Subscription Finance Loan Agreement Series — Part 3

August 16, 2019 | Issue No. 41

After the first two articles in the series, we continue through the form of Loan Agreement, this week focussing on a small but crucial part of the Agreement relating to the definition of "control" or "change of control" and how that applies and is used in a Loan Agreement for subscription/capital call facilities.

In many ways, the considerations that apply to this particular section of the Agreement are similar for a subscription/capital call facility as to any other type of facility. Essentially, the lenders want to know that if they have entered into credit arrangements on the basis that they are contracting with a particular entity, that entity will remain in control of the affairs of the fund or funds that are the borrowers or guarantors of the facility. The difference lies in how and where that control is exercised. Where the borrower is a fund, that borrower can have one or any number of investors. Its affairs will also typically be conducted via a general partner and/or manager rather than by the borrower itself.

So given these structural considerations, how should lenders approach the issue (and to what extent should lenders consider the investors themselves in the fund in the context of "control")? To answer the second question first, lenders will look at the fund's investors and their make-up. If the fund consists of a single investor (or of only two or three investors), or if there is a "cornerstone" investor or investors crucial to the continued viability of the fund, then lenders should consider including those investors in the definition of "control" and any change in any of those investors as a "change of control." However, if the fund has a wider multiple investor base (and particularly if, as is often the case, those investors can change over time) then this approach will generally be both impractical and unnecessary (since there is never a specific investor or group of investors that can be said to be crucial to remain in "control") and lenders will look to rely on alternatives.

Fundamentally, though, the most important "control" questions are who controls the general partner and/or manager of the fund (as it is these entities that will in practice run the fund and will be largely responsible for its success or failure). In making decisions as to whether to provide facilities to a fund, lenders will therefore look hard at the track record of the manager in particular and at who controls/owns the manager and the general partner, and they will expect that ownership/control to remain in place through the life of the facility. So any "change of control" provisions should precisely define what is envisaged by "control" of the manager and the general partner. Care should be taken to ensure that the "control" definition is extended far enough "up" the structure to identify those who in fact ultimately control the entities (and on whose control the lenders ultimately rely). Lenders (and their counsel) should also focus carefully on the nature of that "control." For example, in a corporate structure, reference to ownership or control by "shareholders" would normally be a sufficient definition, but in a fund structure (and some general partners or managers are themselves structured as funds) the "control" may be through investors or even a series of investors in that fund.

A related question (and one which lenders should be asking themselves specifically after recent events in the subscription finance/capital call market) is whether there is any need to add any further elements to the question of "control." Given the way in which these facilities have developed, the focus has traditionally been very much on the ultimate "ownership" of (or interests in) the general partner and the manager. However, in an insolvency situation, it is quite possible that while the ownership position will not change, the way in which that ownership is conducted may change fundamentally (in particular, if a liquidator or trustee in bankruptcy is appointed to the ultimate "controlling" entity). Such an event could in some circumstances have potentially significant knock-on effects on the ability of the general partner and/or the manager to continue to operate the fund and (or in the case of the general partner, which might also be an investor in the fund) to continue to fund investments. Where that is a concern, consideration may be given to whether an insolvency event should trigger similar consequences to any other change in control or ownership.

Once "control" and "change of control" have been properly defined, the usual convention is that a change of control will (as with any other type of facility) result in a draw stop (usually immediate or within a very short period) and/or a requirement to repay the facilities in full (usually referred to as a "mandatory prepayment"). The mandatory prepayment will usually be an option exercisable by the lenders, rather than an absolute requirement, and there will usually be a grace period allowed between the change of control occurring and any requirement to make a prepayment.

Finally, it is worth commenting on a couple of related issues. First, a fund will often want to retain an ability to change general partners and/or managers through the life of a facility for a mix of internal, tax or regulatory reasons. In the context of "control" and "change of control" only (other consequences will be discussed in subsequent articles in this series), that will generally be something lenders can consider permitting, provided the replacement general partner or manager remains in the ultimate "control" of the same entity or entities. Next is the question of "key person" provisions. For now, though, while the lenders (and indeed the investors) may rely on specific "key" individuals remaining actively involved in the management of a fund (so to that extent it is a similar “reliance” issue to that raised in this article on “control” and “change of control”), the treatment of it will be different. Again, we look forward to addressing this in a subsequent article or articles in this series.

What We Are Reading on Private Markets

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It's been a busy week in secondaries. In what could be one of the largest deals of its kind, ***Crestview Partners*** is running a stapled tender offer on two of its previous funds with a reported NAV of $4.6bn. Potential buyers are being asked to make a primary commitment to its fourth fund raised last year with a $3.5bn target. ***Eurazeo*** has moved a strip of five assets that were then used to seed its latest fund, Eurazeo Capital IV, which held a final close of EUR700m in July. Campbell Lutyens reports that strip sales accounted for 34% of all GP-led transactions last year, and this trend is set to continue.

Citic Capital has closed the fourth largest fund ever raised for China by domestic firms, closing at $2.8bn, $300m over target and 80% larger than its predecessor. Most of the capital was raised from existing investors, including Canada Pension Plan Investment Board. The fund is focussed on a “China buyouts 2.0 strategy,” which essentially uses Western know-how on buyouts and adapts these to Chinese founder-led companies. China-focussed funds raised $22.8bn in 2018 – the highest amount raised since 2015 – with $10.6bn having already been raised in H1 2019.

Hamilton Lane has joined the likes of Partners Group and other asset manager peers in launching a high-net-worth-focussed fund and has already attracted $91m. The evergreen fund is open-ended evergreen, offering investors based in Europe, Australia and Asia the opportunity to invest in the private markets, typically only available to institutions. As an evergreen fund, it provides investors with the ability to adjust their monthly allocations and puts their money to work immediately, thus mitigating the J-curve effect. Unlocking this vast pool of capital has been a focus for many private markets managers. The fund will manage liquidity via cash inflows, investment returns and potentially a credit line.

London Business School Article on Fund Finance

August 16, 2019 | Issue No. 41

Florin Vasvari, Professor of Accounting: Chair, Accounting Faculty and Academic Director of the Private Equity Masterclass at London Business School, published an article earlier this week on fund finance titled, "What Have Cheap Bank Loans Done to Private Equity Funds?" The piece is far more balanced than many of its predecessors and does a nice job of thoroughly setting out the utility that subscription lines provide to their fund borrowers. It also summarizes the updated ILPA guidelines and discusses the growth of fund-level leverage. High five to Professor Vasvari for referencing Cadwalader data estimates. The article is available **here**.

Save the Date: Finance Forum 2019

August 16, 2019 | Issue No. 41

It’s time to mark your calendars for our fourth annual Finance Forum at The Ritz-Carlton in Charlotte, North Carolina, on October 17.

We had a record number of more than 400 attendees last year – all leaders in the financial services, investment management, private equity and legal communities. We are still finalizing the agenda, but we plan to provide updates on some of the key topics from last year, as well as a number of new areas of focus. You can expect comprehensive coverage of fund finance, the loan market, commercial real estate and other timely and important topics, including industry diversity. Speakers will include Cadwalader partners and leading practitioners from across the country.

This is a half-day program, beginning with a welcome and keynote address at 12:30 p.m. and ending at 5:45 p.m., with a rollicking networking cocktail hour to follow.

There is no charge to attend the Finance Forum, and Cadwalader has arranged for very favorable hotel rates for Forum participants attending from out of town.

Click **here** to register for the Finance Forum.

Contact **Cori Niemann** for general information and hotel reservation information.

Looking forward to seeing you there!

FFA Asia-Pacific Symposium Update

August 16, 2019 | Issue No. 41

The FFA announced this week that the 3rd Annual Asia-Pacific Symposium scheduled for Sept. 25 in Hong Kong will proceed as scheduled. The FFA is monitoring the public events in Hong Kong closely and will update attendees should anything change.

Outside the Lines — These Girls Can Fish

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Outside the Lines

By Michael Mascia
FFA Board Member

I just got back from a terrific vacation to the North Carolina coast and mountains, and my daughters continued a ridiculous run of good fishing. To start the summer, Victoria boated an insane 48-pound catfish on Lake Wylie in South Carolina. (I highly recommend Rodger Taylor of **Catfish ON! guide service**; he is great with kids.) While she was happy to reel, she refused to hold the fish for the picture. Then in May, she won the "Catch of the Day" award for a solid largemouth at a local family fishing tournament. And by then, she got super cocky. We went out to a local pond aiming for sunfish, and I got a really big catfish to take on my ultralight rod with 4lb test. I was holding the rod high and the fish was just screaming off drag during a long run. And Victoria got mad at me and yelled, “Dad, you aren’t even reeling. You’ve got to fight. Fight like it’s the last cookie in the house.” Um. OK. So I tried harder. And we landed an ugly 10-pounder after about 20 minutes.

My 7-year-old, Kristina, was unimpressed with her sister’s exploits and started asking me to take her fishing (note: it takes excellent parenting skills to get your kids to think that what you want to do is their choice). She immediately caught an 8-pound catfish on a single kernel of corn on her pink Little Pony rod. Then, to top it off, last week she boated a nearly 50-pound bonnet head shark, reeling it in virtually herself. These girls can fish!