Designing subscription facilities to account for limited partner preferences

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Introduction

Funds use subscription facilities for a variety of reasons, including to partially or fully finance acquisitions, pay fees and expenses related thereto or otherwise applicable to the Fund, increase the Funds' internal rate of return, or give the Fund flexibility to issue letters of credit or support hedging transactions at lower rates. While subscription facilities can provide a number of benefits for Funds, it is important for practitioners to remember that the facilities are complementary to the core objectives of the Fund, namely investing and providing a return of capital to the Fund's limited partners.

While limited partners historically have been concerned with tax risks associated with borrowing at the Fund level,[1] that has largely changed. Now, most limited partners are familiar with subscription facilities and generally accept that Funds use short-term borrowings for bridge purposes and/or longer-term borrowings in lieu of equity contributions and third party financing in connection, in each case in lieu of calling capital from investors. Nevertheless, while subscription facilities have become more familiar, limited partners are not a monolithic group. As subscription facilities have evolved, limited partners have had different reactions. This article discusses how Funds and their counsel may try to structure limited partnership agreements and subscription facilities to accommodate different limited partner preferences and how to balance risks and obligations between the Fund, the investors and the lenders in a manner that accounts for the concerns of all.

The article will address, in this context: (1) the role of the partnership agreement; (2) length of borrowing; (3) lender interaction with investors; (4) access to information about the subscription facility; (5) confidentiality of limited partner information; (6) minimising costs of administering the subscription facility; (6) minimising costs of borrowings under the subscription facility; (7) ability to put liens on partnership interests; and (8) maintaining flexibility.

<u>Assessing limited partner preferences: Negotiating the partnership agreement</u>

There are two negotiations required when setting up a subscription facility. The first negotiation takes place with the limited partners, e.g., what is permitted in the limited partnership agreement (as modified by any side letters). The second negotiation takes place

with the lender on the credit documentation. The initial negotiation with limited partners can help Fund management understand each limited partner's preferences early and set expectations as the partnership agreement establishes the bounds of what is permissible under the facility. In other words, the subscription facility may have additional restrictions and limitations that are not in the partnership agreement, but the facility will always be limited to – and cannot override – the partnership agreement. Accordingly, it is preferable (from the vantage point of the Fund) to have expansive language in the partnership agreement, since the language can be more restrictive in the subscription facility.

This is not to say that that there can be no restrictions on issues such as the length of borrowing or percentage cap on the amount of indebtedness, but these provisions should be negotiated thoughtfully with investors to allow for the reasonable use of borrowings and subscription facilities. In many instances, fund counsel who negotiate with investors may be different from finance counsel who negotiate the subscription facility. Accordingly, when possible, finance counsel should also review the partnership agreement and any thorny side letter questions and, in particular, any provisions in side letters that may have "most favoured nation" implications, as these limitations can, especially if they spread to a number of investors in the Fund, materially impact the ability of the Fund to borrow. Some specific limited partner concerns are discussed below. Many of these issues will come up early in side letter discussions and fund counsel should take care to vet these issues with finance counsel so that the Fund manager can fully understand the implications.

Limited partner preference: Length of borrowing

As the market has developed from short-term bridge facilities of 90 days or less to subscription facilities that permit borrowings to remain outstanding for a year or more, limited partners have been evaluating how this impacts their return on investment and related risks and rewards. From the Fund perspective, it is important to communicate with limited partners the benefits and uses of subscription facilities and to ensure that adequate flexibility is built into the limited partnership agreement.

Why do some limited partners like longer term borrowing? In general, limited partners prefer to receive consistently-timed capital calls. Smaller, non-institutional investors may not have the administrative resources to fulfil frequent capital calls from multiple Funds, and even large institutional investors prefer to limit the number of resources devoted to administrative matters. Fewer and more consistent capital calls also mean limited partners are able to invest their money in other assets or investments pending capital calls, provided that the investor maintains the required liquidity. Finally, if Funds are able to quickly draw on the subscription facility for investments, the Funds can avoid calling capital from limited partners well in advance of an acquisition, only to then return the capital to the limited partners if the investment does not materialise.

At the other end of the spectrum, some limited partners may be opposed to longer borrowing terms for subscription facilities as it becomes harder to compare the rate of return for Funds with such long-length facilities, or they simply equate leverage with risk. For these reasons, many institutional investors have policies in place for lengths of borrowings related to subscription facilities and related requirements.

Ideally, the Fund will be able to reach an agreement with all investors on the permitted length of outstanding borrowings; however, if consensus does not form around optimal borrowing length, counsel may be able to identify other creative alternatives depending on the facts and circumstances. For example, the Fund could consider including those investors preferring short-term borrowings in a separate vehicle where capital would be

called earlier. This is administratively burdensome but allows flexibility by keeping limited partners with a preference for shorter time timeframes happy.

To ensure that the preferences of the limited partners, rather than the terms of the credit agreement, are driving the frequency of capital calls, finance counsel can negotiate to conform any limits on borrowing in the credit agreement to what is required in the applicable limited partnership agreement. Fund counsel should also be aware if the Fund intends to borrow for fees and expenses and include language in the limited partnership agreement to permit this type of use of proceeds for borrowings. Finance counsel may also request that the Fund be permitted to capitalise any interest or fees payable under the subscription facility itself, including commitment fees and letter of credit fees, thereby avoiding any need to issue a capital call to the limited partners for a relatively small amount. Capitalisation of interest and these expenses is the height of flexibility in these facilities.

As length of borrowings has increased in the past several years, in addition to funding acquisitions, Funds have also used the subscription facility to pay for fees and expenses for the Fund, rather than calling capital to cover what is often a small amount. While most subscription facility lenders are aware that the Funds may use the facilities to pay for fees and expenses, finance counsel still should review the use of proceeds provisions in the subscription facility and ensure the language is broad enough to permit such borrowings. Ideally, the use of proceeds language in the subscription facility would track the language of the limited partnership agreement.

Limited partner preference: Limit lender contact with investors

Generally, limited partners prefer not to have any direct contact or interactions with the lender for a variety of reasons. Funds are generally successful in limiting this contact. There are exceptions, however, largely driven by the lender's perception of the Fund's or Fund manager's historical track record, creditworthiness of the investor and the number of investors in the Fund. At the beginning of the credit agreement negotiation, Fund managers should discuss its specific expectations regarding investor contact with lenders and finance counsel.

From a limited partner standpoint, when negotiating with lenders, the Fund should resist any requirement for investors to provide investor letters or opinions. Even though a lender would always prefer to have contractual privity with investors with respect to representations and covenants of the investors regarding the size of their commitment and in what amount, when and where such investor will fund its capital commitment, lenders have generally moved away from requiring these investor documents for large sponsors with varied and well established investment records and investor bases. However, as noted above, there are certain situations where lenders will still ask for investor letters and opinions (for example, funds-of-one) based on the risk profile of the Fund and/or its investors.

Nevertheless, even for new Funds with less established investment records, it is possible to accommodate investor desires to be insulated from lenders. To achieve this, as a baseline, finance counsel should work with Fund counsel when fund documentation is being negotiated to include the relevant provisions lenders would look for in the fund documentation itself to support the establishment of a credit facility (and to allow them to exercise rights and remedies). In addition to these necessary provisions, Fund counsel and finance counsel will need to assist Fund management in determining whether to include provisions in the partnership agreement that constitute additional obligations of investors in favour of the lender, such as agreements to provide "investor letters", consents and opinions to the lender to support the credit facility. These letters typically provide information such as an acknowledgment of the amount of such investor's capital contribution, an acknowledgment

of the lender's lien over uncalled capital commitments, and an agreement to fund capital commitments to a specified bank account at the direction of the lender. Lenders will almost universally prefer to receive these agreements and acknowledgments directly from the investor, primarily to assist in an exercise of remedies if ever needed, but from the investor's perspective, of course, this is an additional work stream, with documents and opinions that need to be reviewed, negotiated and delivered, that it would like to avoid. This can be achieved by including provisions in the partnership that clearly state that by signing the partnership agreement, the investor has consented to all the material aspects of the subscription facility, the general partner is authorised to negotiate and execute facility documentation (including the pledge of uncollated capital as collateral), and the investor need not be contacted for confirmations related to the subscription facility.

In general, Funds should try, as an accommodation to investors, to limit any direct contact between investors and the lenders, and avoid requiring investors to take affirmative action in connection with the subscription facility. However, as discussed below, the Fund may be required to provide investors notice of the establishment of the facility. Accordingly, the Fund should generally update investors about the facility on a regular basis.

Another situation where a lender may have direct contact with an investor is during an event of default under the subscription facility that results in the exercise of remedies. In such a scenario, the lender (or an agent for the lenders) under the subscription facility has the right to issue a capital call notice to the limited partners in place of the Fund. However, limited partners prefer to only receive capital calls from the general partner, in part out of a concern that funding a lender-issued capital call would not be credited to their uncalled capital account, and are more likely to fund such calls. Funds managers should seek the ability in subscription agreements in such circumstances to issue one capital call before the agent is permitted to do so, which allows the agent to control the process while still limiting lender contact with investors in the first instance (and is, potentially, a better outcome for the lender given that the likelihood of limited partners funding on the capital call notice is greater if it is viewed as a more ordinary course issuance). This situation is rare, but maintaining this control is important to manage the relationship between the Fund and its limited partners. If finance counsel is unable to negotiate for the Fund to first issue the capital call in an event of default, the Fund should request that the agent provide written notice before the agent issues any capital calls to the limited partners. This accommodation should allow time for proper communication between Fund managers and the Fund's limited partners.

Investor notices

Subscription facilities are much more common in the private equity space than they have been in the past, and most limited partners understand how a subscription facility works. Fund management should nevertheless provide clear information about how it plans to use the facility, given the varieties of facilities available to Funds, so that expectations are clear for the investors. This article does not address legal disclosure requirements, but Funds should consult with the relevant specialists.

Disclosure of the subscription facility is often driven by local law. Depending on the Fund's jurisdiction, there may be different requirements to perfect the security interest in the uncalled commitments and right to call capital. Certain jurisdictions (such as the Cayman Islands) require the Fund, in its capacity as borrower, to deliver a notice of the security interest to the limited partners in order to perfect the lender's lien over uncapped capital of the limited partner. Other jurisdictions go further, requiring an acknowledgment of the notice by the limited partners. Fund managers should understand, at least on a preliminary

basis, what the legal requirements are, especially for the granting and perfection of a security interest, in a jurisdiction that is being considered when a new fund or fund vehicle is being formed, to ensure such jurisdiction's legal regime is supportive of the legal requirements of most lenders under a subscription facility.

Finance counsel should work closely with the Fund on the language in the notice to investors and means of delivery. If possible, Funds should resist requirements that investors provide any kind of acknowledgment unless absolutely necessary in the relevant jurisdiction. The notice should be written in plain language and avoid legalese. The Fund should be prepared to answer questions from the investors about the subscription facility after sending out the notice, and finance counsel can help craft those responses as well.

Finance counsel should also inform Fund counsel that notifications will be required to be sent to future limited partners who are admitted in an additional closing or via transfer. Fund counsel can then determine where to include this information in the investor materials that are sent to the limited partners (for example, the footnotes to the financial statements) so that investors are not bombarded with extra documentation. Any information provided to the limited partners should include a clear description of the lenders' collateral, rights and remedies as well as a summary of the information the general partner will provide to the lenders about the investors. Fund counsel may also include language in the limited partnership agreement stating that any required notices can be distributed via portal.

Limited partner preference: Preserve confidential information

Limited partners value confidentiality with respect to any information relating to the limited partner, including the fact of their investment in the Fund, the amount of their commitment, their financial information and any personal information to which the Fund may have access. These confidentiality concerns can sometimes be at odds with the establishment of a subscription facility. Fund managers are required to provide identifying information about the limited partners (including capital commitments, ratings (if such investor is rated), names and notice information) to the lenders in connection with the lenders' diligence for the lenders' own regulatory compliance purposes, and in determination of the borrowing base in a subscription facility that provides advance rates against specific limited partner commitments. However, Fund managers also have a responsibility to ensure the lenders uphold the confidentiality that is required by the Fund by the terms of the limited partnership agreement and any side letters. Subscription facilities should have clear confidentiality provisions in place that protect the limited partners and prevent the disclosure of confidential information by the lenders.

Protection of confidential information comes up in several different aspects of a subscription facility. When negotiating the assignment provisions of the subscription facility, the Fund manager should consider what consent rights exist for assignments and participations, as well as potential assignments and participations. While subscription facilities are generally not widely syndicated, the Fund will want to understand who and when a new party may get access to confidential information about the Fund itself and also the Fund's limited partners.

Some limited partners are particularly concerned about keeping their names and information confidential, and may negotiate specific provisions in their respective side letters limiting the ability of the Fund to share limited partner names and/or subscription documents with any third party. If Fund counsel is aware that the Fund will be entering into a subscription facility, they can ask the limited partner for an exception to the confidentiality provision that applies to lenders under a subscription facility. Without this accommodation, the limited partner will be excluded from the borrowing base and there could be other potential

issues, such as the potential lender being unable to complete its own regulatory compliance necessary for it to enter into a lending transaction with the Fund. Other potential solutions to this problem include disclosure of the limited partner by the Fund, but only if it did not fund its capital call in accordance with the provisions of the partnership agreement when requested.

Finance counsel for the Fund, in tandem with Fund counsel, should consider flagging any problematic confidentiality provisions in the side letters early in the negotiation with potential lenders. Similarly, they should take care to address any necessary carve-outs to the conditions and other relevant provisions in the subscription facility.

Limited partner preference: Costs of administration

Most limited partners are aware that Funds use subscription facilities and find that subscription facilities can minimise the administrative burden on the investors and the Fund, as well as allow Funds to move quickly to achieve investment objectives. However, by their nature, subscription facilities do require the Funds to incur additional costs, including commitment fees, agent fees, and legal costs and expenses, as well as the less quantifiable costs associated with maintaining compliance with the covenants in the subscription facility. It is in the interest of both the Fund and the limited partners to keep these costs as low as possible.

For larger Funds, the quantum of the subscription facility can be large enough that it is often syndicated to multiple lenders, and will include an agent to act for the syndicate (including by holding any liens or collateral that support the facility). In a syndicated deal such as this, it is important for the agent to have a centralised process for diligence and other communications. The agent alone should also manage any amendments, draws and repayments, changes in lender commitments and payoff of the facility, to ensure the facility operates smoothly on a day-to-day basis.

Finance counsel for the Fund may also be able to negotiate for the agent to have significant discretion in approving matters in the subscription facility, which also helps ensure efficient operation. For example, the agent may have discretion to: (1) permit alternative investment vehicles or qualified borrowers to join the facility; (2) determine if any limited partnership amendments are material; and (3) release any collateral. Such discretion, if carefully negotiated to make it clear that the lenders have authorised its use, should limit the involvement of the full lender group in management of the facility, limit amendments and secondary negotiations. However, different banks approach the role of agent differently, and some banks may be hesitant to fully exercise their discretion when acting in this capacity. Fund managers should be mindful of this when soliciting preliminary proposals and term sheets from financing sources, and try to understand early what approach the agent bank would take in administrating the facility.

Funds can also consider including an accordion feature in the subscription facility, which gives flexibility for additional borrowings under the existing facility. The accordion may be committed or uncommitted, and may be a permanent increase to the commitments or simply temporary, depending on lender and borrower negotiations. The benefit of the provision is that the Fund has the built-in ability to fund a potential unforeseen investment opportunity without needing to negotiate and execute a new document, thereby saving time and preventing unnecessary legal costs.

Many subscription facilities include the flexibility to add feeder funds, alternative investment vehicles and qualified borrowers (generally, portfolio companies in the Fund structure) as borrowers under the facility. This flexibility allows the Fund to accommodate limited partner and Fund deal team preferences for tax-structuring a specified investment. But adding feeder

funds, alternative investment vehicles and qualified borrowers to the subscription facility can be costly, so finance counsel should pre-negotiate joinder forms and minimise required deliverables (including opinions of counsel) if possible, again saving future fees and allowing these vehicles to be joined to the subscription facility quickly and efficiently.

Limited partner preference: Minimising costs of borrowings

Limited partners also prefer that Funds minimise the cost of commitments and of borrowing loans under a subscription facility. As subscription facilities are relatively low-risk products for lenders (as referenced above, often designed to allow a specified advance rate of borrowings against specified limited partners), they typically have relatively low interest rates. Still, there is a market for these facilities, and there can be a range of interest rates and other terms offered by different banks. If possible, Fund managers should engage various banks in a competitive process for subscription facilities to ensure they are getting the best interest rates and lowest bank fees. However, Fund managers also need to balance rate and fee arrangements with having a facility that includes the flexibility and protective provisions referenced above, as well as a strong relationship with the agent or lender who will partner with the Fund to get the facility closed and manage the facility through its lifetime. A subscription facility with the lowest interest and fee structure may end up being more costly to the Fund (and therefore to the limited partners) if it does not also provide functional flexibility and ease of compliance.

Finance counsel should seek information from the Fund team regarding what kinds of borrowings the Fund will require. If the Fund expects to frequently use letters of credit, finance counsel can focus on negotiating fronting fees or other letter of credit fees. If the Fund expects to make acquisitions in a variety of currencies, finance counsel can prioritise negotiating the kinds of available currencies, the foreign exchange rate and the ability to incur secured hedges under the facility.

Finally, as referenced above, as many subscription facilities also include the ability to join qualified borrowers as borrowers under the facility (subject to a guaranty by the Fund), allowing access to credit at a rate that may be more favourable than what the qualified borrower could otherwise obtain on its own.

Limited partner preference: Maintaining flexibility

As many subscription facilities feature the borrowing base concept described above, it is in the best interest of the Fund to include as many limited partners in the borrowing base as possible. Subscription facility documentation will govern inclusion in the borrowing base by specifying "exclusion events" which, if occuring with respect to a limited partner, would exclude the limited partner from the borrowing base for the duration of such event (often requiring affirmative action by the agent or by the lenders to readmit such limited partner to the borrowing base). Exclusion events can be negotiated to achieve the goals of the Fund, acknowledge the requirements of the lenders, or accommodate limited partner concerns. For example, limited partners occasionally request the flexibility to grant a lien on their limited partnership interest in the context of entering into an all-assets financing. A subscription facility can accommodate this by negotiating to remove any exclusion events based on liens on the limited partner's interest, or limiting such exclusion events only to after remedies are being pursued with respect to such lien.

In addition, limited partners may require flexibility to be excused from certain investments due to internal policies or regulations, and the exercise of such excuse rights will potentially affect the inclusion of such limited partners in the borrowing base. A subscription facility could be designed to preserve flexibility for the limited partner by negotiating to exclude

the relevant investor from the borrowing base only in relation to the relevant excused investment, preserving the legitimate policy-related requirement of the investor but also allowing the subscription facility to include the investor in the borrowing base for non-implicated investments.

Conclusion

As subscription facilities continue to mature and evolve, Funds should continue to communicate with their limited partners on the best way to use the subscription facilities. It is important during the negotiation and implementation of subscription facility to balance the risks and obligations of the lender and the Fund with the preferences of the limited partners so that these facilities can both accommodate these preferences and also benefit all the parties involved.

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