities. Such documentation may expressly provide that, as a condition to borrowing, no material adverse effect shall have occurred since a specified time. The documentation will then contain a likely-negotiated definition for what constitutes a “material adverse effect” but may include: some combination of a material adverse effect on assets, operations, properties, liabilities or the credit party’s condition; a material adverse effect on the enforceability of the loan documents; or the credit party’s obligations to fulfill their obligations, among other occurrences. In addition to or in lieu of a condition precedent to borrowing, some documentation will have a representation and warranty that since a specified time, no circumstances exist or changes have occurred which could result in a material adverse effect. And, finally, some loan documentation will have the occurrence of a material adverse effect as an automatic Event of Default.

To the extent a material adverse effect appears as a condition to borrowing or as a representation and warranty, fund counsel often seeks to include language that reads “except as otherwise disclosed to the Agent.” When presented with this comment, lender’s counsel needs to analyze the effect of it not only with respect to the applicable provision where the comment is being made but holistically, and consider what other protections the lenders may have on this point. As an example, assume the representation and warranty contained in the credit documentation reads as follows:

“*Except as otherwise disclosed to the Administrative Agent*, since the Closing Date, no circumstances exist or changes have occurred which could reasonably be expected to result in a Material Adverse Effect.”

If the credit documentation does not contain an event of default that triggers upon the occurrence of a material adverse effect, then there are no repercussions for the credit parties if a material adverse effect occurs, so long as the credit parties disclose it to the Administrative Agent. In other words, if the credit parties disclose the material adverse effect to the Administrative Agent, they have not made a misrepresentation and no event of default will be implicated. On the other hand, if you have a material adverse effect as an automatic event of default, perhaps you do not mind accepting the comment because you have protection elsewhere and aren’t relying on a misrepresentation to ultimately trigger an event of default. Thus, be cautious when considering this comment or when coming across these provisions in older forms.

We hope that Part 1 of this series has been helpful for lawyers on both sides of a transaction. Additionally, our sincere hope is that it has the effect of getting older legal documents (and newer ones, in some cases) cleaned up and sanitized. More to come next time…