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The Rise of Qualified Borrowers

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Credit agreements often allow private equity funds to join their portfolio companies to fund finance facilities as "qualified borrowers." In the past, many sponsors did not take advantage of this option, but there has been a marked increase in qualified borrower joinders in recent months. The following is a general overview of the treatment of qualified borrowers in traditional subscription credit facilities (it does not, however, deal with NAV and hybrid facilities, which provide for the pledge of a fund's underlying assets).

A qualified borrower is generally a portfolio company of a borrower or a guarantor under the credit facility (a "Fund Party"). A portfolio holding company may also be a qualified borrower, but, in either case, qualified borrowers differ from other credit parties in that third-party limited partners do not hold direct equity interests in the qualified borrower. Instead, LPs make capital commitments to a Fund Party, which in turn holds a direct or indirect equity interest in the qualified borrower. The qualified borrower is joined to the facility by (i) a promissory note executed by the qualified borrower in favor of the lenders and (ii) a guarantee by a Fund Party of the loans and other obligations of the qualified borrower under the facility.

All loans to a qualified borrower are ultimately secured by the unfunded capital commitments of limited partners of the Fund Parties and collateral accounts into which capital is called. Such capital commitments are the primary source of repayment for lenders in traditional subscription facilities.

Subscription lenders are generally more concerned with unfunded capital commitments (which constrain the borrowing base as well as serve as collateral) than their secondary source of repayment – an unsecured claim against the borrowers that may be made if capital contributions are insufficient to repay outstanding obligations. It is worth noting, however, that there may be additional limitations on claims against the assets of qualified borrowers. Any Fund Parties that guarantee a qualified borrower's obligations are liable for all loans made to the qualified borrower. However, the reverse is not true – a qualified borrower may only be liable for loans made to the qualified borrower itself and not jointly and severally liable for loans made to Fund Parties or other qualified borrowers. Even if the qualified borrower is jointly and severally liable, an unsecured claim against a qualified borrower is likely to be of dubious value. In making loans to a qualified borrower under a subscription facility, lenders should be satisfied that the loan can be supported by the collateral (their unfunded capital commitments of the Fund Parties), given that the assets of portfolio companies are commonly used as collateral for leveraged loans. The security interest of the asset-level lender will have priority over an unsecured claim by the subscription lender with respect to portfolio company assets.

Since they are cross-collateralized by the same capital commitments, loans to qualified borrowers are typically made on the same terms as loans to Fund Parties (although it is possible to include additional covenants and sub-limits applicable only to qualified borrowers). Letters of credit are also commonly available to qualified borrowers to the same extent as to Fund Parties. Letters of credit are often more useful to portfolio companies than to funds, and have been one of the main drivers for joining qualified borrowers in the past.

To the extent that the cost of credit in the leveraged loan market increases, sponsors are more likely to find it attractive to obtain additional liquidity for their portfolio companies through the use of the qualified borrower provisions of fund finance facilities.