Ka-Pow! Ka-Zoom! Subscription lines – the 2020 superheroes

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Introduction

As we noted in previous editions of this chapter, subscription facilities have evolved into a significant and global financing tool for investment funds seeking efficient access to capital. Borrowers utilise subscription facilities in a variety of ways, ranging from short-term borrowings (used primarily to bridge liquidity needs *in lieu* of making investor capital calls frequently and/or at irregular intervals) to long-term leverage (which seeks to increase the overall fund size and serve as a permanent source of capital).

Now a financing staple, subscription facilities are used by a wide variety of (principally closed-ended) funds, with different investment strategies, across the full range of asset classes in North America and around the globe, most notably in Europe (in particular the UK) and Asia, where the market is continuing to significantly expand. As the use of leverage by funds has become ubiquitous, investors are becoming increasingly accustomed to, and more educated about, the use of such facilities, and fund structures have evolved in many cases to offer investors a menu of levered and unlevered fund products to choose from.

Over the years, the number, size, variety and complexity of investment funds have grown, and subscription facilities have adapted to the changing landscape, with fund sponsors and lenders collaborating to develop financing solutions designed to address the evolving needs of fund borrowers and their investors. Indeed, a "cookie-cutter" subscription facility is a myth. The subscription facility market today is robust and sophisticated, continuously attracting new entrants on both the borrower and the lender side, as it caters to increased demands and has resulted in the need for customised liquidity solutions in virtually every case to suit the particular profile of the underlying fund.

In 2020, subscription facilities rose to prominence, as investors and sponsors placed premium on liquidity and sought to conserve capital. They became lifelines for many funds, and in turn businesses in their investment portfolios, performing a crucial role in the markets disrupted by an unprecedented global pandemic and geopolitical events. Even though the structuring and negotiation of transactions became almost universally virtual, the benefits they afforded were very much tangible and real.

This chapter looks at the breadth of the types of subscription financings and trends currently in the marketplace by examining select aspects of facilities for various kinds of investment funds in the US and UK markets.

The Caped Crusader – subscription facility fundamentals

Subscription facilities are effectively a form of "asset-based lending", where the ability to borrow is determined principally by reference to the value of certain eligible assets that the borrower (or a related entity) provides as collateral for such loan and which count towards the "borrowing base" against which a bank will advance. A subscription facility's collateral package is anchored by the commitments of the fund's investors that have not yet been funded.

These financings tend to be structured as revolving credit facilities, so that the borrower has fast access to liquidity for the purposes of making investments, without having to call equity capital and wait for the contributions to be received. The short period required to draw advances (typically one to three days) enables quick execution of underlying asset acquisitions. It also allows funds to avoid inefficient holding of cash for covering expenses, and the facilities often provide additional flexibilities, such as availability of foreign currencies and letters of credit.

Subscription facilities are typically secured by: (i) the unfunded capital commitments of the fund's investors; (ii) the right to make capital calls from investors, and receive proceeds of such capital calls in the form of contributions; (iii) the bank accounts into which the capital contributions are funded; and (iv) certain rights related to the foregoing (including the right to enforce against such investors), as well as the documentation evidencing such rights (including subscription agreements of the investors and organisational documents of the fund).

Because the collateral for a subscription facility is intrinsically tied to the obligation of the investors to make capital contributions, lenders closely scrutinise the investor base of the fund and the legal relationship between the investors and the fund. The types of investors and the life-cycle stage of the fund will determine what structure the optimal borrowing base takes.

Investors may be considered eligible, and therefore an "included investor" (usually institutional investors with a certain rating and/or sufficient financial strength) or a "designated investor" (other investors meeting certain criteria). Alternatively, they may be ineligible due to restrictions on their ability to fund certain investments, or being below a certain threshold of creditworthiness. It is important to note that the uncalled commitments of ineligible investors still form part of the collateral, leading to over-collateralisation, and that an eligible investor may become ineligible due to certain exclusion events, such as a decline in its financial position (including bankruptcy).

After determining the basic composition of investors that will be included in the borrowing base of the subscription facility, the parties negotiate appropriate advance rates and applicable concentration limits in respect of these investors. Advance rates are the basic measure of the amount of credit a lender will allow a borrower, and are generally expressed as a percentage of the included investors' (up to 90–100%) and designated investors' (up to 70%) uncalled capital commitments.

However, there are other potential approaches to categorising investors – for example, a now common segment of the US market functions on the basis of a "simplified" borrowing base with a "flat" advance rate against an aggregate investor pool, which generally encompasses all of a fund's investors, regardless of eligibility criteria or exclusion triggers (which is similar to the "coverage ratio" principle used in traditional subscription lines in the UK market).

We also increasingly see further bifurcation of advance rates, depending on additional supporting criteria. For example, there may be a higher advance rate afforded from the moment in time at which capital commitments over a certain threshold (sometimes referred to as a "hurdle") have already been funded; this feature caters to the natural cycle of an investment fund because, as capital is drawn, the amount of credit support available for a subscription facility decreases. However, a higher advance rate may alleviate or even equalise these consequences – and, from a lender's perspective, the diminished uncalled capital is counterbalanced by the investors having more "skin in the game". Another similar feature is a fluctuation of the advance rate based on the value of assets in the fund, when as the value of fund assets increases over time, so does the percentage applied to uncalled commitments.

Concentration limits present a further refinement of how the overall borrowing base credit is distributed among various classes of investors, and are generally determined based upon the makeup of a particular fund's investor pool. Lenders often look to reduce risk through diversification, and thus aim to calibrate the classes of investors within the borrowing base in order to achieve a certain level of diversity and ensure that, from their perspective, no disproportionate amount is advanced against the uncalled capital commitment of any investor of a particular class, either individually or in the aggregate for such class – so, for example, historically there has been much focus on limiting the amount of credit that is attributed to such investor categories as individuals (natural persons) and their tax and estate planning vehicles.

A variation of this principle that we have seen banks increasingly propose is that they seek to ensure that the largest investor (no matter what class or category it would have otherwise been in) does not constitute more than a certain percentage of the overall fund commitments. On the other hand, in order to increase flexibility, lenders may consider holidays or waivers in respect of concentration limits (e.g. not apply them during a "ramp up" period while the borrower has had a first fund closing, but is still in fundraising stage and therefore the initial investor pool is more concentrated than it ultimately will be).

From a legal perspective, sponsors and lenders alike pay attention to the organisational documents of the fund, which (within the statutory framework applicable to the particular fund entity in question) set forth the contractual obligation of the investors to fund capital if and when called. Express provisions, in addition to the general powers of the fund, authorising the borrower (or its general partner, manager or other controlling person) to incur debt and grant liens (including, importantly, a pledge of the uncalled capital commitments) without further consent or action by the investors, as well as a host of other ancillary acknowledgments and consents for the benefit of such lenders (often as express third-party beneficiaries), can provide additional comfort to lenders when analysing the capacity of the fund to incur indebtedness and the contractual relationship between fund and investors.

As the sophistication of market participants grows, much more attention is paid to subtle nuances and technical drafting of the relevant provisions of the fund documentation (including the limited partnership agreement), particularly certain of those that have come to be increasingly negotiated between the funds and investors, such as investment "excuse" provisions (allowing an investor not to participate in a particular investment due to regulatory, tax or other considerations specifically applicable to it).

As a result of these developments, "investor letters" (i.e. separate bilateral arrangements between the lenders on the one hand, and the investors on the other hand, which would establish contractual privity), are only used in exceptional circumstances. We will address certain situations in which obtaining such letters may be beneficial for structuring the subscription facility from both the borrower and lender perspective in more detail below.

Superheroes for all

The variations of fund structures and underlying investor pools can result in differing considerations, and typically require custom and complex loan documentation in each specific case. Below, we illustrate the need for bespoke facility structuring in the context of: (i) separately managed accounts (so-called SMAs, which may have only a single investor); (ii) complex commingled vehicles (which may have hundreds or more investors and utilise numerous entities that are part of one fund family); and (iii) by comparison, funds in the UK market.

Separately managed account – the Lone Ranger

As discussed above, the investor composition of a fund is a key factor for lenders in establishing the borrowing base for a subscription facility. When there is only one investor, as is the case for SMAs, unique considerations for the related subscription facility arise, including those stemming from an increased concentration risk. In our experience, SMAs continue to be popular for a number of reasons (and have continued to increase during 2020), in particular among large institutional investors such as state and private pension funds, educational endowment funds, insurance companies and sovereign wealth funds.

While from a financing perspective SMAs present some specific challenges, there are also advantages and, indeed, it appears that as the number of SMAs in the marketplace has increased, so too have subscription facilities for these investment products. Like any other fund, the terms of the organisational documents of an SMA must satisfy the general requirements of the subscription facility lender.

As an alternative (or an addition) to incorporating such provisions in the organisational documents, lenders may request that the investor in the SMA enter into an investor consent letter to address any other specific issues that may arise in a particular context (for example, as many investors in SMAs are government pension plans, there may be sovereign immunity issues that lending against such investors might potentially present to banks). Understandably, the treatment of such issues requires a highly individualised analysis that needs to be performed on a case-by-case basis.

As compared to subscription facilities for multiple-investor funds, advance rates for the single-investor SMAs tend to be more customised and negotiated. While banks generally lend based on the creditworthiness of each investor, and thus would be expected to assign an advance rate for an investor in an SMA that is substantially equivalent to the advance rate such investor would receive if it were investing in a commingled fund, other factors may necessitate a different approach. For example, in an SMA scenario, lenders cannot rely upon a diversified investor base that, in the aggregate, reduces the exposure to an individual investor's funding failure. Further, as noted above, in many commingled fund facilities there are investors who do not qualify for inclusion in the borrowing base, but their uncalled capital commitments are still pledged as collateral and so effectively provide for "over-collateralisation".

There may be other terms in SMA subscription facilities for which lenders may seek a different regime, as compared to commingled fund subscription facilities. For example, certain exclusion events (i.e. events that, if they were to occur with respect to an investor, would trigger removal of such investor from the borrowing base) under a commingled fund subscription facility may be characterised as events of defaults (i.e. events that give the lender a right to accelerate the amounts outstanding under the facility and pursue remedies) under an SMA subscription facility.

There is sound rationale for this approach for a number of exclusion events: for instance, if the only investor in an SMA defaults on its obligation to fund a capital call, the lack of any other investor commitments to fall back on makes it reasonable to characterise such an occurrence as an event of default. However, if the same failure to fund capital were to occur in a commingled fund, the typical subscription facility would simply no longer give credit for such investor's commitment in the borrowing base. Only if investors with material capital commitments (above agreed-upon thresholds) defaulted, might an event of default be triggered under a commingled fund's facility.

Focusing on potential advantages, sponsors with multiple SMAs may be able to utilise the straightforward nature of the single-investor vehicle in order to achieve greater efficiency with respect to the facility documentation. Indeed, some sponsors have found that SMAs are generally well suited for employing the so-called "umbrella" technology, pursuant to which the same lender provides individual and separate loan commitments to multiple borrowers under one credit agreement.

Under these instruments, many of the terms are shared by all of the SMAs party to the loan document, but investor-specific terms, such as the advance rate and the loan amount, can be different for each SMA, and each SMA remains severally (and not jointly) liable for its own borrowings. Additionally, the distinct facilities are not cross-defaulted or cross-collateralised, meaning potential issues under one SMA's facility will not impact another SMA's facility, even if both are party to the same credit agreement. Umbrella facilities allow sponsors to negotiate a single set of documentation while putting multiple facilities in place.

<u>Commingled funds – the Avengers</u>

At the other end of the fund spectrum, there are pooled investment fund vehicles with diverse investor bases, which may include a variety of institutional investors, as well as private wealth management clients (such as high-net-worth individuals and their family offices) and, at times, the sponsor's management and employees. Depending on the composition of the investor base, such funds often require, due to various tax, regulatory and other considerations, multiple entities through which the investors can access the underlying investments, resulting in structures that can be quite complex.

A frequently used technology is a multi-tiered structure, sometimes referred to as the "master-feeder" structure. This arrangement utilises two or more separate entities on top of each other; investors contribute capital through a "feeder" fund, which then passes on (feeds) the capital to a "master" fund, which in turn makes investments, either directly or indirectly through subsidiaries. In certain circumstances, there may be some investors who invest through the feeder fund, and other investors who invest directly into the master fund. In other situations, a separate fund structure may be formed for different types of investors without there being an aggregating master fund, sometimes referred to as a "parallel fund" structure.

For US-based sponsors, an initial fund is often formed as a Delaware or Cayman Islands limited partnership that is treated as a pass-through entity for US federal income tax purposes and typically includes taxable US investors. When the investor pool includes non-US investors and/or certain tax-exempt US investors, one or more separate "offshore" funds, which are treated as non-US corporations (or non-US limited partnerships) for US federal income tax purposes, are often formed in various jurisdictions (frequently the Cayman Islands, British Virgin Islands and Bermuda, and increasingly also European domiciles such as Luxembourg, Ireland and Scotland).

Regardless of jurisdiction and/or legal form, all of the entities in these types of structures are part of one fund family, and are managed by a common investment manager, which can be accomplished in a variety of ways, including by utilising multiple affiliated entities and/or independent managers. Each of the various vehicles is typically a separate legal entity, though the exact characteristics may depend on how the relevant legal forms of the vehicles are treated in their applicable jurisdictions and, in some cases, may statutorily be required to act through another entity (for example, a Cayman Islands limited partnership acts through its general partner).

The considerations that determine the characteristics of each entity can contribute to the complexity of the structures in terms of which entities need to be party to the subscription facility documentation. Most multi-tiered funds need to ascertain at which level borrowings will be made (in other words, which entity will be the borrower under the subscription facility). This choice of borrowing entity may be affected by any number of different factors, including tax and regulatory considerations, administrative ease and operational requirements of the sponsor. To the extent that investor capital commitments are not made directly to the borrowing entity, consideration must be given as to how to mechanically ensure that a security interest in the collateral has been granted, directly or indirectly, for the lenders' benefit.

A "cascading pledge" structure is one potential method utilised to assure that lenders have an appropriate "path" to the ultimate source of capital commitments. In this scenario, the upper-tier feeder fund pledges the capital commitments of its investors to the lower-tier master fund, in order to secure such feeder fund's obligations to make capital contributions into the master fund. The lower-tier master fund then, in turn, pledges the capital commitments of its "investors" (i.e. the upper-tier feeder fund(s)), and any rights it may have under the pledge granted to it by the upper-tier feeder fund, to the lenders to secure such master fund's obligations as a borrower under the subscription facility.

Other possible alternatives include an arrangement where (if permissible from a regulatory and tax perspective) the feeder fund may become a party to the subscription facility agreement and/or security agreement with the lender. Under this approach, the feeder fund may become a co-borrower of the loans, become a guarantor of the indebtedness incurred by the master fund, or just provide a "naked" pledge of the investors' capital commitments directly to the lender.

There are situations where it may not be possible to have multiple parallel entities within a fund structure jointly and severally liable for repayment of the loans and, in some instances, the "onshore" and "offshore" entities may be required to enter into separate credit agreements. Such separate credit agreements may or may not be permitted to be cross-collateralised, whether for tax and/or regulatory reasons or because of an understanding with the investors in the separate vehicles. This effectively means that each of the parallel vehicles must rely on a borrowing base comprising only capital commitments of its own investors.

Because banks will typically provide different advance rates and concentration limits for different investors based on their underwriting criteria, the borrowing capacity of one silo may be different from the borrowing capacity of the other silo(s). Since sponsors ordinarily aim to manage borrowings on a consistent level across the various vehicles in a fund family, the ability to borrow might then be dictated by the vehicle with the lowest borrowing capacity.

One potential solution may be to provide for a cross-guarantee and/or cross-default between the individual credit agreements, which might allow the borrowing base to be calculated on an aggregate basis. Another approach may be to utilise "investor letters" which may give an increased level of comfort to the lenders, which may result in higher advance rates and/or concentration limits.

The Avengers in Asgard – the European perspective

The internationalisation of the subscription finance market has influenced the documentation and transaction terms of subscription facilities in the European market. US-based sponsors have been expanding their investment activities across the Atlantic and continue to seek subscription facilities similar to what they have been accustomed to in the US. In addition, European and US-based lenders have increasingly offered subscription facility terms similar to those seen in the US market.

Nevertheless, despite a trend for convergence of the terms, certain differences persist due to differing approaches to credit evaluation and local law requirements with respect to the creation and perfection of security interests in collateral. The recent trend for ESG-linked financings in the European finance market has also started to be seen in the subscription finance market in Europe, with certain sponsors targeting ESG-driven financing terms to align such terms with the fund's strategy and take advantage of potential pricing or term improvements. While Europe may be ahead of the US and Asia in this regard, ESG considerations are also quickly picking up steam in those markets as well.

Subscription facilities in the UK market were historically almost exclusively the product of "relationship" deals, with lenders primarily focusing on the success record of the larger sponsor group when determining whether to offer a subscription facility to an individual fund. This difference in approach used to be reflected in some of the terms typical of subscription facilities in the UK market. For example, traditionally, subscription facilities in the UK market frequently used the "coverage ratio" to limit the amount that may be drawn under the facility at any given time.

The coverage ratio is the ratio of the uncalled capital commitments of the included investors to the aggregate indebtedness of the fund, and is typically set at no less than 1:1. Notably, the coverage ratio approach does not typically involve applying advance rates to the uncalled capital commitments of included investors, meaning that once an investor is deemed an "included investor", the borrower receives credit for 100% of that investor's uncalled capital commitment. In recent years, the coverage ratio approach has become less common in the UK market and is frequently substituted by a US-style borrowing base model.

Parallel to the development of the borrowing base methodology, investor exclusion events have also been refined. These events are typically narrower in scope for facilities that apply a borrowing base methodology, but are often tailored to particular investors and address a greater number of specific events which would result in a reduction of the borrowing base. More recently, lenders have increasingly been focused on the exclusion event definitions – a trend that goes hand in hand with the increased focus on and diligence of organisational and fund-related documents.

Irrespective of the internationalisation of the subscription finance market and the convergence of certain terms of subscription facilities in US and European markets, the granting of security interests in respect of a borrower's obligations under a subscription facility remains specific to the jurisdiction applicable to the relevant fund entity. Granting and perfecting security interests over the uncalled capital commitments of the funds' investors, the rights of the general partner to call capital commitments, and the bank accounts into which any capital commitments called from investors are funded, represent, for the lenders, the building blocks of the principal collateral base of the subscription facilities it provides.

Whilst in the US market, to perfect the security interest and enforce the lender's rights against third parties, generally a UCC-1 financing statement should be filed, under English law, the security interest of lenders in the rights of the general partner to call capital is typically created pursuant to an assignment by way of security which is perfected by notification to the investors in the fund. To manage and protect the relationship with their investors, borrowers often seek to negotiate the timing for the delivery of the notices to investors, and are also highly sensitive to the form of any such notifications. This process needs to be balanced against the lenders' need to obtain a perfected security interest promptly after the facility is made available.

The conclusion – up, up and away!

We continue to see a sustained and steady increase in the volume and size of subscription facilities, and more broadly, of fund financing transactions overall. As noted, the number of users and providers in this market has increased exponentially. A key shift is the willingness of sponsors and investors to work with lenders on devising and implementing customised solutions addressing all parties' needs and requirements, and thus developing products flexible enough to adapt to evolving fund structures as well as liquidity solutions for the "long run" that can adopt to the different stages of the life of a fund.

This is evidenced by a growing number of combinations of subscription facilities and so-called asset-based facilities (collateralised by the underlying fund investments), whether in the form of hybrids (with a collateral package that consists of both uncalled capital commitments and underlying investment assets) or other bespoke instruments (for example, where a traditional subscription-based borrowing base is enhanced by a component based on value of the underlying investment assets, but without a corresponding pledge). Moreover, there has been a convergence of the larger fund financing market where we are observing an increasing appetite for syndicated facilities globally (as has been common in the US for some time).

Furthermore, as ESG-compliant investments become more prevalent, the broader loan market is developing financing products that include ESG-linked criteria for borrowers to meet. In credit facilities in particular, a margin adjustment – either a discount if certain ESG-related performance criteria are met or a premium if the criteria are not met – may be used to incentivise the borrower to meet certain ESG-related thresholds. In the fund finance market, ESG criteria are also featured in some facilities, including, for example, a recent syndicated subscription credit facility where the interest rate is determined by a ratchet mechanism based on the average compliance across the fund's portfolio companies in respect of gender equality on management boards and renewable energy transition. Compliance will be monitored using measurable key performance indicators reported quarterly and tested annually. Whilst sustainability and ESG-linked financings are increasing in size and prevalence, clear market norms have not yet emerged in respect of measuring and assessing compliance with sustainability and ESG targets. However, ESG-linked investment strategies and debt products are relatively new developments, and so we expect the market to evolve and reach a general consensus on a consistent set of global principles and reporting standards. This general market development will inform and shape ESG-linked fund finance products and the fund finance market generally.

We believe that the popularity of subscription facilities is driven in part by the strong performance these loans have demonstrated over extended periods of time, and the strength of the alternative asset sector, as well as the continued ability of sponsors and lenders to craft solutions that meet the growing needs and complexities of today's investment fund structures.

We are pleased to note that this segment of the market remains very active. Even during the current period of global macro-economic uncertainty and market disruption caused by the COVID-19 health crisis, the fund financing space has largely remained stable and has not resulted in material changes to the terms of the underlying financing documents. Indeed, throughout the year, the fund finance market has shown itself to be resilient and innovative, with borrowers and lenders working to provide solutions for highly pressing capital and funding needs where other sources became constrained or unavailable.

It has never been more true that we remain optimistic about the outlook for the industry, which, due to the versatility and adaptability of its product and market participants, has weathered yet another set of challenges to date.

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Acknowledgment

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The authors would particularly like to acknowledge the assistance and input provided by Aja-Fullo Sanneh in preparing this chapter. Aja is a corporate finance associate in Fried Frank's New York office and represents clients on a wide array of corporate matters including fund financings.

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