Subscription Finance Loan Agreement Series, Part 6 — Included Investors and Exclusion Events

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As we have discussed previously in this series, subscription financings usually adopt a borrowing base approach or a coverage/leverage approach to calculating investors' available commitments. Under the borrowing base approach, lenders calculate the borrowing base by applying different advance rates to different categories of investor (usually depending on internal and external ratings of the investors). Under the leverage/coverage approach, the lenders generally look at the whole investor base and apply a single debt ratio covenant to the total commitments. The borrower must comply with that covenant on an ongoing basis. In both approaches, investors will be excluded from the relevant calculations in certain circumstances, and the events which trigger such exclusion will be similar regardless of which approach is adopted.

Naturally, the terms setting out when an investor and/or its commitments will be included or excluded from the borrowing base or financial covenant calculations are vitally important to both lenders and borrowers. Lenders undertake due diligence on a fund's investors prior to entering into a financing and will agree with the fund if any of the initial investors are to be excluded. However, lenders must also be confident that if the circumstances of an investor changes such that the lenders are no longer willing to lend against that investor, it will be excluded from the borrowing base or leverage calculations. At the same time, from a borrower's point of view, it is important that an investor is not excluded from those calculations at a time when the investor's creditworthiness and reliability are not reasonably in doubt. A borrower will also look to avoid uncertainty as much as possible by ensuring that investors are excluded from any borrowing base or leverage calculation only in clearly defined circumstances.

The extent of the exclusion events that may be included in a facility agreement will depend on the particular circumstances, status and track record of the borrower. Common exclusion events that relate to the status and activities of an investor include the following:

- insolvency
- entry into insolvency proceedings
- being subject to or affected by sanctions
- failure to pay a capital call when due or other breach of the fund's formation documents
- failure to maintain a certain minimum credit rating or net worth
- exercise of rights under a "most-favoured nations" provision in a manner that is materially adverse to the lenders
- withdrawal from the fund
- transfer of its interest in the fund to another person
- excusal from making investments or redemption as a result of the operation of ERISA

A lender will also wish to exclude an investor if there are adverse changes to the investor's obligations under the fund's formation documents or related security. For this reason, exclusion events may also include some or all of the following:

- an investor's obligations under the partnership and subscription documents (in particular, its obligation to make capital calls) cease to be legal, valid and binding
- the investor and the fund enter into agreements which adversely affect the ability of the fund to call or receive payments of capital
- security over the fund's call-down rights ceases to be effective and enforceable
- the investor repudiates or challenges its obligation to make capital calls
- the lender does not hold up-to-date information to enable it to enforce its security against any investor (*e.g.*, contact details of the investor)

Some of the events listed above will be subject to further refinement in negotiation. To take a couple of the more uncontroversial examples: (i) in respect of a failure to pay a capital call, it is often the case that an investor will not be excluded until a grace period has elapsed beyond the initial due date for the payment and (ii) in respect of a partial transfer, commonly only the amount of the commitment that is transferred will be excluded (rather than the whole of the transferring investor's commitment).

On a separate but related issue, which in practice may lead to a similar result, frequently partnership agreements or side letters allow investors to be excused from participating in certain kinds of investment. This may be for internal policy reasons or to comply with local regulations. Where this applies and excuse rights are exercised by such investors, a lender must ensure that any capital that cannot be drawn down to repay loans is excluded from any relevant covenant calculations.

A final word in relation to transfers and overcall rights: the end result of excuse rights and many exclusion events is that the investor will not ultimately pay in any commitment it was otherwise due to pay. In considering the implications of this, it is important that lenders and their counsel have a full understanding of any limits on a fund's ability to call on other investors to make up any shortfall. Lenders also need to consider carefully at what level (say, as a result of transfers) a reduction in leverage or the borrowing base might become, as a result of reduced commitments, a general concern rather than something that can be managed simply through leverage or borrowing base adjustments.

Recent Amendments to Delaware Law: What You Need to Know

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By **Wes Misson**
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The State of Delaware recently made meaningful amendments to the Delaware Revised Uniform Limited Partnership Act ("DRULPA") and the Delaware Limited Liability Company Act ("DLLCA") that will impact fund finance transactions. The amendments became effective on August 1, 2019.

Divide and Conquer Deja Vu

First, Section 17-220 was introduced to the DRULPA to provide for a "division" of a limited partnership in much the same way and with the same effect as its sister provision, DLLCA Section 18-217 (enacted last year), has on Delaware limited liability companies (see our previous article **here** for analysis and recommendations). In short, since the vast majority of fund finance borrowers are Delaware limited partnerships, lenders now need to be aware of the possibility of a partnership division and ensure that negative covenants restrict any division without lender consent, and that any permitted division requires the resulting partnership to join the facility and pledge collateral in the same manner as the dividing partnership.

Why So Serious

Second, Delaware enacted legislation to provide for a concept of a "registered series" under DLLCA Section 18-218 and DRULPA Section 17-221. Delaware limited liability companies and partnerships have for years been able to form multiple "series" to segregate assets and liabilities. These older series have been renamed a "protected series" and now have the ability to convert into a "registered series." The legislation was intended to clean up ambiguity around the perfection of security interests related to a protected series, which are not separate legal entities. A registered series will be a registered entity under Delaware law, have its own certificate of good standing issued by the Delaware Secretary of State and qualify as a "registered organization" for Uniform Commercial Code ("UCC") purposes. Thus, lenders taking a security interest over assets of a registered series will simply file a UCC-1 financing statement in the name of the registered series.

Another IRR Study

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Results of another study on the impact of subscription facilities on fund IRR was published this week, this time in Private Equity International by guest contributor Christopher Jackel of Montana Capital Partners. The study looks at 491 buyout funds with vintages from 1990 to 2007, based on data from Preqin. It assumes that each capital call is deferred for 12 months by the hypothetical subscription facilities. The findings include that the impact on IRR for the majority of funds is small, but that it can be meaningful for both otherwise well-performing funds and on interim performance for funds early in their lifecycle. The report is available **here**.

Pref Equity Gaining Ground

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Preferred equity is gaining ground as a financing tool that allows LPs or GPs to accelerate liquidity against fund assets while retaining ownership and upside potential. In a typical transaction, fund interests held by an investor are sold into an SPV in which the preferred equity issuer is granted a priority interest in the proceeds from the investments while the original investor maintains an equity stake. Compared with debt financing, preferred equity has no repayment date, no cash interest, no covenants and no security over the underlying assets. These are among the points made in a podcast from *Secondaries Investor* featuring Augustin Duhamel of 17Capital. The interview is available **here**.

Private Debt Investor Article on Fund-Level Leverage

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Earlier this week, *Private Debt Investor* published an article titled "Under the Hood of Fund-Level Leverage," written by Neil Rudd, Senior Managing Director and Chief Operating Officer of NXT Capital, a commercial finance company. The article discusses the basics of fund-level leverage and the importance of understanding a fund's leverage strategy as a part of investor due diligence. The article is available **here**.

Women in Fund Finance 'Wit & Wisdom Series' (September Breakfast Meeting): Building Your Profile and Your Business

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Women in Fund Finance is pleased to hold the second "Wit & Wisdom Series" meeting in London, connecting senior women in the fund finance industry with junior members for intimate breakfast discussions. This second meeting will take place on Thursday, September 26 and will focus on the topic of Business Development. Discussions will include what to do to build your brand and attract clients, as well as how to effectively promote yourself and your firm. For more information and to register, click **here**.

FFA Next Generation in Fund Finance New York Event — September 16

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Join us the night before FFA University for light hors d'oeuvres and beverages at Haynes and Boone’s New York Office in Rockefeller Center. Connect with colleagues after an eventful summer and prepare for FFA University’s two-day intensive program led by senior fund finance practitioners. Whether you'll be flying in from out of town or walking across from Park Avenue, we’re excited to see you.

Date of event:
Monday, September 16

Venue:
Haynes and Boone, LLP
30 Rockefeller Plaza, 26th Floor
New York

Time:
7-9 pm

Register **here**.

Recommended Reading

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Below is a look at what we are reading this week outside of the four corners of Fund Finance:

PitchBook has studied typical capital call timelines over fund lifecycles to help investors manage their liquidity. [**PitchBook**]

The market is predicting the Fed will cut interest rates another quarter point later this month, primarily based on uncertainty driven by trade disagreements. [**Wall Street Journal**]

Capitalism is increasingly being questioned as wealth and income distribution concentrate. [**CNBC**]

Spotlight on how investors fund their commitments: News that CalPERS is considering leveraging its portfolio has put the spotlight on the risks and merits of institutional investors taking on systematic borrowing. [**PEI**]

GP focus on Change of Control provisions in LPAs: GPs eyeing potential capital from the fund of firms market are building in legal requisites to ensure such transactions could happen without LP consent. [**PEI**]

Fisherman Benjamin Grunder reportedly caught a massive nine-foot Wels catfish on the River Po in Italy. [**The Epoch Times**]