Private Equity Law Report pelawreport.com

Sep. 5, 2024

Lending Strategies

# Structuring and Finance Considerations of Evergreen Private Credit Funds

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As non-bank lenders continue to serve as an alternative to traditional lenders, and private credit investments remain attractive to institutional LPs, fund managers may wish to consider evergreen fund structures to reduce the costs of raising new funds and to grow LP capital invested in private credit strategies.

To achieve that goal, the two most common evergreen structures adopted by fund managers are rolling vintage funds and liquidating account funds. Although both types of structures are evergreen, they offer a range of different considerations for fund managers to weigh at the fund formation stage.

This article describes alternatives for customizing the fundraising, equalization, investor liquidity and recycling terms in both types of evergreen private credit fund structures, as well as considerations when using subscription or net asset value (NAV) financing facilities with either approach.

See "Trends in Management Fee Base Calculations, Evergreen Structures and Tax Issues for Private Credit Funds (Part One of Two)" (Jan. 26, 2023).

## Two Types of Evergreen Structures

The first type of evergreen private credit fund structure has consecutive fundraising periods and investment periods within a single fund (Rolling Vintage Fund). Each fundraising period in a Rolling Vintage Fund – and the corresponding investment period and harvest period – are considered to be a "vintage."

A Rolling Vintage Fund shares many structural traits of a typical PE fund, including:

- commitments are accepted during a fundraising period;
- capital calls are issued so that investments are made during the investment period; and
- following a harvest period, proceeds are returned to LPs at the end of the term through a distribution waterfall.

Unlike a typical PE fund, however, a Rolling Vintage Fund provides for consecutive vintages. That feature is structured such that LPs' capital commitments in a new vintage are increased by the LPs' receipt of distributions from prior vintages until the LPs are eventually released from their commitment to the fund.

The second common evergreen private credit fund structure uses liquidating accounts to segregate the interests of withdrawing LPs from the remaining fund interests (Liquidating Account Funds). In a Liquidating Account Fund, the pro rata slice of portfolio investments attributable to a withdrawing investor is segregated into a liquidating account until the investments are realized in the normal course. That permits a fund manager to exit portfolio investments in the ordinary course, when it is in the best interest of the fund, rather than forcing an exit at an inopportune time to meet a withdrawal request.

See this three-part series on permanent capital vehicles: "Why Sponsors Look to Unlisted Registered Funds to Achieve 'Functional' Permanence Beyond Typical Private Funds" (Dec. 8, 2020); "Confronting Certain Challenges of Operating Unlisted Registered Funds, and the Appeal of Private BDCs" (Dec. 15, 2020); and "Weighing the Merits of Pursuing Permanence Through Unlisted Closed-End Funds of PE Funds and Interval Funds" (Jan. 12, 2021).

## Fundraising

A key evergreen fund structuring consideration is how often the fund will accept new capital, whether that is in the form of commitments from new LPs or additional capital from existing LPs.

Rolling Vintage Funds typically have consecutive defined fundraising periods that correspond to defined investment periods. A fundraising period begins (and new capital is accepted) when the previous investment period has ended, which is often the earlier of a period of years or the date that a minimum threshold of the unfunded commitments is invested.

There may be some exceptions, however, when Rolling Vintage Funds can accept new capital. One instance is when new capital is accepted outside of a fundraising period to replace the unfunded commitments of LPs that have been released. Another is the GP being able to accept new capital outside of a fundraising period if it would benefit the fund because of a market opportunity or other portfolio management consideration. If the GP is afforded that discretion, it may be contingent on approval by the LPs or the LP advisory committee.

By comparison, Liquidating Account Funds offer much greater flexibility when structuring fundraising terms. For example, some Liquidating Account Funds may accept new capital monthly, while others give the GP discretion to determine when to accept new capital.

Both Rolling Vintage Funds and Liquidating Account Funds may allow LPs to submit irrevocable commitments with the understanding that the commitments will only be accepted in the GP's discretion or upon the occurrence of a specified event. A benefit is that the GP can quickly deploy capital without additional fundraising in the context of an investment opportunity or to replace LP

capital that has left the fund (*e.g.*, due to released commitments or withdrawals). Further, LPs may see these arrangements as a quasi-capacity right for future investment opportunities.

For more on funds with similar features, see this three-part series on contingent dislocation funds and market disruptions: "Appeal, Application and Adoption Before Adverse Events" (Mar. 15, 2022); "Unique Mechanisms That Position Them to Pounce" (Mar. 22, 2022); and "Suitable Fund Participants and Potential Downsides to Avoid" (Mar. 29, 2022).

## Reconciling New and Existing Capital

### Equalization

Another key structuring consideration is whether new capital will "equalize" with the fund's portfolio (*i.e.*, participate in existing portfolio investments). Rolling Vintage Funds are often structured with true-ups during each fundraising period, so that new capital accepted after a vintage has begun making investments can participate in that vintage's existing investments based on their cost or NAV. A true-up may be unnecessary for a fund with liquid investments, however, if the GP has the ability to use the new capital to purchase liquid investments that are identical to the fund's existing liquid investments.

Alternatively, equalization may be achieved at the investment level rather than across the entire portfolio. Assigning a participation percentage on a deal-by-deal basis would be appropriate when LPs participate in the same investments across investment periods. Although that approach gives GPs flexibility to negotiate different investment periods with different LPs, it can be more burdensome to administer than applying a single participation percentage to all portfolio investments in which new capital will participate.

### Side Pockets

Side pockets can also be used to exclude new capital from existing investments. For example, the GP may have discretion to side pocket investments that are impaired, so that those investments do not harm ongoing fundraising efforts. When an investment is moved to a side pocket, participation ownership percentages are frozen as to the side pocketed investment, and new capital cannot participate in profits and losses from the investment. Unlike a liquidating account, side pockets typically only relate to a single investment rather than a withdrawing investor's interests in all investments.

### Series Vehicles

Participation in, or exclusion from, existing investments can also be facilitated by establishing a series that only holds some of the fund's investments. A fund manager can decide when a particular series – which may relate to terms LPs receive or a group of investments – is no longer accepting new capital.

For a fund that is a Delaware limited partnership, protected series or registered series can be used to give each series limited liability, which allows each series to function like a separate legal entity. If protected series or registered series are not established, then the fund's limited partnership agreement (LPA) can still establish "contractual series" to provide that the performance of different series will not be netted, along with conferring rights to specific investments, related expenses, profits and losses.

See this two-part series: "Using Delaware Statutory Series LLCs to Offer Customization to Investors" (Apr. 20, 2021); and "Uncertainty Surrounding Liability Shields and Cost Savings of Series LLCs" (Apr. 27, 2021).

## Investor Liquidity

Evergreen funds use a range of terms to manage liquidity. Although the mechanics differ, Rolling Vintage Funds and Liquidating Account Funds both typically require LPs to agree to "lock up" or commit capital for a specified period. GPs may achieve that objective by offering more favorable fee rates to LPs that agree to remain invested for a longer period.

### Rolling Vintage Fund

A Rolling Vintage Fund is typically structured so that LPs can request to be released from their commitment after the specified commitment period is complete. Investment proceeds attributable to any investments held by the fund at the time of the release will be distributed to the LP through the distribution waterfall as the investments are realized.

GPs can ease the strain caused by releases from a Rolling Vintage Fund by building certain buffers into the fund documents. One option is to create additional runway before LPs are released by establishing a notice period. Another is to incorporate carve-outs from the release, which resemble carve-outs that would apply after an investment period ends in a typical PE fund – *e.g.*, requiring funding of in-process investments, expenses, borrowings and guarantees, as well as follow-on investments. GPs may also have the ability to treat a request from the LP to be partially released from their commitment as a request to be fully released, if the remaining commitment is below an established minimum amount.

As with other terms in a Rolling Vintage Fund, GPs can establish consecutive windows to submit requests to be released from commitments so that an LP cannot request to be released from their commitment after a new investment period has begun.

### Liquidating Account Fund

In a Liquidating Account Fund, lock-ups and other limitations on withdrawals may apply. For example, a fund manager may impose a fund-wide limit on the amount of withdrawals that can be processed on any withdrawal date, with the excess carrying forward to the next withdrawal date,

known as a fund-level gate. Another option is to establish investor-level gates by setting limits on the amount of withdrawals permitted by each specific withdrawing LP, with any excess amount typically carried forward to a future withdrawal date.

Mechanically, liquidity under an investor-level gate is achieved by the GP moving the LP's share of the portfolio investments into a liquidating account on the withdrawal date and simultaneously exchanging the LP's fund interests for interests in the liquidating account. The LP's liquidating account interests will remain subject to fees, expenses and performance of the underling investments until the investments are realized. The liquidating account interests will generally not participate in fund investments that are not held in the liquidating account. In some cases, the GP may have the ability to cause the fund to purchase the liquidating interests from the withdrawing LP if doing so would be in the best interest of the fund.

It is worth noting that separate withdrawal terms may apply to current income, which generally can be paid to withdrawing LPs without impairing the value of any underlying investments.

## Recycling

Providing the GP with the ability to reinvest investment proceeds can be mutually beneficial to all parties. Reinvesting proceeds may be appealing to any LP that invests in an evergreen product with the objective of remaining exposed to the fund's strategy with limited interruptions

As for GPs, reinvesting provisions offer two obvious benefits. First, reinvested proceeds will continue to be subject to management fees in some manner. If management fees are calculated based on invested capital, then reinvesting proceeds will cause the amount of invested capital to increase. When management fees are charged on unfunded commitments, investment proceeds that are distributed (or deemed distributed) will increase unfunded commitments. Second, the ability to reinvest provides GPs with dry powder to capitalize on opportunities and fund more deals.

See "Latest on Private Credit Funds' Recycling Provisions, Subsequent Close Models and Use of Levered Parallel Funds (Part Two of Two)" (Feb. 9, 2023).

Reinvesting provisions can be customized several ways, including by placing limits on the amount or type of reinvested proceeds. For example, proceeds eligible to be reinvested may be limited to the LPs' initial commitment to the fund (*i.e.*, prohibiting reinvestment of profits in excess of the return of capital to LPs). Alternatively, the limit imposed may be a percentage of the initial commitment or a multiple thereof. When there is no limit on reinvesting proceeds, or the limit is a multiple of the initial commitment, LPs often negotiate to prevent the GP from charging a management fee on distributions of investment proceeds in excess of their initial commitments.

Further, current income may be included or excluded from the investment proceeds that are eligible to be reinvested. One variation of that approach is to permit LPs to make an election at the time of their commitment – or, alternatively, at any time after their commitment has been accepted – to receive distributions of current income as it is received by the fund.

## Borrowing

As evergreen funds are a relatively new entrant to the private fund space, the fund finance market is still developing financing products for these vehicles. The nature of the credit facility provided to these funds will be highly dependent on how they are structured.

The classic fund finance product – *i.e.*, a subscription facility secured by LPs' uncalled capital commitments – was developed for closed-end PE funds. An essential prerequisite of subscription facilities is that each LP's commitment to fund capital contributions is fixed and will not decrease, terminate or increase over time. That feature may be less certain for evergreen funds, leading to complications when pursuing subscription lines for those funds.

See "Forming Private Credit Funds: Key Differences in Fund Lifecycle and the Use of Subscription Facilities Versus PE Funds (Part One of Two)" (May 12, 2020).

### Subscription Lines for Rolling Vintage Funds

When LP commitments can be released or terminated, as is the case in a Rolling Vintage Fund, a subscription line lender may be unwilling to lend against those commitments. If LPs are permitted to unilaterally walk away from their commitments without penalty, then the lender's collateral (*i.e.*, LPs' uncalled capital commitments) could evaporate without warning.

To address that issue, many LPAs for Rolling Vintage Funds only permit LPs to cancel their respective commitments to a subsequent vintage during a window that precedes the investment period applicable to such vintage. In that scenario, a lender may be comfortable lending to a vintage (whether structured as a series of a limited partnership or otherwise) as long as those evergreen commitments are only included in the borrowing base after the deadline has passed for the LPs to elect to terminate their commitment to the vintage. That solution would likely only work for a lender if the assets and liabilities of the applicable vintage were fully separated from the assets and liabilities of any other vintage, which could be accomplished by establishing protected series or registered series.

Along that vein, subscription lenders may be unwilling to lend to Rolling Vintage Funds in situations when LPs' capital commitments in a new vintage are increased by the LPs' receipt of distributions from a prior vintage. That reluctance is rooted in some lenders' belief that the changeable amount of the commitment makes it less reliable collateral. Nonetheless, a lender may get comfortable with a subscription line for an evergreen fund when the LPs' commitments are known at the outset of each new vintage and cannot be released until after a defined period.

Another potential issue to be addressed is how the borrowing base of a subscription facility is calculated when investor commitments increase as a result of distributions made in connection with a prior vintage. Lenders could likely mitigate the issue by requiring notice before GPs make any distribution that increases the LPs' commitment and by providing that the borrowing base will be increased to reflect the increase, which is a similar approach to how some subscription facilities handle the issuance of recallable distributions to LPs in traditional PE funds.

Finally, fund managers need to ensure fairness across the vintages when putting a subscription facility in place for a Rolling Vintage Fund. It could be problematic, for example, for the fund to borrow money based on commitments from the LPs of a certain vintage and then to use the proceeds of that borrowing to make investments that will benefit another vintage in which some members of the original vintage of LPs may not be participating.

See "Trends in the Use of Subscription Credit Facilities: Structuring Considerations Negotiated With Lenders and Important LPA and Side Letter Provisions (Part Two of Two)" (Feb. 7, 2019).

## Subscription Lines for Liquidating Account Funds

Rather than using a drawdown feature, many Liquidating Account Funds are structured similar to hedge funds in that investors fund their capital contributions up front when they are admitted to the fund. Unfortunately, a subscription facility is not an option for a Liquidating Account Fund structured that way, and that fund would instead need to pursue a NAV facility.

A subscription facility is still available for a Liquidating Account Fund that has a drawdown feature, but certain complications and considerations still exist. For example, if, upon an LP's election, that LP's assets are moved to a liquidating account and the LP no longer has any obligation to fund capital contributions for future investments, a lender would not likely be willing to lend against that LP's capital commitment in the fund. The lender's concern would be that the LP's commitment could be released in connection with the movement of its share of the assets to a liquidating account.

One potential solution could be an LPA provision requiring that, notwithstanding the LP's election to be released from their commitment to the fund, the LP will still be obligated to fund capital contributions that are used to pay off borrowings used to make investments before the date the LP's commitment was released. In that scenario, the investor would be included in the borrowing base for purposes of calculating availability under the subscription line until it opts to be released from its commitment to the fund. After the election, the LP's uncalled capital commitment would be excluded from the calculation of availability for future borrowings but would not trigger a mandatory prepayment under the credit facility.

Some (and perhaps most) lenders may not be able to get comfortable with the aforementioned construct, but that approach offers a path for a subscription facility to be put in place based on LPs' capital commitments to a Liquidating Account Fund notwithstanding those LPs' ability to terminate their commitments to the fund.

## NAV Financing

If a subscription line is unavailable to a Rolling Vintage Fund or a Liquidating Account Fund, then a NAV financing facility, which is based on the NAV of the fund's investments, could be an option. One drawback of a NAV facility is that lenders often charge a premium because the valuation of fund assets is less certain than the valuation of capital commitments (which are much closer to cash), and fund assets are more difficult to liquidate.

Another complication of entering into a NAV facility is that, by definition, LPs in both types of evergreen fund structures may not be equally participating in all investments. In that scenario, it could be problematic to use assets attributable to one group of LPs as collateral for borrowings that will benefit another group of LPs. A solution could be to only use borrowings attributable to one vintage or group of LPs to support investments attributable to that vintage/group. That approach may defeat the utility of the entire NAV facility, however, if the pool of investments and investors is sliced and diced narrowly in that way.

See "The State of NAV Loan Facilities in the PE Industry and Current Obstacles to Widespread Adoption" (Feb. 9, 2023).

## Conclusion

Evergreen private credit funds may be useful to meet the objectives of both fund managers and LPs, particularly because a number of fund mechanics – including fundraising, equalization, investor liquidity and recycling terms – can be customized based on the degree of flexibility a fund manager needs and the terms LPs are willing to accept. Fund managers that intend to use leverage in their evergreen funds will also want to consult finance counsel when drafting their fund documents to adequately consider the concerns that a lender may raise.

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