A Waiting Game …

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One of the core principles of subscription finance is the ability of the lender to call capital upon a default for repayment of the loan. Nearly every deal permits an immediate right of the lender to do so following an event of default, or at least following a short standstill period that permits the fund to make the initial call before the lender steps in. One issue that threatens to limit this enforcement mechanism and potentially delay repayment of the loans via capital calls is the annual capital call limit. This is typically a limit prescribed by the fund's LPA that prohibits capital calls, on an aggregate basis, during an annual period that exceed a certain percentage of total commitments – usually set in a range of 20-40% of total capital per year. Fortunately, this issue appears with low frequency. Even more fortuitous for lenders is the fact that even when it does rear its head on occasion, the provision is often drafted in a manner that carves out calls made for the purpose of repaying any liabilities that become due during such annual period. But what if it's a flat and absolute limit?

In practice, such a limitation would mean that lenders could call a default and have to wait up to 364 days before the investors have *any* obligation to fund an additional capital call for repayment (or any purpose, for that matter). This hypothetical assumes the fund calls down the full limit on day one and then leaves nothing for the remainder of the year. As unlikely as it seems, it's very likely that the limit could be approached or even exceeded with a substantial stub period remaining in the year. Any period extending beyond the typical 10-15 days to call capital is not a delay that any lender knowingly signs up for. It's a waiting game.

In our experience, no lender in this market has accepted such a risk of delayed enforcement. If an LPA amendment is not feasible under the circumstances, then there are a couple of different ways to manage the risk. A borrowing base haircut could be applied to limit available uncalled capital (prior to applying advance rates and concentration limits) to only the portion of total capital that could be called during such period. So when capital is called, the availability reduces in a corresponding amount and the lender is never advancing against collateral that is subject to delay. The second and somewhat more popular method, given that it does not reduce the borrowing base, is to include a negative covenant that manages the issue. The covenant would say something like: the fund shall not call capital in an amount during any annual period (*e.g.*, calendar year or other applicable period as set out in the LPA) such that the total amount called during such period *plus the principal obligations outstanding* would exceed the threshold limit set forth in the LPA (*e.g.*, 40% of total commitments) for such period. This effectively sets forth a reserve requirement on the fund to ensure that capital is always available during any day of the annual period to repay the obligations if needed. This appropriately shifts the risk to the fund and eliminates the waiting game.

In many cases, however, the fund can override the limit with advisory committee approval. In this case, pre-approval or a floating limit that springs into effect upon such advisory committee approval may be appropriate to give the fund additional flexibility and capacity on the line. As this issue comes in many flavors and can have unintended consequences on structuring a facility (and potentially usage thereof), funds counsel should examine this issue closely when preparing LPAs and negotiating these limits with investors. Nobody likes to wait.

Subscription Finance Loan Agreement Series, Part 13: Transfers by Investors of Interests in a Fund

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Back in September, in Part 6 of this series, we touched on the issues surrounding the inclusion (or not) of investors in the leverage or borrowing base calculation in a subscription/capital call facility and the factors which might impact on that. In this article, we look a little more closely at one of those issues – namely, transfers by investors of their interests in a fund. In particular, we focus on the impacts of any such transfer on the level of leverage or borrowing base that a lender will be looking at under the facility and at the extent to which lenders can (or would want to) control transfers between investors. Why is this important? Because, as will have been apparent in a number of the articles in this series, the level of commitments of the investors to the fund (and the investors' ability to make good on those commitments when called) are at the heart of all subscription/capital call financing. These will be assessed by any lender at the outset by reference to the then-current group of investors, and any change in those investors (in particular, by transfer to a different investor) will impact both and may well alter that assessment.

How a transfer is treated in terms of a subscription/capital call facility will often depend at least in part on whether the facility is a leverage-based facility (*i.e.,* where the investor base is viewed as a group based on the lender's own assessment of the investors within that group) or a borrowing base facility (where the investor base is looked at by reference to ratings or an equivalent of the relevant investors). In the former, the inclusion (or otherwise) of any transferee investor and its commitment in the leverage covenant will often (but not always) be left to the discretion of the lender. In the latter, such inclusion (or not) will often be (at least outwardly) more "objectively" based (*i.e.*, on whether the transferee investor meets the relevant ratings or other criteria). In both types of facility, there is likely also to be an overarching "aggregate" limit on the amount of commitments which can be transferred, often set at around 15% or 20% of overall commitments and sometimes lower, before the cumulative transfers trigger a repayment obligation.

Whether the lender retains discretion as to the inclusion of transferee investors or is obliged to include or exclude them depending on their fitting or not within set criteria, the issues are the same. The lender needs to be able to make an accurate assessment of whether the transferee investor can make good on the commitments transferred and adjust its leverage or borrowing base accordingly to take account of this. Other issues that both sides need to consider are (in no particular order of importance):

- whether if the effect of the transfer is to reduce the leverage or borrowing base below the current level of utilisations, a prepayment of the excess will be triggered (and, if so, the period allowed to effect that prepayment);
- related to the above, whether if a transfer is contemplated or in progress, it is possible to effect a prepayment obligation prior to the date of the actual transfer;
- whether the transferee needs to be notified of or acknowledge any security arrangements that may have been put in place in respect of the investor commitments on transfer;
- what "KYC" needs to be completed on any new investor and the level of information required to effect that; and
- the extent of information that the lender will require in respect of the new investor.

In the discussion above, we have focused on the inclusion (or not) of transferee investors within any leverage or borrowing base criteria. The other issue that is usually the subject of some debate in a subscription/capital call facility is the extent to which lenders may have some control over or ability to restrict transfers among investors. As stated above, this may be somewhat less of a concern for lenders who are dealing with a borrowing base than for lenders who are looking at a leverage covenant. For funds and their GPs, there are a couple of considerations here. The first is the extent to which the fund or the GP itself has any control over or ability to restrict those transfers. To the extent it does have such control, then it is at least legally possible to allow the lender also to have some equivalent element of control, but it will not always have such control. The second is the extent to which it is desirable to allow the lender, in effect, to exercise this control right. This second consideration is not straightforward. One way to look at this is to determine whether the control right is related simply to a voluntary transfer by one investor to another (in which case some element of lender control may be acceptable) or whether it is something that the investor has to do (for example, where for that investor to continue as an investor in the fund would cause legal or regulatory issues either for that investor or for the fund). In the latter case, lender control would generally not be acceptable (and, indeed, a lender would be unlikely to want to restrict transfers given the potential adverse consequences to the fund of doing so).

In any subscription/capital call facility (and whether it is based on an investor leverage or an investor borrowing base), getting the balance right between fund and lender in terms of the level of control over investor transfers and the extent of inclusion of transferee investors in any leverage or borrowing base calculations is crucial for all sides. It is hoped that some of the comments in this article will help to properly assess that desired level of balance.

Player Profile — Holly Loftis

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Player Profile

This week we break with convention and interview our own Holly Loftis in the latest installment in our Player Profile series featuring leaders in the fund finance industry. While we've from time to time highlighted our counterparts at law firms elsewhere, we decided it's high time to add a U.S. lawyer's perspective to the discussion. Holly is a Counsel in Cadwalader's Fund Finance practice.

***FFF*: Holly, tell us a bit about how you became involved in fund finance.**

In May of 2008, I had just completed my second year of law school and was a summer associate at a law firm in Charlotte, NC. As part of the internship, I did an informal rotation through most of the practice groups that the Charlotte office had to offer. The work that I found to be most interesting involved representing banks and other financial institutions lending to closed-end private equity funds and securing the obligations related to the loans via the fund's unfunded capital commitments and related assets. As the financial crisis developed and things began to take a turn for the worse towards the end of summer, I was appreciative that the firm extended an offer to me for full-time employment upon graduation from law school in 2009. As things continued to deteriorate that fall when I was in my last year of law school, the firm requested that the incoming class of first-year associates "stagger in" over the course of the year. It was a decent-size class as compared to the overall size of the office and would be easier to absorb us slowly. This was really music to my ears – especially since several of my classmates had their law firm offers rescinded that fall. I decided to use the extra time to do something valuable and moved to Boston to obtain an LLM in Banking and Financial Law. After I graduated from the program in May of 2010, I headed back to Charlotte as a first-year associate and picked up right where I had left off in the summer of 2008, working on subscription lines of credit. And the rest is history, as they say.

***FFF*: What do you see as the three most negotiated points in fund facilities these days?**

Sanction, sanctions ... and sanctions.

***FFF*: The number of active lenders continues to grow. Do lenders tend to be more accommodative to win a deal in 2019?**

For a top sponsor, I would say yes.

***FFF*: Does it help the process to involve counsel in drafting the term sheet?**

It does. As an example, I've been in a situation where one of my clients negotiated a term sheet for an SMA without consulting internal or external counsel. The client and the fund both agreed that the "investor" would provide a signed investor consent in favor of the bank. However, there was never a true meeting of the minds between the bank and the fund because the bank did not realize that the actual investor was investing through an SPV. The fund intended that the SPV would sign the consent, and the bank intended that the parent would sign. We got there in the end, but it likely could have been avoided if we had been roped in earlier. The lawyers are going to be very focused on the structure from the outset. There are other structural and jurisdictional considerations we've seen get missed or potentially problematic LPA provisions fail to get mitigated in some way by not pulling in counsel. We understand that involving counsel in the term sheet drives up legal fees for the fund in the beginning, but banks can be specific regarding what type of review they are looking for (*i.e.*, "please just let us know if you think we've missed something," etc.) and, on balance, it may not cost the fund any more than it will when the issue inevitably comes up later.

***FFF*: Taking a longer-term perspective, how has working as fund finance counsel changed over the past ten years?**

It used to be that funds wanted subscription lines but didn't have sufficient language in their governing agreements or, as lender's counsel, we spent a long time negotiating the substance of security agreements or other protections that the bank may want. That phase, for the most part, seems to have passed, as there is “settled precedent” existing between most counterparties or even law firms involved on both sides of the transaction, both with respect to governing agreements and loan documents. Because the industry has become so relationship-driven, I’ve noticed that negotiating and closing transactions has become less adversarial in nature and more procedural and goal-oriented. Banks can spend more of their time understanding the fund’s business and what their specific needs are rather than sitting on lengthy all-hands calls or trying to understand how Article 9 of the UCC works.

I will also add that there has been a shift over the ten years that I have been doing this with respect to formation of offshore vehicles from the Cayman Islands to Luxembourg. This has caused me to be more involved on the offshore aspects, since Luxembourg doesn’t have the 10-year sort-of “settled precedent” that now exists in the U.S. and Cayman markets.

I will also add that as a result of the increased players in this space, if you’re a lawyer, it is crucial to understand where your client falls on that spectrum of “I understand everything about how these funds and facilities work” to “this is the first time we’ve led a deal.” I’ve been told everything from “we understand; move on” to “wait, please slow down since I’m not understanding how the enforcement process works,” etc. Ten years ago the spectrum wasn’t at broad.

***FFF*: How does the toolkit for success as a fund finance lawyer differ from other finance and capital markets practices?**

In my opinion, it’s somewhat related to the above, because there are times that zealous advocacy means dropping a point that you may otherwise fight for if the transaction didn’t involve parties with a pre-existing relationship. It is difficult to understand this as a junior lawyer because you are trained to fight tooth and nail to get the best deal possible for your client.

***FFF*: What are the must-read resources for a young professional getting underway in the sector?**

On the legal side, I still refer people to The LSTA’s Complete Credit Agreement Guide (the latest version). While it is not specific to fund finance, it does an excellent job explaining why each provision is contained in a Credit Agreement. If you are right out of college or new to lending relationships, you may not understand what “match funding” or breakage is. You cannot effectively negotiate or make decisions on comments to a loan agreement without a minimum level of understanding. It is also something that could be read to cover to cover in your “spare time” or simply used as a reference.

***FFF*: What do you like to do outside of the office?**

Travel would be at the top of the list, but, in reality, I mostly spend time with my three tiny tornadoes (they are humans, not dogs). I like to attend and watch a variety of sporting events. My husband and I have gotten into biking as a means of exploring cities that we have traveled to (Pittsburgh, as an example, is actually a really cool place to bike in).

***FFF*: Tell us one fun fact about yourself.**

I am related to U.S. President Dwight D. Eisenhower via my mother’s side of the family.

***FFF*: Any bold fund finance predictions for 2020?**

Can it be a wish? My wish is that in 2020 we have our first SOFR-Credit Agreement subscription line close. The sooner these things start happening, the sooner we can all rest assured that December of 2021 won’t be a complete nightmare.

New York Private Equity Manager Accused of Fraud

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GPB Capital, a New York-based alternative asset management firm, stands accused of fraud in a class action lawsuit filed in Austin, TX, on Nov. 6. The complaint alleges that investment returns paid to investors were funded out of the capital commitments of new investors and that principals participated in less-than-arm's-length transactions in selling assets to the funds. GPB Capital has been in the news periodically since the summer of 2018 when it announced plans to restate its 2015 and 2016 financial statements and delayed its 2017 audit. We are not aware of any fund finance exposure to the firm.

Law360 summarized the lawsuit and the events leading up to it **here** (subscription required).

On the Move — Fund Finance Tidbits

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On the Move

Olawale Ajayi has joined Bank of China as Senior Relationship Manager in its Financial Institutions Department. Based in London, Olawale joins from HSBC (where he was a Global Relationship Director in Leverage Portfolio Management) and will be leading Bank of China's fund finance offering from Europe, with an initial focus on subscription line financing in the EMEA region. Bank of China has been increasingly active in fund financing in the U.S., and Olawale's hire bolsters the bank's global presence.

FFA Next Generation in Fund Finance London Event

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The European Chapter of the FFA's Next Generation in Fund Finance is pleased to host its fifth event in London – an educational discussion on "Unchartered Territory - Default & Enforcement in Fund Finance" – on November 13 from 8:15 a.m. to 9:45 a.m.

Next Gen is a forum for junior professionals in the fund finance industry to share insights and to benefit from educational networking and mentorship opportunities, as well as to give back to local communities. It is open to all junior professionals currently engaged in or looking to become involved in the industry.

Location details are below:

Macfarlanes LLP
20 Cursitor Street
London EC4A 1LT

Spaces are limited, so please **RSVP here!**

Fund Finance Partners on Hybrid Facilities

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Hybrid facilities offer funds maximum flexibility to meet liquidity needs at longer facility terms while maximizing both availability and eligibility throughout the fund life cycle, according to an article published by Fund Finance Partners this week. Read the full article **here**.