The Deal Pipeline

Subscription (Capital Call) Loan Facilities:
The Devil is in the Details

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A subscription loan or capital call lending facility is a loan facility provided to a private equity fund secured by the unfunded capital commitments of the fund's investors. Due in large part to their strong performance during the financial crisis, with notably few reported incidences of investor defaults, these subscription loan facilities have experienced a sustained resurgence.

Typically, a subscription loan facility is secured by a pledge by the fund (and, if applicable, the fund's general partner) of (i) the unfunded capital commitments of the fund's investors; (ii) the right of the fund to make capital calls upon and to enforce the unfunded capital commitments against, such investors; and (iii) the subscription accounts into which the capital contributions are funded. A lender's obligation to make a loan is generally contingent upon the fund's compliance with a borrowing base test, which requires that the outstanding indebtedness under the facility not exceed the facility's borrowing base of eligible collateral.

Due Diligence Review

The capital commitments of the investors of a fund are contract rights arising from the limited partnership agreement or similar constituent documents of the fund, as well as the subscription agreements executed by such investors. The establishment and structuring of a facility require a comprehensive legal due diligence review of the underlying fund documents.

Fund document provisions of critical importance to a subscription loan facility lender include: (i) language explicitly permitting borrowing facilities and the ability to pledge the unfunded capital commitments and related rights; (ii) an irrevocable and unconditional obligation of investors to fund capital calls without any defense, counterclaim or offset; (iii) an agreement by investors to deliver to the lender essential financial information and an "investor acknowledgment" pursuant to which such investors acknowledge the facility and the pledge of the fund's rights and remedies in respect of the unfunded capital commitments; and (iv) a prohibition on transfer of any investor's interest in the fund without the fund's (or general partner's) consent.

The loan documentation can often address issues that arise in the due diligence of a fund's underlying documents. For example, if the fund documents do not expressly allow capital calls after the investment period to repay obligations arising under the facility, or allow the investment period to be terminated upon events such as "key man events," covenant breaches or at the election of a requisite percentage of investors, the fund documents should be amended to clarify that even after a termination of the investment period capital calls may be made to pay such obligations. Otherwise, the loan documentation must be drafted to ensure that (i) the final maturity date of the loans precedes the expiration of the investment period by a sufficient margin to enable at least two capital calls and (ii) the unfunded capital commitments remain available long enough to satisfy the fund's obligations in full.

Other fund document terms that may significantly impact the structure and terms of a subscription loan facility include provisions: (i) limiting the amount of indebtedness that may be incurred by the fund; (ii) limiting the amount by which nondefaulting investors can be drawn upon to cover defaulting investor shortfalls; (iii) restricting the purposes for which loan proceeds may be used or limiting the tenor of loans; and (iv) in an investor side letter (whether actually therein or incorporated therein as a result of "most favored nation" clauses), excusing such investor from participating in an investment or permitting the termination of the commitment or the fund's investment period.

The Devil is in the Details

When evaluating fund documents in the context of a subscription loan facility, the devil is in the details. A number of less obvious fund document provisions can significantly impact a lender's rights and remedies.

Alternative Investment Vehicles

Fund documents generally empower a fund or its general partner to effect all or a portion of a portfolio investment through an alternative investment vehicle, or AIV. Investors are required to contribute capital directly to the AIV to the same extent, and on the same terms and conditions governing capital contributions to the fund. However, capital contributions made to an AIV reduce the unfunded capital commitments of the investors to the fund as if such capital contributions were made to the fund itself, yet they are funded into an account of the AIV instead of the fund's pledged subscription account. Such AIV capital calls diminish the lender's collateral without providing cash control over the contributed funds or contractual control over the ability to make such capital calls.

One approach to mitigating such risk is to prohibit the establishment of any AIV pursuant to the loan documentation unless such AIV (i) is made a party to the loan documentation and pledges to the lender both the subscription account into which the proceeds of the capital calls will be remitted and its rights and remedies in respect of the unfunded capital commitments and (ii) enters into a control agreement with the lender and the account institution that maintains the AIV's subscription account, perfecting the lender's security interest in such account.

Alternatively, the parties to the loan documentation can agree to (i) prohibit the establishment of any AIV unless the borrowing base test would be satisfied after deducting from the borrowing base computation the aggregate maximum capital commitments of the investors of the fund who are also investors of the AIV and (ii) correspondingly reduce the borrowing base by such aggregate maximum capital commitments.

Excuse Rights

Under certain discrete circumstances, fund documents may also permit (i) an investor to exercise an "excuse right" to opt out of funding a capital call relating to a particular portfolio investment or (ii) the fund or its general partner to excuse an investor from its obligation to fund capital calls relating to a particular portfolio investment. Typically, an investor who is excused from funding a capital call to acquire a portfolio investment cannot be called upon to fund a capital call to repay the loan utilized to fund the acquisition of such portfolio investment, effectively reducing the unfunded capital commitments securing the facility and causing the amount of the borrowing base available to repay facility obligations to be overstated.

Further, investors are customarily notified of a prospective portfolio investment when a capital call is made to fund the acquisition of such investment, at which time such investors are afforded a specified period to exercise their excuse right. The terms of a subscription loan facility are at odds with this practice since capital calls are made not at the time of acquisition, but when the loan that financed such portfolio investment is repaid.

The ability of an investor to exercise its excuse right should not be overly broad and should be conditioned upon the investor providing the fund with certain verifying opinions and/or certifications. Ideally, advance notice should be given to investors such that the period of time in which an investor can exercise its excuse right expires prior to the date of acquisition. The borrowing base should be reduced to reflect the exercise of any excuse rights, and the acquisition of a portfolio investment should be prohibited if the resulting borrowing base reduction would cause a borrowing base test violation.

Deemed Capital Contributions

Fund documents may allow utilization of the proceeds or distributions from a portfolio investment that would otherwise be distributed to investors to fund certain reserves, costs, expenses, fees and follow-on investments, and to deem such amounts as having been distributed to the investors and immediately recontributed to the fund as capital contributions. These deemed capital call provisions reduce the unfunded capital commitments with no corresponding contributed cash being remitted to the lender-controlled subscription account, effectively decreasing the borrowing base without providing the lender control over any related contributed cash.

The loan documentation should limit the circumstances where a fund can avail itself of the right to make deemed capital contributions. Further, it is advisable that fund documentation prohibit the effectiveness of such deemed capital contributions until the related proceeds or distributions are remitted to an account pledged to the lender.

In-Kind Distributions

Fund documents may allow an investor's capital call obligations to be satisfied "in-kind," by securities or other assets valued at fair market value. Because such noncash capital contributions are not funded to the pledged subscription account and there are no cash flows from capital calls readily available to repay outstanding loans, the loan documentation must be drafted to limit the circumstances in which a fund may accept in-kind capital contributions.

Third-Party Beneficiary Provisions

Fund documents typically contain a boilerplate provision that such documents are not intended (and shall not be deemed) to create or confer any rights for the benefit of any third party who is not a party thereto. Since a lender under a subscription loan facility is granted a security interest in the unfunded capital commitments of the fund investors, including the right to make capital calls and enforce remedies against breaching investors, provisions of this nature conflict with the fundamental premise of a subscription loan facility. This can be easily remedied by carving out the lender's rights and interests contemplated by the fund documents from the "no third-party beneficiary" provision.

Conclusion

The popularity of subscription loan facilities is on the rise and showing no signs of slowing down. Due diligence must be performed with great care, as the devil is in the details.

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