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Considerations for Subscription Line Facilities for Late-Stage Funds

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Key Takeaways:

- Closed-end private equity funds do not immediately cease to exist at the end of their stated term, and subscription-secured credit facilities ("***Subline Facilities***") can be extended to funds past their term with proper diligence, structuring, and underwriting.
- Delaware[1] law supports that limited partners' capital obligations continue through a fund's winding-up period, subject to any specific requirements under the fund's limited partnership agreement ("***LPA***").
- Lenders should ensure LPAs allow late-stage Subline Facilities by reviewing obligations, collateral, and repayment structures.
- Increased demand for late-term Subline Facilities may arise due to challenging exit environments.

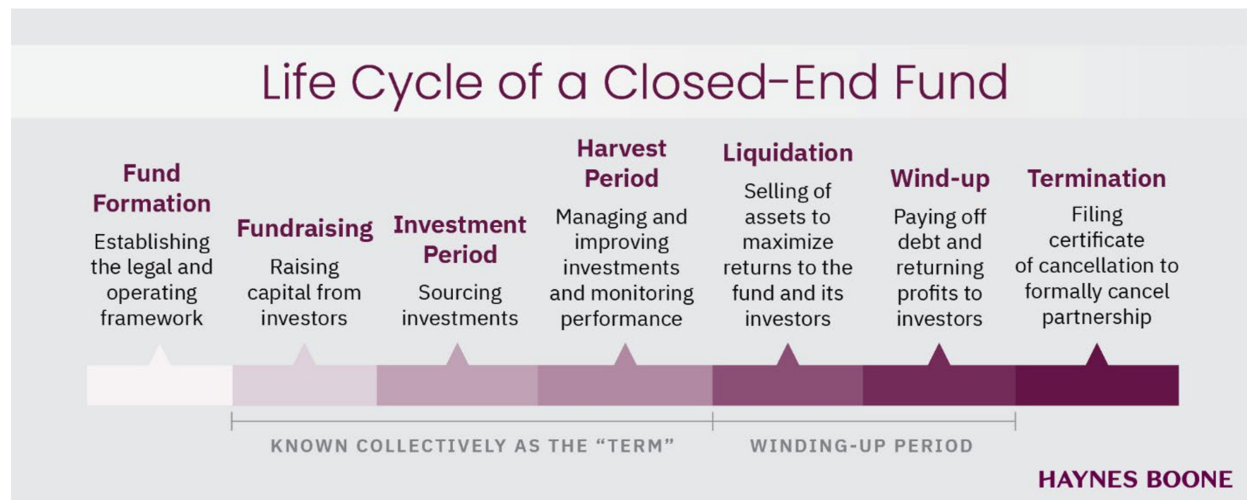
A Fund's Life Cycle Explained

Most private equity funds[2] define the duration of the fund life as an initial seven to ten year term, sometimes with optional general partner-discretionary extensions of one or two years (with further extensions often requiring limited partner consent). Investment periods are typically shorter, in the three to five year range (including extensions). After the investment period, during which the fund sources and makes its investments, funds focus on realizing the value of the investments, and aim to manage the investments in order to divest during the term under the LPA or the winding-up period. Historically, Subline Facilities have been offered during the fund's term, but the fund does not cease to exist when its term ends under the LPA. Termination or expiration of the fund's term under the LPA is generally an event of dissolution that triggers the fund's winding-up and liquidation process, which may take some period of time to complete (though there is no specific timeframe required under Delaware law). During the winding-up period, the fund's LPA generally governs and includes the ongoing obligation of the limited partners to contribute capital as the investments are unwound. As liquidating a fund's assets takes time and can require working capital to optimize and streamline the process, funds may seek to avoid the logistical complexities of frequent capital calls by seeking financing for their post-term activities via the extension of an existing, or a new, Subline Facility.

[1] As more than 60% of the Subline Facilities we help structure involve some form of Delaware entity, this article will limit its scope to Delaware Limited Partnerships; there may be parallels to entities in other jurisdictions, but a separate analysis is required for each other jurisdiction in consultation with local counsel. (See https://www.haynesboone.com/news/alerts/fund-finance-insights-jurisdictions).

[2] This article is focused on closed-end private funds that have a finite term, rather than evergreen funds with indefinite term duration.

A typical life cycle of a closed-end Delaware private fund is illustrated below:



Subline Facilities depend on the unfunded capital commitments of the limited partners of a fund for repayment. The first question to answer when investigating the viability of a Subline Facility for a late-stage fund is whether, following expiration of the fund's term under the LPA, the fund's limited partners remain obligated to fund unfunded capital commitments when called upon by a lender or general partner to repay the debt. Typical "bankable provisions" that lenders rely on when extending a Subline Facility expressly define this obligation during and after the investment period but are often silent with respect to the winding-up period. The Delaware Revised Uniform Limited Partnership Act ("***DRULPA***") generally defers to the fund's LPA and does not have any superseding requirement that would relieve a limited partner of its obligation to contribute unfunded capital after the term of the fund for the repayment of debt, if required under the LPA. Lenders may be satisfied that the stated obligation to fund capital calls after the investment period is sufficient, but the best way for a fund to facilitate a Subline Facility at its later stages would be to expressly state that the obligation to fund after the end of the investment period extends through the winding-up period for purposes of repaying a Subline Facility.

Diligence Considerations

Similar to the analysis undertaken when a Subline Facility is structured at the beginning of the fund's life with a focus on the rights and ability of the fund's general partner to pledge assets and call capital, when extending that analysis to the late or post-term period, lenders and their counsel should consider:

- Whether the fund's ability to borrow and repay borrowings with capital contributions from limited partners is limited to the term of the fund under the LPA, or whether the limited partners' obligation to fund capital contributions to repay debt extends into the winding-up period.
- Whether any of the "bankable provisions" in the LPA - including the agreement to fund contributions to repay the Subline Facility without defense, setoff or counterclaim - are limited to the term of the fund under the LPA.

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- Whether the general partner's ability to overcall in the case of defaulting partners is limited after the term of the fund under the LPA.
- Whether the dissolution provisions in the LPA provide a typical waterfall, where debt must be settled before liquidation proceeds can be distributed to partners.
- Any restrictions in the LPA limiting when debt can be incurred.
- The amount of available unfunded capital of the limited partners, including recallable capital.

Lenders should also ask the sponsor about its experience with calling capital past the termination or expiration of the term of prior funds, both generally and for the repayment of debt.

Documentation Considerations

If the diligence for a late or post-term Subline Facility does not uncover any insurmountable obstacles, there are a number of items lenders should consider when drafting the loan documents:

- Whether to include a NAV (Net Asset Valuation) covenant, requiring a defined minimum value of assets and investments over debt, to provide additional repayment support.
- Whether the fund can offer additional collateral in the underlying assets of the fund, converting the facility into a so-called “hybrid facility” which is a blend of a traditional Subline Facility and net-asset-value facility that is solely focused on the underlying assets of the fund.
- Whether concentration limits or advance rates should be modified to limit exposure to any individual partner and to otherwise insulate lenders from repayment risk.
    - The practicality of reducing advance rates will depend in part on what amount the fund requests under the Subline Facility and whether the facility amount would be supported by the unfunded capital commitments at a reduced advance rate (or revised concentration limits).
- The parties may want to consider a “cashflow sweep” provision, where all or some percentage of cash realized from investment disposition is first applied to pay down the Subline Facility.
- The tenor of the facility and related language in the maturity date definition that terminates the facility before the anticipated fund termination date and allows enough time for several rounds of capital calls.
- Whether a short-term committed facility with the opportunity for extension, or an uncommitted facility, works better for the fund's situation.

Conclusion

Lenders have not typically offered Subline Facilities during the fund’s winding-up period. In fact, most Subline Facility credit agreements prohibit dissolution of the fund and prohibit the fund general partner from taking any action to dissolve the fund, so any event of dissolution typically triggers an event of default under the credit agreement. This lack of a history of late-stage fund Subline Facilities means that the market has little experience with limited partners funding post-term capital calls, for debt repayment or otherwise, so, in part given the high demand for Subline Facilities during the normal term of the fund, lenders may be reluctant to branch out into post-term lending.

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However, a challenging investment exit environment may lead to more demand for late-term facilities when a fund extends its life, either formally or by engaging in an extended dissolution, providing opportunities for lenders who are willing to understand the risks and accommodate the ongoing needs of fund borrowers.

The DRULPA supports the interpretation that LPA provisions specifying the obligation to fund capital contributions to repay debt extends beyond expiration of the fund's term and through the winding-up and liquidation period of the fund. A more precise iteration of that ongoing obligation would be useful but is not necessarily a requirement for a late-stage facility, in the absence of provisions to the contrary within the LPA. As with any facility, lenders should engage in full diligence with experienced counsel to ensure that the LPA (and any side letters) permit lenders to rely on the typical collateral and obligations of the limited partners to fund, and also consider the best way to structure the facility to fit their specific situation. As many of these closed-end funds mature, there may be an increase in late-stage Subline Facilities, and we will be interested to monitor how the market responds.[3]

[3] The authors would like to thank Jack Hutchins, a summer associate at Haynes Boone, for his contributions to this article.

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