

Fund Finance Friday



It's My Equity, and I'll Pledge If I Want To

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By **Tim Hicks**
Partner | Fund Finance

Most limited partners (“Investors”) in a private equity fund (“Fund”) understand the basics of the collateral package in connection with a subscription credit facility, which typically involves a pledge by a Fund and its general partner or other managing entity of:

- the right in and to the unfunded capital commitments of the Investors;
- the right to make capital calls and to enforce the obligations of the Investors to contribute capital; and
- the deposit account into which the Investors are required to fund its capital contributions.

Furthermore, most Investors recognize that their unfunded capital commitment can be excluded from the calculation of the borrowing base as a result of an Investor’s actions (or inaction) in respect of certain events. An Investor encumbering its equity interest in a Fund is a commonly included exclusion event in a subscription credit agreement. Despite the regularity of encountering this exclusion event, it presents a number of considerations for the Investor, the Fund, and the subscription lender (“Lender”).

From an Investor’s perspective, its equity interest in a Fund is not generally collateral under a typical subscription facility, and depending on the Fund’s underlying value, this equity interest presents an asset that an Investor may seek to pledge in order to obtain its own leverage. This is all the more relevant to growing sector of secondaries funds. An Investor’s desire to pledge its equity interest can create a natural tension between the Investor and the Fund. The Fund is seeking to maximize its availability under the subscription credit facility by maintaining the inclusion of the Investor in the borrowing base, yet the Investor is seeking to use its equity in the Fund to attract its own lenders. If the pledge of equity occurs, the Investor’s uncalled capital commitment provides the Fund with no borrowing base credit under the subscription credit facility.

This exclusion event requires the Fund to take note of the potential consequences as well. All subscription credit agreements require the Fund to inform the Lender upon becoming aware of the occurrence of an exclusion event. The Fund is tasked with maintaining awareness of an Investor’s actions, which may or may not be taken with advance notice to the Fund. The Fund is often subject to a negative covenant that it will not permit any Investor to pledge or otherwise grant a security interest or otherwise create a lien on such Investor’s right, title and interest in the Fund without the prior written consent of the Lender. Thus, the Fund is not only placed in a position of having to honor its contractual obligations of reporting and avoiding permissive unauthorized actions but also must attempt to maintain its investor relationships and accommodate requests from its source of committed capital.

The Lender is also in the fray and is faced with the conundrum of working with the Fund while maintaining the integrity of its underwriting. The Lender obviously wants the Investor to be incentivized in every way to fund all capital calls. If the Investor is over-levered and/or its equity interest in a Fund will be completely consumed as collateral to service the Investor’s debt, the fear is that the Investor will succumb to the temptation to stop funding additional capital to the Fund (or the Lender upon its exercise of remedies).

So how does the trilogy of diverging interests reach an amicable outcome? This is often only reached through compromise and a balancing of the risks. The covenant preventing the Fund from permitting an Investor from pledging its equity interest in the Fund is occasionally modified to provide some flexibility or the inclusion of a small,

predetermined basket of the amount of equity interests that may be pledged to a third-party creditor. The exclusion event is often modified similar to the below:

“such Investor encumbers its interest in any Fund and a creditor of such Investor has commenced the exercise of remedies in respect of such interest.”

Under this scenario, the Investor is able to obtain the leverage it seeks, the Fund is in a position to grant the Investor’s request to incur leverage while maximizing availability under its borrowing base, and the Lender has some advance warning that an issue may have arisen with respect to the Investor and can resize the borrowing base to exclude the Investor upon the commencement (but prior to the completion) of the exercise of remedies by a third-party creditor.

Certainly, every subscription facility is different and the composition of the pool of Investors dictates the negotiations related to this point. However, in the end, the competing interests of the parties involved can only be reconciled through a willingness to understand each party’s respective concerns.