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Contributing Editor:
Michael C. Mascia

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CONTENTS

General chapters (continued)

Country chapters

Recent developments in fund financing: Hybrid facilities, insider leverage and overcall limitations

Meyer C. Dworkin & Samantha Hait
Davis Polk & Wardwell LLP

Background – Subscription Facilities and NAV Facilities

In recent years, credit facilities provided to private equity funds have been dominated by two forms: the "Subscription Facility" and the "NAV Facility".

The Subscription Facility – sometimes referred to as a "capital call" credit facility – has become increasingly common for newer funds with significant unfunded capital commitments, with the loans secured by the fund's right to call such capital commitments from its investors. Availability under a Subscription Facility is subject to a "borrowing base" determined as a percentage of the unfunded commitments of certain "included" investors in the fund (with the inclusion and advance rates on such unfunded commitments dependent on the creditworthiness of each such investor). Subscription Facilities are generally intended to serve a fund borrower's short-term capital needs by bridging the time between the issuance of capital calls to investors and the time such capital is actually contributed.

But for many funds, Subscription Facilities are not a viable option, either because the fund's organisational documents do not permit such facilities (or do not permit certain essential features – e.g., the pledge of capital commitments to a third-party lender) or, in the case of a mature fund, the fund has already called upon – and thereby reduced – a significant portion of its commitments. These private equity funds have sought instead to raise capital through an "asset backed" or net asset value facility: a "NAV Facility". NAV Facilities are credit facilities backed by the assets included in the fund's investment portfolio. For a "fund-of-funds", these assets will typically be the limited partnership and other equity interests in hedge funds and private equity funds, often purchased by the fund-of-funds borrower in the secondary market.

Availability under a NAV Facility is also subject to a borrowing base, in this case determined by reference to the net asset value of "eligible" portfolio investments satisfying specific investment criteria (e.g., the absence of certain adverse investment events) and often adjusted for manager, industry and other concentration limits. In the event that, at any time, the ratio of loans outstanding under the NAV Facility to the borrowing base as adjusted from time to time (the "<u>LTV Ratio</u>") exceeds a specified threshold, the NAV Facility will require the borrower to prepay loans in order to bring the facility into compliance with such maximum LTV Ratio.

In this article, we examine and contrast the typical structures of and collateral securing Subscription Facilities and NAV Facilities, as well as focus on recent developments with respect to such facilities, including the increasing use of hybrid facilities, with features of each type.

Structure and collateral: Subscription Facilities

Subscription Facilities typically include a "main/onshore" fund borrower as well as an "offshore" fund co-borrower or guarantor, with the ability to add additional fund borrowers that are liable for the loan obligations on a joint and several basis. This structure allows the fund borrower to include a broader range of investors in the borrowing base, since the lender will only give borrowing base "credit" to investors in a fund that is itself a guarantor or joint and several co-borrower of the facility. In a typical Subscription Facility, the main/onshore fund, the offshore fund (together with the main/onshore fund, the "Pledging Funds") and the general partner(s) of the Pledging Funds grant a security interest in favour of the lender in: (i) the unfunded capital commitments of the investors in such funds; (ii) the right to make capital calls on such investors; and (iii) the deposit accounts into which the resulting capital contributions are funded. To perfect the lenders' security interest in such collateral granted by the Pledging Funds, UCC financing statements are filed against each Pledging Fund and its general partner and the deposit accounts of the Pledging Funds are made subject to control agreements, with the lenders' right to block most often springing upon an event of default or borrowing base deficiency.

Structure and collateral: NAV Facilities

Unlike Subscription Facilities, which "look up" to the capital commitments of investors in the fund borrower for collateral, NAV Facilities "look down" to the underlying portfolio investments of the fund borrower for credit support. In a typical NAV Facility for a fund of private equity funds, the fund establishes two special purpose vehicles ("SPVs"). The first SPV, the borrower (the "NAV Facility Borrower"), is created for the sole purpose of obtaining the financing under the NAV Facility and holding the equity interests of the second SPV ("Holdco"), which directly (or, less frequently, indirectly) owns the portfolio investments included in the borrowing base. The NAV Facility Borrower generally provides an "all assets" pledge to the lender to secure its obligations under the facility, including a pledge of 100% of the equity interests of Holdco (the "Equity Interest Collateral").

If the NAV Facility Borrower is a limited partnership, lenders will generally require that its general partner (the "General Partner") provide a pledge of the general partner interests in the NAV Facility Borrower (the "GP Interest"). Holdco most typically guarantees the NAV Facility Borrower's obligations under the NAV Facility and secures such guarantee with a pledge of the deposit and securities accounts into which distributions on and proceeds of the portfolio investments are paid.[1] This double-SPV structure and pledge of Holdco equity and, where applicable, the GP Interest, provides lenders upon a default with the right to foreclose upon (or exercise other secured creditor remedies with respect to) the Equity Interest Collateral, thereby obtaining the ability to manage an orderly disposition of the underlying portfolio investments. To perfect the collateral granted by the NAV Facility Borrower and Holdco, UCC financing statements are filed against both entities and any such deposit or securities accounts are required to be subject to control agreements in favour of the lender.

In contrast, if the NAV Facility is for a fund of hedge funds rather than private equity funds, the lender will typically require the NAV Facility Borrower to credit its underlying hedge fund investments to a securities account under Article 8 of the UCC, which account is held at a securities intermediary. The securities intermediary becomes the legal owner of the underlying hedge fund investments (with beneficial ownership remaining with the fund borrower), thereby creating a "securities entitlement" in favour of the borrower. The borrower then pledges this securities entitlement, as well as the securities account (but not the underlying hedge fund investments) to the lender to secure its obligations under the NAV Facility. To ensure perfection of the lender's security interest in the securities entitlement, the securities account is subject to a control agreement in favour of the lender – here most often with day-one control – and a UCC financing statement is often filed against the fund borrower. The pledge of the securities entitlement, and protections under the control agreement, provide the lender, upon an event of default, with the right to instruct the securities intermediary to redeem the underlying hedge fund interests pursuant to the terms of the underlying fund documentation.

Recent developments in NAV Facilities

Historically, NAV Facilities have been used by fund-of-funds to borrow against the value of limited partnership and other equity interests in private equity and hedge funds. Recently, however, some private equity funds have been using the NAV Facility technology to borrow against the equity value of their investments in operating/portfolio companies.[2] Given the illiquidity of these assets, these facilities will likely take the form of "Hybrid Facilities", secured not only by interests in the underlying portfolio investments but also by fund investors' capital commitments. Typical features of Hybrid Facilities – consistent with other forms of fund financings – include: (i) posting additional collateral or pre-paying in the event the LTV Ratio (calculated on the basis of the value of the underlying portfolio investments) exceeds a certain threshold; and (ii) a mandatory prepayment upon the loan amount exceeding a certain percentage of unfunded capital commitments. Hybrid Facilities are particularly useful for a fund looking for long-term financing that is available from the fund's inception (when it has significant uncalled capital commitments, but few (if any) investments) until the time the fund is fully invested (when all such commitments have been utilised to finance such investments).

In another recent devolvement, funds have used the NAV Facility technology to permit fund management and other insiders to leverage their existing investments in the funds they manage. Given that, in these cases, the collateral consists of internally controlled underlying funds, lenders are permitted to take a direct pledge of the underlying fund interests and, thus, lend on a greater percentage of the value of the underlying fund interests.

Recent developments in Subscription Facilities

Limited partnership agreements and other organisational documents of Pledging Funds for Subscription Facilities (especially investor "side-letters") often contain various types of "overcall" limitations. These limitations ("Overcall Limitations") take a number of forms, but all limit the obligation of the applicable investors to fund more than a specified percentage of any capital call or capital calls in the aggregate. Overcall Limitations most typically arise in connection with a defaulting (or excused) investor's failure to fund a capital contribution, in which case, absent such limitation, the other investors would effectively be required to make up the resulting shortfall. An Overcall Limitation limits the performing investor's obligation to fund that shortfall.

Recently, there has been a particular focus by lenders on the terms of side letters to identify any Overcall Limitation applicable to an individual investor (an "Individual Overcall Limitation"). For example, assume a fund borrower has agreed to an Individual Overcall Limitation capping an investor (the "Capped Investor") at not more than 19.99% of aggregate funded capital of the fund. Assuming that such Capped Investor represents 17.5% of the fund's commitments, on a $100 million capital call, the Capped Investor should be required to fund $17.5 million. However, if one or more investors constituting 25% of the fund's commitments default, the actual amount funded will be only $75 million. This would mean that the Capped Investor will have funded $17.5 million of $75 million, or 23.3% of the aggregate call, in excess of its 19.99% limitation (requiring the fund to return approximately $2.5 million to such Capped Investor).

Where the capital commitment of the Capped Investor relative to the fund size makes the likelihood of breaching the Individual Overcall Limitation reasonably likely, lenders may insist that Individual Overcall Limitation not apply to capital contributions utilised to repay the Subscription Facility. Another solution, where the remedy of the Capped Investor for a breach of the Individual Overcall Limitation is limited to transferring its capital commitment (as opposed to the more customary withdrawal right by the Capped Investor), is for the lender to prohibit in the Subscription Facility documentation the general partner of the fund from consenting to any such transfer that would result in a borrowing base shortfall by virtue of a transfer to a less credit-worthy investor, unless the borrower repays any outstanding loans in the amount of such shortfall. Finally, depending on the mix of "included" investors, lenders have taken comfort that, as a practical matter, the Overcall Limitation would only be breached in the exceedingly remote circumstance in which a significant number of high-grade investor defaults occur.

Conclusion

As funds continue to realise the benefits of using NAV Facilities, we expect to see the types of funds using such facilities, as well as the purposes for which such facilities are used, continue to broaden. Further, as the use of Subscription Facilities continues to rise and lenders continue to focus on the organisational documents of funds seeking Subscription Facilities, we expect to see further developments in the approach to Overcall Limitations, as well as a rise in other, even more technical issues implicated by such documents.

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Endnotes

1. We note that in certain NAV Facilities, the Holdco entity acts as borrower, with the top-level SPV providing a downstream guarantee of the borrower's obligations secured by a pledge of the Equity Interest Collateral. While for purposes of this article, there is no difference between the two structures, we have referred to the more typical approach throughout.
2. We note that lenders providing these facilities to private equity funds are almost always structurally subordinated to lenders providing financing secured directly by the assets of the underlying portfolio companies.

Meyer C. Dworkin
Tel: +1 212 450 4382 / Email: meyer.dworkin@davispolk.com
Mr. Dworkin is a partner in Davis Polk's Corporate Department, practising in the Credit Group. He advises lenders and borrowers on a variety of credit transactions, including acquisition financings, asset-based financings, debtor-in-possession financings, bankruptcy exit financings and structured financings. In addition, Mr. Dworkin regularly represents hedge funds and corporations in negotiating prime brokerage agreements, ISDA and BMA-standard agreements, trading and financing documentation and other complex structured financial products.

Samantha Hait
Tel: +1 212 450 4556 / Email: samantha.hait@davispolk.com
Ms. Hait is an associate in Davis Polk's Corporate Department, practising in the Credit Group. She advises financial institutions and borrowers on a variety of secured and unsecured corporate finance transactions, including acquisition financings, asset-based financings and fund financings.

Davis Polk & Wardwell LLP

450 Lexington Avenue, New York, NY 10017, USA
Tel: +1 212 450 4000 / Fax: +1 212 701 5800 / URL: www.davispolk.com