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# Subscription facilities: Key considerations for borrowers – a global experience

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## Introduction

As the number of new entrants to the fund finance market both on the fund and lender side has swelled, we have also experienced an increasing demand for subscription facilities and other related fund finance products from fund sponsor clients throughout the U.S., Europe and Asia. Fund sponsors who did not previously use subscription facilities have begun utilising them for their new funds and those that have used a subscription facility before have returned to the market.

This chapter outlines some of the legal and practical aspects that fund sponsors and their counsel should consider when structuring, documenting and/or maintaining a subscription facility, with a particular focus on the issues relating to fund documentation and collateral. This is not an exhaustive list of the issues that are pertinent to sub line borrowers but rather a roadmap or even a conversation starter for a fund sponsor in any jurisdiction interested in exploring using a subscription facility as a financing option.

## Fund documentation

A subscription facility generally takes the form of a revolving credit facility secured by the contractually committed but unfunded capital commitments of the investors in a fund. The size of the facility is determined by reference to the borrowing base, which is calculated (in the case of some sub line lenders) on the basis of the unfunded capital commitments of so-called "included investors" that meet certain credit criteria or (in the case of other sub line lenders) on a global view of the investors and their capital commitments. Given that such unfunded capital commitments are rights of a fund arising from its fund documentation and the sub line lenders' collateral and source of funds for repayment are closely tied to such unfunded capital commitments and related assets as provided therein, having "bankable" fund documentation with top-of-the-market financing provisions is the crucial first step towards a successful subscription financing.

The term "fund documentation" generally refers to the following documents in the collective: (i) the fund's limited partnership agreement (the "***LPA***"), which sets forth the relationships governing the fund, the general partner of the fund and the investors;[1] (ii) the subscription agreements, which are entered into by each investor in the fund and the general partner of the fund, whereby such investor subscribes to the fund as an investor; and (iii) any applicable side letters, which are agreements between an investor and the fund that, among other things, can alter the terms in the LPA or subscription agreements to address any tax, regulatory or legal requirements, investment policy considerations, immunities and/or other issues that are specific to such investor.[2] The fund documentation is the backbone of any subscription financing as it will set the bounds of what is permissible under a subscription facility.

Considerations

If a fund sponsor has decided to explore a subscription facility as one of its financing options, first and foremost, the fund sponsor should engage a finance counsel (if and to the extent possible, during the drafting stage of the LPA and related fund documents) to ensure that the fund documentation has robust language to address the potential sub line lenders' underwriting needs.

While the question of what makes an LPA "bankable" would inevitably involve an extensive discussion of legal and business considerations, it is probably fair to say that, at a minimum, sub line lenders and their counsel generally expect a "bankable" LPA to: (i) expressly permit the fund and/or its general partner to borrow (and if multiple vehicles are parties to, or are expected to be joined as parties to, a subscription facility, to borrow, guarantee and/or incur other credit support obligations on a joint, several, joint and several and cross-collateralised basis); (ii) expressly permit the fund and/or its general partner to call capital from the investors in the fund to service any debt incurred by the fund; (iii) expressly permit the fund and its general partner to pledge their respective collateral (*see* the "*Collateral*" section below); (iv) include the investors' acknowledgment, whereby each investor in the fund expressly confirms its obligation to fund capital contributions without any counterclaim, defence and offset; and (v) designate the sub line lenders as third-party beneficiaries of the financing provisions of the LPA.

Further refinements would be necessary if the fund sponsor is aiming for a subscription facility with optimal flexibility. For example, if the fund sponsor wants to keep a subscription facility and/or the ability to draw from a subscription facility for a longer period, the LPA should expressly permit the fund and/or its general partner to call capital to repay debt even after the investment period is suspended or terminated. If the fund sponsor does not want to be subject to any cap or restriction on the use of proceeds under a subscription facility due to any concentration and overcall limits in the LPA,[3] it should consider adding a 5–10% cushion to the investor-by-investor concentration limit so that limit is always higher than the fund-level concentration limit and thereby overcall protection is preserved.

Fund sponsors should also be mindful that older LPAs tend to be silent on, or expressly limit, certain "bankable" financing provisions. As such, if a new LPA is being drafted based on an older model, even if the investor base is exactly the same and the same sub line lenders are involved or expected, finance counsel should be engaged to review the LPA and bring its terms up to the most current "bankable" standard. For example, the older LPAs often lack a built-in investor acknowledgment, whereby each investor confirms its funding obligations without any setoff, counterclaim or defence (including bankruptcy), because such investor acknowledgment used to be included in separate investor consent letters that were routinely requested by the sub line lenders and delivered by the investors as part of standard subscription financing process in the past. Now that the LPAs (or subscription agreements) typically include such investor acknowledgment and investor consent letters are no longer delivered to the sub line lenders except in certain limited circumstances (*see* the "*Investor consent in the fund-of-one context*" section below), if a fund sponsor follows an older model LPA without consideration of its "bankable" credentials for cost, investor relations and/or other reasons and the subscription agreements also fail to include such investor acknowledgment, the fund sponsor could run the risk of drafting an LPA that would not be sufficiently "bankable" for a subscription facility, which will likely trigger a request for an investor consent letter (to address any perceived gaps in the LPA), increased pricing and/or tighter covenants.

Robust side letter provisions will help the fund mitigate the risk of the applicable investors being excluded from the borrowing base and achieve sufficient borrowing capacity under a subscription facility. As such, promptly upon receipt of any side letter request from an investor, fund sponsors, with the assistance of their finance counsel, should ask for buffers to mitigate any potential adverse effects of any relevant side letter provisions. If an investor requests a side letter provision entitling such investor to withdraw from the fund and/or cease making capital contributions upon the occurrence of certain events that may cause issues from a reputational perspective (e.g., pay-to-play) or breach of specific provisions in the organisational documents or the internal policy of such investor (e.g., excuse from participating in investments in gambling or tobacco businesses), the fund sponsor should ask that such right be conditioned upon the payment of debt incurred prior to such event. If a governmental investor requests that its sovereign immunity be expressly reserved in a side letter, the fund sponsor should propose that such investor acknowledge and agree that its funding obligations under the LPA and subscription agreement constitute a private commercial action. If an investor requests a side letter provision exempting such investor from a requirement to deliver financial or other information and/or documents, the fund sponsor should offer to limit the scope of such deliverables to publicly available information and/or those required by the sub line lenders in order to assess the creditworthiness of such investor. If an investor requests that its identity be kept confidential, the fund sponsor should ask that there be an exception for disclosure, on a confidential basis, of such information to the sub line lenders. Borrower counsel should also make sure to ring fence any limitations imposed by any side letter so that such limitation does not spread to other investors in the fund via a "most favoured nation" election.

Delivery of the fully executed and enforceable fund documentation is the first step of any subscription financing process. Fund sponsors should be mindful that all fund documentation (as well as information and documentation related to the underlying investors)[4] should be ready to be shared with the potential sub line lenders upon execution of a non-disclosure agreement and at the commencement of the term sheet and indicative borrowing base solicitation process. Accordingly, fund sponsors should consider running an inventory of, and reviewing, all fund documentation to make sure that all such documents are properly dated and fully executed with all the investor questionnaires and signature blocks correctly filled out. Such preparation will significantly reduce the number of follow-up lender requests and the need to go back to the investors to get the documents re-executed during the diligence period. To the extent any confidentiality restrictions are contained in any subscription agreement or side letter, the fund sponsor should allow itself sufficient lead time to obtain such confidential investor's waiver or consent prior to sharing their information and documents with the potential sub line lender.

Lastly, fund sponsors and their counsel should remember that given the importance of the fund documentation, the sub line lenders will often require prior notice of any proposed amendment to the LPA, subscription agreement and/or side letter and that the administrative agent or the sole lender, as applicable (not the fund sponsor or its counsel), will have the right to determine the materiality of such proposed amendment. In the case of a syndicated deal, if the administrative agent determines that such proposed amendment is a material amendment that would impact the collateral and/or the sub line lenders' related rights, the required lenders' consent will be required. Given that the lender approval process could take more than two weeks from the date the administrative agent or the sole lender, as applicable, receives a notice of such proposed amendment from the fund or its general partner and failure to so notify and/or obtain the necessary lender approval is an event of default under a subscription facility, the fund sponsor should always be mindful that any

request or need for an amendment or modification to any fund documentation (regardless of how immaterial it may be) is a material issue to the sub line lenders and should set up a system of notifying such lenders at the earliest opportunity to ensure timely execution of such amendment without breaching any covenants under the subscription facility.

### Investor consent in the fund-of-one context

With a growing number of funds utilising fund-of-one structures, we have seen an uptick in the number of fund-of-one facilities in recent years.

In the case of a subscription facility for funds-of-one or separately managed accounts for a single investor, due to the increased concentration risk and lack of overcall protection, most sub line lenders will require an investor consent letter, which will, among other things, establish direct privity of contract between such investor and the sub line lenders and address any pertinent issues (e.g., sovereign immunity as a defence to funding obligations).[5]

Considerations

If a fund sponsor is interested in exploring a subscription facility for a fund-of-one or a separately managed account, the fund sponsor should start socialising with the investor the need for such subscription financing and potential requirement to deliver an investor consent letter early in the financing process (or if possible, during the fund formation process) as the investor's willingness to provide such a consent letter and cooperate with the sub line lenders' credit diligence and reporting obligations under the subscription facility will be vital to the success of the fund-of-one subscription facility.

Fund sponsors should be mindful that investors often resist the sub line lenders' request for an investor consent letter. From an investor's perspective, not only is it an additional, if not unnecessary, contract to be entered into in favour of the fund's third-party lender, but also the notion of expressly and contractually waiving any counterclaim, offset or defence it may have with respect to its funding obligations certainly does not make it an attractive one. Further, the execution and delivery of an investor consent letter is often subject to a lengthy administrative review, approval and/or execution process, particularly with governmental investors that are investing in a fund-of-one structure. Putting the need for such investor consent letter on the investor's radar early in the financing process will give the investor sufficient time to understand the reason for such letter and therefore increase the likelihood of the investor's cooperation.

In terms of the actual documentation required, it may be appropriate for the fund sponsors and their counsel to review and reach an agreed form of the investor consent letter with the sub line lenders and their counsel first, and thereafter send the mutually agreed form to the investor for review. Such initial review process provides the fund sponsor and its counsel an opportunity to: (i) make sure that the obligations of the investor set out in the investor consent letter are not more onerous than those under the LPA, such investor's subscription agreement and any side letter; and (ii) present a form of investor consent letter with the standard representations, warranties and covenants that are absolute must-haves for the sub line lender's underwriting needs and that are consistent with the market standard, which will help the investor's review and often result in an easier sign-off.

### Collateral

Scope

A subscription facility generally takes the form of a senior revolving credit facility secured by: (i) the unfunded capital commitments of the investors; (ii) the right to call capital from

the investors and receive capital contributions; (iii) the deposit or securities accounts into which the capital contributions are deposited or credited (each, a "***collateral account***"); and (iv) the right to enforce the investors' funding obligations and other enforcement rights under the LPA.

Considerations

Given the limited nature of the sub line collateral, it is vital that there is a clear business understanding of the scope of the agreed-upon collateral and an accurate reflection thereof in the finance documents. Borrower counsel should carefully review the granting provision of the applicable security documents and ensure that the collateral description does not go beyond what is typically required in a subscription facility unless otherwise agreed as a business matter. For example, sub line lenders or their counsel may inadvertently request for expanded collateral that includes investment assets and/or equity interests in a subsidiary holding investment assets in addition to the capital call-related assets. Although such expanded collateral may be appropriate in a hybrid facility with a hybrid capital call-portfolio investment borrowing base, which is often utilised early in the life of the fund until the fund acquires a sufficient amount of assets and becomes ready for a more permanent "asset-based lending" facility backed by such investment assets, it should not be included in a pure subscription facility where the borrowing base is determined by the uncalled capital commitments of the eligible investors only.

Setting the correct parameters around the collateral is an important point to remember as lien restrictions in subscription facilities often take the form of a negative pledge on the collateral. Any inadvertent over-pledge may create a problem if the fund plans to do an asset-based facility supported by its investment assets while the subscription facility remains in place.

## Collateral accounts

Because all investors' capital contributions to the fund must be deposited or credited to one or more collateral accounts, the collateral accounts are a material part of any sub line collateral package. All collateral accounts must be pledged, directly or indirectly, to the sub line lenders at the initial closing (and at each joinder or accession of the related vehicles to the extent applicable) of any subscription facility. Each collateral account must be set up in the name of the fund and each other vehicle (other than any pass-through blockers) where capital contributions are or will be received. If such account is located in the U.S. and is not held with the administrative agent or with the sole lender, as applicable, an account control agreement over such collateral account will need to be put in place at the initial closing (or, if applicable, at such joinder or accession closing) to provide a perfected security interest to the sub line lenders. For accounts located in other jurisdictions, such as England and Wales and Hong Kong, it is sufficient that notice of the security interest be given to the account bank. In certain jurisdictions, such as Luxembourg, the account bank may be required to acknowledge the granting of the pledge and waive pre-existing rights it may have on the collateral account to ensure the sub line lender has a first ranking security interest.

Considerations

As soon as a fund sponsor has made a decision to enter into a subscription facility and identified the sub line lender(s) and the fund's related vehicles to be joined to the subscription facility as co-borrowers and/or pledgors, the fund sponsor should start the process of opening the collateral accounts at an eligible financial institution. It is important that the

opening process is started early as the depositary bank or the securities intermediary, as applicable, will need sufficient lead time to conduct their "know your customer" diligence on each of the applicable entities and, depending on the number of such entities and/or location of such accounts, a longer lead time and additional steps and documentation (e.g., a foreign-law security agreement) might be required to open and pledge a collateral account.

A fund sponsor should also ensure that each applicable borrower and/or pledgor (i.e., main fund, parallel funds, alternative investment vehicles ("***AIVs***") and/or feeder funds) is the actual named account holder of the related collateral account. If any such collateral account is held in the name of the investment manager, the related master fund or any other entity for the benefit of the applicable borrower and/or pledgor, it is likely that a new account will need to be opened in the name of the correct entity. Any lack of clear ownership with respect to any collateral account could alert the sub line lenders and trigger additional lender requests, including, but not limited to, the opening of a new account, all of which could potentially delay the facility closing.[6]

Furthermore, extra time should be allocated if the transaction requires an account control agreement as it is a tri-partite agreement among the account holder, the administrative agent or sole lender (as applicable), as secured party, and the depositary bank or securities intermediary, which will typically be based on the depositary bank or securities intermediary's standard form but will often take time to negotiate.[7]

Lastly, the fund sponsors should remember that only the capital contributions received from the direct and indirect investors should be deposited or credited to the collateral accounts as the facility documents will not permit the borrowers and/or pledgors to commingle the capital contributions in such collateral accounts with other funds of such borrowers and/or pledgors. To avoid any inadvertent commingling of funds, fund sponsors should consider setting up the accounts designated for capital calls only and direct the investors to fund capital contributions to only such designated account(s) from the outset (or, by no later than when a subscription facility is put in place). It is also worth noting that in the unlikely event that an event of default or a cash control event, as applicable, occurs, such segregation will ensure that the borrowers and/or pledgors are only blocked from accessing the funds in their collateral accounts and that all other funds that are not part of the subscription facility collateral package remain accessible to the borrowers and/or pledgors.

### Capital calls

Any actual or perceived delegation of the fund and/or its general partner's right to call capital to a party that is not an obligor under a subscription facility may be deemed potential collateral leakage by the sub line lenders.

Considerations

It is imperative that the fund and/or its general partner retain the right to call capital from the investors of the fund at all times during which the facility is in place. Ideally, neither any fund documentation nor investment management agreement should delegate the fund and/or its general partner's right to call capital to the investment manager, as in such a case, the sub line lenders may ask the investment manager to be a party to the subscription facility and to grant a security over its right to issue capital calls to the investors. While an investment manager typically signs the subscription facility with respect to the subordination covenant, whereby such investment manager acknowledges and agrees to subordinate its claims against the fund and its affiliates to the obligations owed to the sub line lenders under a

subscription facility, any further exposure to the subscription facility and restrictions therein should be avoided. Similarly, if and to the extent a fund and/or its general partner has retained a third-party service provider to handle its capital calls, it should make it very clear, both in writing as well as in practice, that the authority to call capital remains with the fund and/or its general partner and that such provider is acting at the direction of the general partner. Otherwise, the sub line lenders may ask the third-party service provider to become a party to a subscription facility and to grant a lien on its right to call capital, and it is unlikely that any third-party servicer provider would agree to do so.

**Investor notices**

In certain jurisdictions, in light of the law governing security with respect to the unfunded capital commitments of the investor of a fund (which is generally the law of the jurisdiction where such fund is formed and/or registered as that will be the governing law of the fund documentation), such fund and/or its general partner must notify the investors that their unfunded capital commitments have been pledged or assigned to the sub line lenders as collateral as such notice is required for the perfection of the security with respect to the unfunded capital commitments of the investors. The Cayman Islands, England and Wales and Hong Kong are examples of the jurisdictions requiring an investor notice to be delivered to perfect the security. An acknowledgment of the notice from the relevant investor is not strictly necessary for perfection of the security, although it is desirable as evidence that the notice has been given. Security agreements in such jurisdictions will typically include an obligation on the fund and the general partner to use "reasonable endeavours" to obtain acknowledgments from the investors. In Luxembourg, a pledge over unfunded capital commitments is perfected by the mere conclusion of the pledge agreement between the fund and the sub line lender or the security agent. However, given that investors may validly discharge their obligation in the hands of the fund as long as they are not aware of the conclusion of the pledge, the pledge agreement usually includes an obligation to notify them of the granting of the pledge.[8] It is generally not required to obtain acknowledgments from the investors.

Considerations

Method of delivery of the investor notices often becomes a point of negotiation as this is closely related to the collateral as well as the day-to-day administration of the fund. A fund sponsor, particularly if such fund is an open-ended fund, should find the appropriate timing and method of delivery that can be easily complied with during the life of the subscription facility.

Subject to the terms of the LPA notice provisions and applicable law, investor notices are commonly delivered in one or more of the following ways: (i) by hard copy; (ii) by uploading the notices on investor portals; and/or (iii) by emailing directly to the investors. If the investor notices are delivered via investor portal, lenders and their counsel may require that the fund and/or its general partner provide evidence that each investor in the fund has actually opened such investor notice. If and to the extent any such investor notice has not been accessed by the designated time, the sub line lenders and/or their counsel may require that additional actions be taken (i.e., sending follow-up emails with a copy of the investor notice attached, obtaining receipt confirmation from the investors and submitting such confirmation to the sub line lenders and their counsel as evidence of delivery), which can be onerous and administratively burdensome from a fund's perspective especially if it is an open-ended fund where such delivery must be repeated every time new investors are admitted to the fund. To ensure that the fund is in compliance with such notice covenant,

the fund sponsor should consider establishing and maintaining a system (e.g., an investor portal) where such information can be easily and timely delivered and reaching an agreement with the lenders as to the most commercially sensible timing and delivery method that is not administratively burdensome but still effectively achieves a first priority security interest.

## Dual security structures

As the private funds market has matured and fund structures have become increasingly more complicated, many subscription facilities now include one or more borrowers and/or pledgors organised in multiple jurisdictions pledging their respective collateral to the sub line lenders.

In certain jurisdictions (e.g., England and Wales, Ireland, Luxembourg, etc.), the law of the location of the pledgor's assets (the *situs*) will dictate how security is taken over such asset. It is important that the specific assets or rights that are the subject of the security in question are carefully considered. For example, for an LPA and subscription agreements governed by the laws of Luxembourg, the unfunded capital commitments and other LPA-derived capital call right security will be taken under the laws of Luxembourg as the investors' funding obligations derive from Luxembourg-law governed documents. This will be the case even though the subscription facility will be governed by New York or English law.

Considerations

In the case of a U.S. subscription facility, if it is agreed that the collateral includes foreign assets, then if and to the extent the sub line lenders feel strongly that an additional set of security documents is necessary to preserve its enforcement rights in such foreign jurisdiction, a second set of security documents under such foreign law are prepared. For example, in U.S. subscription facilities involving Luxembourg parallel funds, usually two sets of security are granted with respect to such Luxembourg parallel funds – one under New York law and the other under Luxembourg law. When dealing with such dual security structures, the fund sponsors and their counsel should make sure that the business terms do not differ under both security structures. Borrower counsel should closely coordinate with its local counsel and carefully cross-check the scope of the collateral, representations, covenants and events of default under both security documents.[9]

## Conclusion

Despite the current economic situation, we are optimistic that the subscription facility will remain resilient as it has done so in numerous past downturns and will continue to be an attractive source of financing for many fund sponsors.

As discussed above, the best sub line financing terms are the final product of the robust bankable fund documentation as well as early and continuing cooperation among fund sponsors, sub line lenders, investors and their respective counsel. This is because the subscription facility terms will always be limited to the bounds of the fund documentation, and the more robust financing provisions are in the fund documentation, the less restrictions and limitations to which the fund will be subject under a subscription facility.

Given the importance of fund documentation and cooperation among the finance parties and investors, it is recommended that the fund sponsor engage finance counsel early in the financing process (and to the extent possible, during the fund formation process) and have them steer the way to avoid unnecessary pitfalls and maximise the chances of obtaining and successfully maintaining a subscription facility.

## Endnotes

1. Certain types of funds in certain jurisdictions are established as corporate entities and not as partnerships, are governed by articles of incorporation or similar organisational documents and not by LPAs, and are managed by a board of directors or similar governing body and not by a general partner.
2. Certain types of funds in certain jurisdictions (e.g., Luxembourg and other European countries) are also required to issue a prospectus or an offering document, which will also need to be considered in the context of a subscription facility.
3. LPAs may include overcall provisions, which allow the fund to overcall capital from its non-defaulting or non-excused investors to make up for any shortfalls created by the defaulting or excused investors' failure to fund the initial capital call. Investors often put a cap on the maximum amount they may be required to fund with respect to any investment in excess of the amount that would have been required had all investors participated in the relevant investment funded.
4. In the case of deals involving a European fund, additional documents such as an offering memorandum, depositary agreement and alternative investment fund manager agreement will need to be delivered to the sub line lenders for diligence.
5. An investor consent letter may also be used in other contexts to address any actual or perceived deficiencies or gaps in the fund documentation.
6. A master account structure is an exception, whereby the master fund (i.e., main fund or parallel fund) opens an account in the name of the master fund and agrees to act as agent for each of the appointing entities (e.g., AIVs) and agrees to grant a lien in favour of the sub line lenders on the amounts in the account that are held for any such entity.
7. Similarly, most account banks in Luxembourg have their standard forms of notices and reaching out in advance to the relevant account bank to ensure its most up-to-date forms are used in the legal documentation will definitely facilitate and speed up the negotiation and the establishment of the collateral account pledge.
8. In Luxembourg, some take the view that, based on the conflict of law rules, non-Luxembourg investors in a Luxembourg fund must be notified according to notification rules applicable in their local jurisdiction, which could end up being an onerous and administratively burdensome process for fund sponsors.
9. In contrast, in our experience lenders to Cayman Islands funds do not require a separate set of security documents governed by Cayman Islands law as the Cayman Islands courts generally respect and give effect to valid foreign law security.

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