Fund Finance

2017

First Edition

Contributing Editor:
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Capital call subscription facilities: the borrower's view

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Introduction

The attitude of private fund sponsors and investors toward capital call subscription facilities has changed significantly. Historically, investors and sponsors were not enthusiastic about fund credit facilities secured by the investors' unpaid capital subscriptions for several reasons. Investors were concerned that borrowings by the fund limited partnerships would increase tax risk: tax-exempt United States investors (such as endowments and pension plans) might incur unrelated business taxable income if they were deemed to be actively involved in a U.S. trade or business for federal income tax purposes by reason of making investments with borrowed funds, as opposed to merely investing resources they already own. Similar concerns troubled foreign investors, who avoid investment leverage to minimise the appearance of conducting a taxable trade or business within the U.S. Sponsors resisted the drag on fund earnings from interest expense, upfront fees, unused availability fees and transaction costs, as well as the added overhead expense of administrating a credit facility on behalf of the fund.

In today's market, however, capital call subscription facilities are increasingly popular with investors and sponsors. Many private fund groups that had not used capital call facilities in previous years are adding them for the first time in their later fund series. What are the reasons for this change of attitude?

Primarily, investors have grown more comfortable with private funds incurring short-term borrowing, which has become increasingly widespread without adverse consequences from taxing authorities. In addition, the universe of investors in private funds has become much larger and more varied, and now includes many smaller endowments and pension plans that do not have the administrative capacity to fund capital calls on a weekly basis from the numerous funds in which they invest. Capital call facilities enable funds to use borrowed amounts to make investments and pay expenses in the ordinary course of business from week to week, then pay down these borrowings every quarter or six months with regularly scheduled capital calls. Moreover, while tax concerns still discourage long-term leveraged investing (as opposed to short-term liquidity loans), even short-term borrowing provides an incremental boost to the return-on-equity performance of a fund.

While investors now frequently demand that a fund use capital call borrowings, what are the risks and issues that sponsors (and their counsel) should understand in negotiating these facilities? This article discusses five key areas that fund sponsors (and their counsel) need to understand when negotiating these facilities with their lenders.

Partnership agreement and investor concerns

As the sponsor's first step in preparing for a fund capital call facility, the sponsor should make sure that the limited partnership agreement contains the necessary provisions that lenders will require to accommodate such a facility. Planning for a capital call facility as part of the initial formation of the fund is important because of the unusual nature of capital call facilities: the loans are not secured by the investment assets of the fund borrower, but only by the fund's right to call on the capital commitments of the fund's investors (the proceeds of which will repay the loans). Because these capital commitments are embedded in the fund's organisational documents, lenders (and their counsel) will conduct extensive diligence on the provisions of the limited partnership agreement and related subscription agreements and investor side letters to make sure that they authorise a capital call facility and related lender rights. Including appropriate provisions to accommodate a capital call facility will limit the extent of lender requests to investors when establishing the facility, and avoids the need for an amendment to the limited partnership agreement where a provision objectionable to a lender may have been inadvertently included.

Lender partnership agreement requests

At a minimum, the lender will insist that the partnership agreement authorise the general partner to borrow on behalf of the fund and to pledge: (a) the right to call unfunded capital; (b) the right to enforce remedies against investors who default on the payment of their capital commitments; and (c) the deposit account into which all capital contributions must be paid. Most lenders will also want specific language obligating the investors to make capital contributions in response to a capital call issued directly by the lender (as opposed to the general partner), and third-party beneficiary language entitling the lender to rely on these provisions in the partnership agreement.

In a similar manner, the lender will want to be sure that any debt restrictions in the partnership agreement (or related side letters), such as limiting outstanding debt to a certain percentage of total capital commitments or requiring debt to be repaid within 180 days, provide adequate flexibility to permit the contemplated capital call facility. Similarly, the partnership agreement should provide that, even after termination of the fund's investment period, capital may still be called to repay loans, either expressly or by including principal, interest, fees, expenses, etc., from a credit facility in the definition of "Partnership Expenses", for which capital may be customarily called after the investment period ends. In the absence of this language, the lender will be required to terminate the credit facility upon expiration of the investment period, whether at scheduled maturity or upon an early termination event.

Beyond these basic provisions, lenders may require other provisions that are more controversial. Many lenders request partnership provisions that require investors: (a) to waive offset rights and similar defences against the fund and its general partner when a capital call is made by the lender (though these claims may be brought separately against the fund and its general partner); and (b) to subordinate any claims against the partnership or general partner to the prior payment in full of the credit facility. While these provisions may not be objectionable to the sponsor and are not unusual in the context of secured credit facilities generally, many investors object to any diminution of their rights, particularly if the investors have invested with the same sponsor in earlier series of funds that did not contain these provisions.

Other lender requests

Sometimes lenders request individual letters from each investor, who must make the waivers

and agreements described above (and often other undertakings, such as financial reporting or periodic confirmation of outstanding capital commitments) directly to the lender. While such letters were commonly requested in prior years when partnership agreements did not routinely contain provisions to accommodate capital call financing, now that fund partnership agreements typically contain these provisions, most private funds do not agree to provide investor letters except for facilities where the borrower is a "fund of one" or specially managed account for a single investor or very small group of large investors. Contrary to practice in some European countries, most notably the Cayman Islands, the Uniform Commercial Code does not require notice to, or an acknowledgment from, investors in order for the lender to receive a perfected security interest in the investors' capital call obligations.

Lenders may also request expanded collateral that includes other fund deposit accounts and investment assets, in addition to uncalled capital and the related deposit account. Such expanded collateral is typical only for very small funds or in a hybrid borrowing base that gives credit for the fund's portfolio investments, as well as its uncalled capital commitments, as discussed in the Section, "Borrowing base", below.

Lender diligence issues

In addition to reviewing the partnership agreement, lenders will also conduct investor-level diligence, including the review of investor credit ratings and financial information (where available), know-your-customer information and any side letters between an investor and the fund (these may be redacted before being provided to the lenders to protect sensitive economic or other terms). In reviewing side letters, a lender's primary focus will be any restrictions on the incurrence of debt by the fund, or on the use of a particular investor's capital commitments to repay fund debt, and any assertion by an investor of sovereign immunity. Sovereign immunity provisions in particular require careful legal analysis, which will vary depending on the jurisdiction of the investor, as to whether such immunity could prevent the enforcement of a capital call against the investor.

Confidentiality issues are critical in connection with the lender's diligence investigation. The sponsor should make certain that the lender's confidentiality obligations to the fund explicitly extend to investor information. At the same time, the sponsor needs to make sure that its own confidentiality obligations to the investors permit the sponsor to disclose to the lender on a confidential basis the investors' financial data and know-your-customer information. In instances where investors (most often sovereign wealth funds and high net worth individuals) will not permit such disclosure to lenders, the absence of financial data will exclude the investor from the borrowing base, as described in "Borrowing base", below. Even more difficult issues for the lender arise from the absence of know-your-customer information for a particular investor. In such cases the sponsor must either negotiate limited disclosure by the investor or make the lender comfortable with the results of the sponsor's own know-your-customer diligence investigation.

Borrowing base

The key credit aspect of a capital call facility is the borrowing base, which is expected to provide the source of repayment to the lenders. Under a borrowing base, outstanding loans (as well as exposure from letters of credit and hedging) may not exceed an aggregate amount for all investors equal to the product for each investor of (a) the uncalled capital of such investor multiplied by (b) an advance rate based on such investor's credit-worthiness. For some lenders, the advance rate may be a single percentage applied to the uncalled

capital of all investors in the fund, as a whole. For most facilities, however, the advance rate for a particular category of investor varies based on the relative credit-worthiness of the applicable investors in such category deemed eligible to be included in the borrowing base.

Eligible investors

Investors with an investment grade credit rating or pension plans with very large asset size are typically deemed eligible to be included in the borrowing base either without lender approval or with lender approval not to be unreasonably withheld, assuming that these investors pass customary know-your-customer requirements.

Other investors may require lender approval and special diligence in order to be deemed eligible for the borrowing base. If financial information is available for non-investment grade borrowers and smaller pension plans, the lender may include the investor in the borrowing base, but at a lower advance rate. Sovereign wealth investors may be particularly troublesome if they are unwilling to provide financial information. An experienced lender may have encountered such a sovereign investor in other facilities, and be comfortable including it in the borrowing base at a reduced advance rate. In other instances, the lender may be willing to include such a sovereign investor in the borrowing base only after it has already paid 50% of its uncalled commitment to establish a sufficient track record. In a very few instances, confidentiality restrictions may prevent the lender from obtaining even the identity of a sovereign investor. While such an investor would typically not be included in the borrowing base, in these cases the lender may be able to lend to a fund that includes such an unknown investor only if the lender can rely upon the sponsor's own diligence for know-your-customer requirements and be provided at least contact information (such as a post office address) for the investor to receive capital calls from the lender in the exercise of default remedies.

Many lenders will not include high net worth individual investors in a borrowing base as a matter of policy, though others may make exceptions, particularly for sufficiently large family offices or feeder funds comprised of a group of high net worth individuals.

Borrowing base exclusions

Lenders often require concentration limits, which exclude the portion of an investor's uncalled capital from the borrowing base in excess of a certain percentage of all uncalled capital. If the fund is obtaining the capital call facility after only a single closing or in an early stage of fund-raising, the sponsor should request a ramp-up period during which the concentration limits will not apply. Sometimes lenders also reduce the borrowing base by the percentage of uncalled capital of the single largest investor, which results in an exclusionary effect even more severe than concentration limits.

Eligible investors may be removed from the borrowing base upon the occurrence of various default-type events that reflect a loss of credit-worthiness. Exclusion from the borrowing base for a material adverse change or loss of net worth should apply only to non-rated investors, on the assumption that a material adverse change or loss of net worth in a rated investor will be reflected by a rating downgrade. For exclusion of an investor who fails to make a required capital contribution, the sponsor should take account of the grace period provided in the partnership agreement, typically five or 10 business days. Sponsors and their counsel should also make sure that the exclusion for an investor excused from a particular investment disqualifies that investor only with respect to an advance made to fund an investment in the particular industry or jurisdiction for which the investor is excused under its side letter or the partnership agreement, and not with respect to other investments generally.

Other borrowing base issues

While it is customary for the borrowing base calculation to deduct the amount of any debt of the fund incurred outside the facility, sponsors should make sure that they are not required to deduct liabilities that would not be expected to be paid from capital calls, such as (a) cash-collateralised exposure under letters of credit and hedging provided by third parties, and (b) non-recourse pledges of portfolio assets, for example, to secure portfolio company debt (in the case of a private fund) or asset securitisation financing (in the case of a debt fund).

Some capital call facilities permit the borrower to include investment assets in the borrowing base, either on a secured or unsecured basis. This approach may be appropriate for: (a) a fund near its maturity, where the amount of its assets under management far exceeds its uncalled capital; or (b) a debt fund that uses a hybrid capital call/portfolio asset borrowing base early in its life as a warehouse facility until it accumulates enough assets for a securitisation financing. In both cases, the investment assets are typically included at a relatively low advance rate, based on the most recent asset value as reported by the fund to its investors from time to time.

Large sponsors sometimes employ a single capital call facility for the use of multiple funds across different investment strategies. In such multi-fund facilities, each fund uses only its own borrowing base and collateral. The fund borrowers are never jointly and severally liable for each other's obligations, and a default by one fund borrower would not trigger a cross-default for the other fund borrowers. New fund borrowers can be added to the facility from time to time. The advantages to the sponsor of a multi-fund facility are: (a) to economise on transaction costs with a single credit agreement covering multiple funds; and (b) to minimise the facility size, with the resulting reduction in upfront fees and unused availability fees that would otherwise arise from separate facilities for each fund. These savings are based on the assumption that the different funds will use the facility in a similar manner, but with peak borrowings at different times. Problems may arise if most of the funds need to borrow at the same time. Common expenses generally applicable to all the funds, such as upfront fees, unused availability fees, indemnities and transaction costs, are typically allocated based on relative uncalled capital of the funds from time to time.

Basic borrowing terms

Capital call facilities often mature every 364 days (with renewal in the lender's sole discretion) in order to take advantage of the reduced capital reserve requirement for a lender providing only a short-term facility, and the resulting lower interest rate. In such cases, the expectation of all parties is to renew the facility year to year, absent compelling circumstances. Other facilities are typically three years, often with annual extensions in the lender's sole discretion.

Note that letters of credit and hedging issued under the facility will need to extend beyond the facility maturity date, but must be cash-collateralised prior to such maturity date if the facility will not be extended. Similarly, the lender's commitment should not terminate upon expiration of the fund's investment period if the partnership agreement provides that capital may be called from the fund's investors to repay loans even after the investment period ends.

Funds often require (a) a temporary increase in availability for a 90- or 180-day period to facilitate large investments or other unusual cash needs, and (b) an accordion feature to increase the lender's commitment as new investors are added to the fund through subsequent investor closings.

Covenants

The scope of covenants that a capital call facility lender will expect is narrower than the covenants in a typical revolving credit facility for an operating company. Financial ratios and restrictions on asset dispositions and investments are not typical in capital call facilities.

Negative covenants

From the fund's perspective, restrictions against liens that apply only to the lender's collateral are ideal, and typical. If the lender insists upon a broader liens restriction covering other fund assets, the fund will need to permit, at a minimum, (a) cash collateral for third-party letters of credit and hedging, and (b) liens on portfolio assets that secure obligations of portfolio companies (in the case of private equity funds) or warehouse or other asset-based leverage facilities (in the case of debt funds).

Similarly, the ideal indebtedness covenant from the fund's perspective would permit any indebtedness authorised by the partnership agreement. While this approach is acceptable to many lenders, others will insist upon a broader debt restriction. In addition to permitting the types of debt associated with the lien exceptions described above, sponsors should make sure that ordinary course obligations to make acquisitions or other investments pursuant to bids and purchase agreements are not prohibited by the debt covenant.

Limitations on fund distributions to partners, and the payment of management fees and expenses to the sponsor, raise sensitive issues. Many capital call credit agreements prohibit payment of these items during a potential default or mature event of default. Sponsors will want these payments blocked only when loans or letters of credit are outstanding under the facility, and push for blockage only upon a mature event of default, preferably only relating to payment (including as a result of a borrowing base deficiency or an unpaid mandatory prepayment) or bankruptcy. Sometimes sponsors will insist that tax distributions and management company out-of-pocket expenses be paid regardless of an event of default.

Prepayment covenant

Mandatory prepayments, whether on account of a borrowing base deficiency, key person event under the partnership agreement or other factor, as well as capital adequacy and similar event-driven payments, require special attention. While a typical revolving credit agreement for an operating company would require the borrower to make these payments immediately, a fund borrower will most likely not have sufficient cash on hand to make these payments. As a result, in a capital call facility these payments should be due within two business days to the extent of available cash, with the balance due within the period necessary to make and collect a capital call on investors, typically 10 to 15 business days.

Covenants relating to investors

Because the lender's collateral and source of repayment is so closely tied to the fund's organisational documents, the lender will be especially sensitive about waivers and amendments of the fund's partnership agreement and investor subscription agreements and side letters. Many capital call lenders want consent rights for any amendment or waiver to these agreements, as well as for any new investor side letters and subscription agreements, for the purpose of reviewing whether adverse provisions would trigger most-favoured-nation clauses in side letters for previous investors that are already in the borrowing base. As a starting point, sponsors will want to limit these lender consent rights only to changes that would materially adversely affect the lender, including adjustments to the fund debt limit, changes to capital calls and commitments and similar items. Even with this sort of limitation, the lender may require an extensive pre-clearance procedure, such as 10 business

days for the administrative agent or lead lender to determine whether the proposed waiver or amendment would have such an adverse effect, then 10 additional business days to obtain approval from any other lenders. A preferred approach is for the sponsor to make the initial determination whether an amendment is adverse to the lender, and then provide a lender with a pre-approval period only for such adverse amendments. If the sponsor is unable to avoid initial pre-clearance, the sponsor will want to shorten the review periods as much as possible.

Either as a closing condition or covenant, lenders often require that the sponsor notify all fund investors that the capital call facility is in place. Typically sponsors agree to provide such notice only in the next regularly scheduled periodic investment report. For funds organised in the Cayman Islands, however, notice to investors is a required step to perfect the lender's security interest in uncalled capital, so a special notice prior to the next periodic report may be necessary. The form of notice may be negotiated with the lender, but should be primarily drafted by the fund sponsor, in order to present the facility in an optimal manner from an investor relations perspective.

Defaults and remedies

Capital call credit facilities contain several events of default and remedies that do not customarily appear in a revolving credit facility for an operating company.

Capital call facility defaults

Transfers by investors of more than a certain percentage (typically 10% or 15%) of the fund's total capital commitments is a common default in capital call facilities. At a minimum, the sponsor should push to exempt from this default transfers from an investor to one of its own affiliates. The sponsor could try to limit the default only to those investors included in the borrowing base, or even eliminate the default altogether on grounds that such a transfer should only reduce the borrowing base, and not terminate or accelerate the entire facility.

Another special default trigger is the failure of a certain percentage of investors (typically 5% to 15%) from paying a capital contribution when due. At a minimum, the sponsor should push to include the payment grace period from the partnership agreement. As with the default trigger for investor transfers, the sponsor could also try to limit the default only to those investors included in the borrowing base, or eliminate the default entirely and protect the lender only through a borrowing base reduction.

Often the occurrence of a key person event or change of control under the partnership agreement constitutes an event of default. If the partnership agreement provides a standstill period (typically 30 to 60 days) before the limited partners may dissolve the partnership or permanently suspend new investments as a result of such an event, the sponsor should consider making the occurrence of such an event only a justification for the lender to cease making new advances, as opposed to an event of default that could result in termination and acceleration of the facility. If the investors decide to reinstate the investment period, advances may again be requested. If the investors terminate the partnership or permanently suspend new investments, a mandatory prepayment would occur.

Special remedy concerns

One of the most important protections for a sponsor in a capital call facility is to prevent the lender from calling capital as a result of an event of default, unless the general partner fails to do so for a period of five business days (or other reasonable period) after demand by the lender during the existence of an event of default. Even during a default, the sponsor should

make every effort to maintain usual operations with respect to the fund's investors, and not have to negotiate an amendment or other workout with the lender threatening to contact the fund's investors at any moment. Lenders are usually amenable to this protection, but sometimes insist that this protection should apply only if the default can be cured by a capital contribution, and that during a default the lender should control the issuance of all capital calls. Notwithstanding these lender arguments, the sponsor should always retain the right to call capital during a default for the purpose of paying the facility in full. From an investor relations perspective, it is essential for the sponsor to demonstrate that the fund is operating in the ordinary course of business to the extent practicable. A payment demand upon the fund investors from a third-party lender would be extremely disruptive to relations between the sponsor and its investors.

Even though the lender limits its loans to a borrowing base comprising only eligible investors, the lender's collateral extends to the uncalled capital of all investors in the fund, even those who are not included in the borrowing base. Similarly, even though the lender is secured only by uncalled capital and related rights, the lender's recourse to the fund is not limited only to its collateral: a capital call lender could bring a claim as an unsecured creditor against all investment and other assets of the fund.

Sponsors typically limit this recourse only to fund assets, and not to the general partner's assets, as would be the case under partnership law. General partner assets may include direct or indirect ownership in the management company or other interests of the sponsor that it does not want to expose to a lender at the fund level. Exceptions to such a non-recourse provision typically include: (a) the pledge by the general partner of its right to call capital and exercise remedies on behalf of the fund; and (b) damages resulting from wilful misconduct or fraud by the general partner.

* * *

With the foregoing issues in mind, the sponsor (and its counsel) should be able to negotiate a capital call facility that brings the desired benefits to the investors and the fund, while providing sufficient flexibility for the fund to operate without undue interference from its lender.

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