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Subscription-Secured Credit Facilities: Basic Credit-Related Issues for Secured Lenders

by
Thomas Volet
and
Michael Evan Avidon,
Partners, Moses & Singer LLP

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Quite popular before recent economic dislocations, and beginning to re-emerge, is a credit facility that provides liquidity for an investment fund (a "Fund", particularly a so-called "opportunity fund"), on a faster basis than calling for capital contributions by the fund's equity investors - - typically governmental and private pension funds, insurance companies, endowment funds, and other institutional entities who make substantial commitments to pay subscribed capital.

The defining feature of this type of credit facility (a "Facility") is the nature of the collateral security: the obligations of the Fund's equity investors (the "Investors") to pay remaining unpaid subscribed amounts to the Fund secure the obligations of the Fund under the Facility (whether as borrower or guarantor). It is intended that if there is a default under the Facility, the lender (or agent for the lenders, as well as any letter of credit issuing banks, collectively, the "Lender") will be able to call for and receive payment of those unpaid subscribed amounts for application to the debt. It is significant that despite recent economic troubles, there have been very few reports of investor defaults in making capital contributions to such Funds for the purpose of repayment of a Facility.

In the case of subscriptions to provide equity capital (as opposed to debt), which is typical for Funds organized as U.S. pass-through entities such as limited partnerships or limited liability companies, those Investor obligations are often referred to as "Capital Commitments". Because of the Lender's reliance on ongoing unfunded Capital Commitments as a source of repayment, investment funds with redemption features allowing Investors to cash out and eliminate future funding obligations are not customary users of these Facilities (although establishing a Facility for such a vehicle would not be impossible if appropriate provisions are incorporated in the relevant documentation).

As the collateral for the Facility consists essentially of rights relating to the obligation of the Investors to contribute capital, Lender's counsel will review the Fund's proposed partnership agreement, limited liability company agreement, or similar document (the "Constituent Document"), its form of subscription agreement, and the increasingly common side letters with

larger investors (which have the effect of amending the Constituent Document). There are clear advantages in arranging for that documentary review at the earliest possible stage of the process, so that problematic provisions can be appropriately adjusted before Investors are admitted to the Fund, and, ideally, even before potential Investors review the documents they are to execute. Once Investors have signed documents, Fund sponsors are understandably reluctant to ask for revisions. However, the process of modification of the Constituent Document after it has been reviewed or even executed by Investors has taken place in a significant percentage of such financings, and Investors who have been involved in similar investment vehicles (as is the case with many of the opportunity fund Investors) often have been through the revision process before.

Funding a capital call to repay credit extended under a Facility should not be seen as an incremental investment by the Investor - - if not for that earlier extension of credit, the Fund would have called capital and the Investors would have made contributions, in the same aggregate amount, at the same time, and for the same purpose for which the extended credit was used. An Investor's failure to make its contribution, whether pursuant to a contractual option or a default, has different ramifications for a Fund than for a Facility Lender. Therefore, much like the issuer of a commercial letter of credit who must be reimbursed for a draw, the Lender should not be involved in, or hampered by, issues that arise between the Investors and the Fund's general partner or other manager (the "Manager"). Accordingly, if the Fund has borrowed under the Facility and has used the loan proceeds to make a bad investment, or has made an investment in violation of some covenant in the Constituent Document, those are matters the risks of which should be allocated solely between the Investors and the Manager and should be settled by them separately.

The Lender cannot be cast in the role of overseeing the Manager's fulfillment of its contractual obligations to Investors, and it is therefore not an appropriate allocation of risk for the repayment rights of the Lender to be affected by such circumstances. In a situation in which a Fund calls capital rather than draws on a Facility, an Investor's failure to contribute may inconvenience the Fund's sponsor, or even interfere with the consummation of a proposed investment, but it is not as serious a dislocation of properly allocated risk as in the case of the Lender that has extended credit and is relying on the Capital Commitments as the primary source of repayment. The Lender should have access to the Capital Commitments *without defense, counterclaim, or offset* (a mantra that appears in the Constituent Document of virtually every Fund that has a Facility).

Subscription Facilities invariably have a borrowing base limitation on available credit, which can take many forms. One almost universal constant is that only the unfunded Capital Commitments of certain selected Investors (the "Included Investors") qualify for inclusion in the borrowing base (usually at some discounted amount, which may be tiered based on ratings or other characteristics). The analogy to accounts receivable financing is apt. However, the security interest of the Lender includes the Capital Commitments of all Investors, not just the

Capital Commitments of the Included Investors. This feature is not solely a credit matter - - because the Constituent Document generally requires that capital calls be made to all Investors at the same time, usually pro rata to respective Capital Commitments, it would not be workable for the Lender to have rights to call for contributions only from the Included Investors.

A. Credit Documentation, Generally.

The basic package of credit documentation typically includes the following:

1. *Revolving Credit Agreement*, providing for loans (and letters of credit) in amounts not to exceed the lesser of the Lender's credit commitment or the borrowing base.

2. *Pledge and Security Agreement*, granting to the Lender a security interest in the Capital Commitments, the right to call capital from the Investors, the right to apply the same to obligations under the Facility, and the right to enforce those rights of the Fund and/or the Manager in respect of the Capital Commitments and the application of capital contributions to obligations under the Facility. Each of the Fund and the Manager (and each other party who has rights to call for or apply capital contributions) should join in the agreement and the grant of a security interest in all its respective relevant rights, which remain exercisable by the assignor (subject to certain covenants in the credit documentation) in the absence of a default under the Facility.

3. *Subscription Account Security Agreement*, granting to the Lender a security interest in a designated deposit account or securities account under the control of the Lender used solely to receive payments made pursuant to the Capital Commitments, all of which payments should be required by the Constituent Document to be paid directly into such designated account (the "Subscription Account"). Payments into the Subscription Account by Investors are generally released to the Fund as long as sufficient borrowing base remains. This protects the Lender against the situation in which capital could be called and the contributions used for purposes other than to repay the Facility, which could leave the Lender undersecured after giving effect to the decrease in the amount of the unfunded Capital Commitments resulting from payment of the capital call. Whether or not assets acquired with the proceeds of a capital call enhance the balance sheet of the Fund, each dollar of capital contributed is a dollar less of collateral in the form of unfunded Capital Commitments.

4. *Investor Acknowledgment* (or "Investor Letter"), a highly stylized instrument addressed by the Investor directly to the Lender, which (*inter alia*) acknowledges various aspects of the Facility, the amount and unfunded portion of the Investor's Capital Commitment, the absence of existing defenses of the Investor to the payment of its Capital Commitment for purposes of satisfaction of obligations under the Facility, and that the Investor will not receive credit for its payments of capital unless they are funded into the Subscription Account. This document serves as confirmation of the Fund's representation as to the Investors' uncalled capital, and also as a confirmation that the signatory Investors and the Manager are not involved

in a dispute when the Facility is established. There is a great deal of sensitivity relating to the contents of this instrument in the case of ERISA-regulated Investors out of concern that, depending on the facts, it may constitute an indirect "prohibited transaction" under ERISA. (A fuller discussion of ERISA issues is beyond the scope of this article.)

Because of the large influence of the Investors and the Fund's interest in accommodating them, the Investor Letter is often a sensitive document to negotiate. Experience suggests that the most efficient way to accomplish the desired objectives is to have the appropriate provisions relating to the Facility contained in the Constituent Document, which allows the acknowledgment by the Investors to the Lender to be accomplished through straightforward reference to the Constituent Document. Although the Lender cannot reasonably prohibit the Fund from admitting an Investor who refuses to deliver this document (and a covenant requiring some commercially reasonable level of effort to cause the delivery thereof by each Investor is customarily contained in the Credit Agreement), delivery of an Investor Letter is almost invariably a condition to the inclusion of the amount of the Investor's unpaid Capital Commitment in the borrowing base.

5. *Investor Opinion*, of counsel to the Investor, addressed directly to the Lender, relating to the Investor's obligations in respect of its Capital Commitment. This is often required only for Included Investors, and is not an onerous legal opinion.

B. Fund Documentation Issues, Generally.

The favorable pricing associated with a Facility depends on the principle that the Lender will be repaid without contest by Investors. Thus, its rights in respect of the Capital Commitments are intended to be explicit, not only as to the Fund, but as to the Investors.

It has become common for the Constituent Document to contain an integrated section specifically providing for the Facility and the collateralization thereof, setting forth in some detail various credit-related features, such as the obligation to pay Capital Commitments for purposes of satisfaction of Facility obligations without (and specifically waiving) any defense, counterclaim or offset, including if the same is based on any breach or misrepresentation by the Manager or by any other Investor, any asserted absence of authority on the part of the Fund or the Manager, or the failure of the Fund or the lack of success of its investments. Among the matters that should be addressed in such a section, or elsewhere in the Constituent Document, are the following:

1. *Explicit Contemplation of the Facility.* The Constituent Document should contain provisions making it clear that the establishment of a Facility is contemplated with borrowing (or guarantee) by the Fund, and the securing of the credit in a manner consistent with the Pledge and Security Agreement and the Subscription Account Security Agreement, including the right of the Lender to call for payment of Capital Commitments if there is a default under the Facility.

2. *Unqualified Authority.* The relevant provisions of the Constituent Document providing *authority* for borrowing under the Facility and collateralization thereof should not have any qualifications. If the authority to borrow under the Facility derives from a general borrowing authority provision, it also should not be qualified. This is not to say that the Constituent Document cannot contain provisions restricting the Fund's activities, but rather that such restrictions (including leverage limitations, investment concentrations provisions, and the like), should be contained in separate covenants binding on the Manager that do not qualify or limit the authority, *per se*, to borrow, repay through called capital, and collateralize the Facility in the manner contemplated. The distinction is illustrated by the difference between an unsatisfactory clause such as: "The Manager is authorized to incur debt on behalf of the Fund provided that the Total Debt does not exceed x% of Net Asset Value." and the acceptable alternative: "The Manager is authorized to incur debt on behalf of the Fund. The Manager agrees that it shall not at any time incur debt if after giving effect to such incurrence the Total Debt would exceed x% of Net Asset Value." Whether or not the borrowing may have been in violation of a covenant between the Investors and the Manager, the Lender should not find itself in the position of debating whether the Fund had the authority to borrow in the first instance. It is common for the Constituent Document to contain several enumerated paragraphs specifying the purposes for which Capital Commitments may be called (which surprisingly often in early drafts omit mention of the repayment of debt as such a purpose), and it is obviously advisable that the satisfaction of obligations under the Facility be among the specified purposes (particularly in the case when other specific purposes are enumerated).

3. *Termination or Suspension of Pay-In Period.* The Constituent Document often contains provisions that can result in the abbreviation of the scheduled period (customarily ranging from two to five years) during which payment of Capital Commitments may be required. Abbreviation options may vary with the purpose for which the payments are to be used. Early termination (or suspension) of the pay-in period is often provided where the Manager determines that it has exhausted feasible investment opportunities, when a certain percentage of the aggregate amount of the Capital Commitments has been invested, if the Investors determine that the Manager has breached the Constituent Document, if certain regulatory issues may be presented, or even simply if a certain percentage of Investors have determined that they wish to terminate the period. This is obviously inconsistent with the need of the Lender to call capital if necessary to repay the credit extended. The simplest solution is for the Constituent Document to provide that *in the case of calls to pay Capital Commitments to be applied to obligations under the Facility* (including calls by the Lender as assignee), the pay-in period cannot terminate prior to a fixed date (which would be set later than the scheduled maturity date of the Facility by a specified interval sufficient to call and receive capital contributions if necessary). To the extent termination is in the control of the Manager, it is not uncommon in the case of Managers with whom the Lender is comfortable for the Lender to rely on covenants (contained in the credit documentation) by the Manager not to terminate the pay-in period.

Occasionally the Constituent Document will contain provisions allowing termination of the pay-in period by determination of Investors representing a certain percentage of Capital Commitments. Although more difficult, such a mechanism may be accommodated in principle if the Constituent Document incorporates safeguards for the Lender such as a provision that such a termination is not effective as to capital calls to repay Facility obligations unless and until the Lender has received prior written notice thereof, and in any event will not apply to credit extended prior to such receipt of such notice. (Of course the credit documentation must provide that the Lender's commitment to extend further credit will also terminate upon receipt of such a notice). A contractual obligation that the Lender receive notice of terminations that are under the control of the Investors is not, alone, sufficient, as the failure to give the notice could result in the Lender's having an uncollateralized remedy. Rather, the *effectiveness* of the termination of the pay-in period (which in any event should not apply to contributions for then-outstanding extensions of credit) should be conditioned on receipt by the Lender of the notice.

In general, any limitation of the circumstances under which capital may be called or on the amounts of capital that may be called, whether based on particular uses of the called capital, on particular time periods in which the call is made, on the characteristics of the Investors, or on other parameters, bears careful scrutiny.

4. *Third Party Rights.* The Constituent Document often contains a boilerplate clause to the effect that the rights arising under the agreement are for the benefit only of parties to the Constituent Document, and that no third parties have any rights thereunder. Because the collateral for the credit consists of rights arising under the Constituent Document, and further in view of the many provisions designed for the benefit of the Lender under the Facility that are contained in the Constituent Document, that kind of boilerplate is simply inconsistent with the Facility. Simple carve-outs to the broad language (e.g., "except for provisions [for the benefit of] [relating to] the lenders under the Subscription Facility contemplated by Section X...") are often employed to restore the consistency.

5. *Arbitration.* Rarely, arbitration clauses appear in the Constituent Document. That manner of dispute resolution can be inconsistent with the parameters of subscription financing, and serious consideration should be given to carefully circumscribing, or if possible removing, such provisions.

C. Special Credit Issues.

1. *Section 365(c)(2) of the Bankruptcy Code.* This statutory provision, relating to the treatment of certain executory contracts in bankruptcy, is potentially relevant in the scenario in which the Fund or the Lender is attempting to enforce the Capital Commitment against an Investor. Among other things, it may affect a contract to "issue a security of the debtor" if the Fund is a bankruptcy debtor. It is not common for pass-through entities to "issue" securities, in the customary usage of that term, at any time after the initial acceptance of the Investor into the Fund. Rather, the equity interest held by the Investor is generally an "assessable" security (i.e., it

is not "fully paid and non-assessable"), with the customary capital accounting mechanism incorporating the requirements of the regulations under Section 704 of the Internal Revenue Code. However, in some cases the fund "issues" additional interests whenever capital is contributed, although generally the issuance consists of nothing more than a Constituent Document provision that the Fund shall "issue" new "shares" so that the Investors end up with the appropriate number representing their respective interests, coupled with the act of making an entry in the records of the Fund to the effect that the capital contribution has been received, with no share certificate or corresponding instrument being delivered to the Investors. This issue frequently has been addressed by constituting the Lender as an agent for the ministerial issuing function pursuant to an instrument functioning in accordance with relevant provisions of Article 8 of the UCC. Furthermore, the provisions relating to the Facility in the Constituent Document often contain a specific waiver of Section 365(c) to the extent applicable in the case of the insolvency of the Fund. There is case law rejecting the post-petition waiver of Section 365, but it is difficult to see a good policy reason why the bankruptcy process would be offended by a pre-petition waiver of Section 365(c) by an equity investor, particularly by an equity investor with the economic wherewithal and sophistication of the typical Investor that subscribes for interests in a Fund with a Facility.

2. *Borrowing Base Issues.* The credit documentation for a Facility customarily contains a number of features designed to protect the integrity of the borrowing base.

a. *Disqualification, Investor Default.* The credit documentation typically employs a concept of an "Investor Disqualification Event" as a result of which the unfunded Capital Commitment of the affected Investor is no longer eligible for borrowing base inclusion. Obvious paradigms of such events are defaults in responding to capital calls, insolvency filings by the Investor, and repudiation of the Investor's Capital Commitment. The range of remedies available to the Manager under the Constituent Document in the case of Investor default are customarily broad, however exercise of some of those remedies (e.g., termination of the right of the Investor to contribute after it once defaults), may be inconsistent with the ongoing interest of the Lender in its collateral whether or not the relevant unfunded Capital Commitment continues to be included in the borrowing base. The Lender should not be at risk of interference from exercise by the Manager of such remedies, and it is common for the Constituent Document to explicitly provide that the exercise of such rights is subject to the consent of the Lender. Exercise of those remedies is usually left to the discretion of the Manager, in which case it may be addressed in the credit documentation, but any Constituent Document provision for automatic termination of the right to contribute should be removed.

b. *Compromise, Withdrawal, Transfer, and Borrowing Base Shortfalls.* Clearly, if an Investor is excused or otherwise released from its remaining Capital Commitment, the Investor drops out of the borrowing base. In addition, the Facility credit documentation usually excludes the Capital Commitment of any Investor that has transferred its interest in the Fund. Even if the Investor remains responsible for future contributions, the Lender typically will not be

comfortable with an "absentee" obligor that has liquidated its investment and lacks customary incentives to make further contributions (although the Lender may agree to include the Capital Commitment of any acceptable transferee). Excused, withdrawn, and transferor Investors are treated for borrowing base purposes in the same manner as Investors who drop out of the borrowing base because of a ratings decline or for failure to maintain other requirements, much as an ineligible account receivable is excluded from the borrowing base in accounts receivable financing.

It is important to note that when the removal of an Investor from the borrowing base causes an excess of credit exposure over the remaining borrowing base, a pro rata capital call to all Investors in the aggregate amount of that excess will not suffice to solve the problem. When the Investors make the capital contributions in that aggregate amount, the borrowing base will be further eroded to the extent of the amounts paid by the remaining borrowing base Investors (by virtue of the resulting decrease in the amount of their unfunded Capital Commitments). A subsequent corrective capital call in the amount of that new shortfall would similarly result in yet another (albeit smaller) shortfall, and so on. The algebra that anticipates that infinite series is not complex, the point being that the amount of the payment required under the Facility credit documentation must be an amount greater than the original excess, appropriately grossed-up to account for the additional borrowing base reduction resulting from the corrective contributions.

c. *Amendment of Constituent Document.* It is inherent in collateral in the nature of contractual rights that the collateral is subject to potential impairment by virtue of modification of those rights in a manner that is detrimental to the secured party. In theory, the Fund and the Investors can amend contractual provisions constituting or relating to the Capital Commitments in a manner disadvantageous to the Lender. Accordingly, the credit documentation should contain provisions in which the Manager (a party to that documentation in its individual capacity as well as in its representative capacity as to the Fund), whose consent to such amendments is required under the Constituent Document to which it is a party as well, agrees with the Lender to a wide range of limitations on amendments of the Constituent Document to which it will consent. (In the case of a Delaware limited partnership, the Constituent Document could also contain provisions of the type contemplated by Delaware Revised Uniform Limited Partnership Act Section 17-302(f), requiring the Lender's approval or the satisfaction of other stated conditions to amendment.)

D. Exclusions and Other Special Investor Issues.

1. *ERISA and Other Regulatory Concerns.* Many Investors are ERISA-regulated pension entities. This raises in particular the issues of (i) whether the assets of the Fund are to be treated as "plan assets" under ERISA, and (ii) whether any aspect of the transaction (including the delivery of the Investor Letter) would otherwise result in a "prohibited transaction". Other Investors may be subject to other regulatory regimes. Often the Constituent Document will provide that if an Investor subject to ERISA or other such regulation furnishes an opinion of counsel that it should not honor a particular capital call or class of capital calls, then, under the

Constituent Document, it need not honor such a call or calls. That kind of provision, despite a superficial appeal, is not analytically supportable if the Capital Commitment of such an Investor is to be included in a borrowing base. In that context, it is tantamount to a clause in a loan agreement providing that the loan is due and payable at maturity unless the borrower furnishes an opinion of counsel that regulatory constraints prohibit repayment. The objective reality, not a counsel opinion, should decide the matter: if the Investor can successfully assert (including by prevailing in litigation, if necessary) that applicable law prohibits it from honoring a capital call for the purposes of repaying a Facility, then the Lender ultimately must deal with that outcome. But the risk of the objective reality should not be accompanied by a separate contractual exit that might be available notwithstanding that the litigation would have been lost by the Investor (for example, if its counsel's opinion was simply incorrect, and the capital call could have been paid under applicable law).

Counsel opinions as a shield to a contribution may well make sense in the case of a call by the Fund for purposes other than repayment of a Facility, but where the Lender is relying on the Capital Commitments, their justifiability is questionable. This issue has been successfully addressed by adding to the Constituent Document provisions requiring that any prepayment required under the Facility must be made as a condition to the effectiveness of the contractual excusal of the Investor (including an excusal initiated by a counsel opinion). Without satisfactory resolution, an Investor that can be excused without such constraints by furnishing a counsel opinion (or other similar mechanism) should not be an Included Investor.

2. *Immunity.* Investors include governmental pension entities (not subject to ERISA), state endowment funds, instrumentalities of foreign governments, or other entities that may have various forms of immunity. Unless such immunities are waived (either in applicable documentation, by statute, or otherwise), or can be determined to be inapplicable to the Capital Commitment, it is difficult to justify the inclusion of such an Investor's Capital Commitment in the borrowing base.

3. *Side Letters and Most-Favored Nation Clauses.* It has become increasingly common for Investors with substantial Capital Commitments to have side letters with the Fund that specifically override inconsistent provisions of the Constituent Document. The side letters occasionally include "opt-out" opportunities for the Investor, or essentially equivalent rights to trigger a termination of its pay-in period. There also may be provisions that result in an adjustment of the amount of the Investor's Capital Commitment upon the occurrence of certain events, including events relating to other Investors. Because the side letters effectively amend the Constituent Document, it is essential that the side letters be reviewed by Lender's counsel.

There is also a particularly troublesome feature of the customary side letters: most favored nation clauses. These provisions may require, for example, that the Investor in question must get the benefit of any provision appearing in the side letter of (i) any other Investor (or of any other Investor whose Capital Commitment does not exceed a certain threshold), or (ii) any other Investor that is a state or municipal entity with "similar" statutory constraints. It may be

quite difficult in the latter case to be sure how many Investors are affected. Furthermore, a most favored nation clause is equally sensitive to a provision appearing in a side letter of an Investor not included in the borrowing base. Thus all side letters must be obtained and reviewed. This has become an increasing difficult area in subscription financing, requiring diligence by Lender's counsel.

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