

FUND FINANCE FRIDAY

A Lender's Perspective on Special Purpose Entities, Alternative Investment Vehicles and Qualified Borrowers

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In order for fund credit parties to maintain flexibility for investments and meet the changing requirements of investor requirements (tax, ERISA, etc.), they often need to establish multiple investment vehicles to accommodate those requirements. When putting in place a subscription credit facility, a fund borrower (the “Main Fund”) must remain mindful of how the establishment of alternative or subsidiary entities could impact a lender’s security under the credit facility – namely, direct access to the uncalled capital of the Main Fund’s investors. From a lender’s perspective, in order for it to retain its security interest, there will be covenants requiring the Main Fund and other obligors to ensure that the lender has direct access to the commitments of the Main Fund’s investors and also to ensure that the called capital is paid into an account over which the lender has a security interest. In order for that to occur when using multiple investment vehicles, the primary lender concern surrounds making sure that commitments are not redirected into vehicles outside of the lender’s collateral reach. This article touches on some of the options that a Main Fund borrower has when setting up these additional vehicles together with what a lender needs or expects as a result of each approach.

What is a Special Purpose Entity?

What is a multiple investment vehicle and/or special purpose entity? In credit agreements, the term typically used is special purpose entity (“SPE”), and they are often defined as “an entity that holds portfolio investments of or on behalf of, or which are otherwise beneficially owned directly or indirectly by, or controlled by, a borrower under the subscription credit facility.” As noted above, SPEs are not a creation of the lender, but instead, created by the fund as a means to manage their investment portfolio and the various businesses within that portfolio.

SPEs generally do not show up on the Main Fund's balance sheet and operate as an individual entity. For example, if the Main Fund is buying ABC Manufacturing, this portfolio investment will likely occur via one or more intervening SPEs ultimately owned by the Main Fund – *e.g.*, the Main Fund will not typically own the equity of ABC Manufacturing directly. When used in the credit agreement context, SPEs generally refers to entities below the Main Fund on a structure chart.

What is an Alternative Investment Vehicle?

What is an alternative investment vehicle? In credit agreements, alternative investment vehicles (“AIV”) are often defined as “any entity other than a Main Fund/general partner of the Main Fund under the credit facility that has the right to enforce any capital commitment or to otherwise call, demand or receive any callable capital or capital contribution proceeds.” While AIVs are separate legal entities like SPEs, AIVs are distinguished by having the right to call capital from the investors of the Main Fund. Alternative investment vehicles can be set up for a variety of reasons, including tax, ERISA, etc. For example, a fund may offer to certain tax-exempt or foreign investors the ability to contribute capital to the AIV rather than to the main fund to avoid tax issues resulting from an investment in a particular jurisdiction.

For clarity, there is a subset of AIVs that are often referred to as feeder AIVs (“Feeder AIV”) but are different than the AIVs contemplated above. A Feeder AIV is an investment vehicle that pools capital commitments of investors separately and invests directly (or indirectly) into the Main Fund. When used in the credit agreement context, Feeder AIVs generally refer to entities above the Main Fund on a structure chart. Rather than making investments directly into the SPE portfolio investment, the Feeder AIV “feeds” its capital commitments into the Main Fund vehicle, with the Main Fund ultimately using all of the capital to make the portfolio investments directly. Whether for tax, legal or other regulatory issues, Feeder AIVs often contribute to a “blocker” entity first rather than directly to the Main Fund vehicle, but the main distinguishing factor is that a Feeder AIV does not make portfolio investments of its own.

What is a Parallel Fund?

What is a parallel fund? A Parallel Fund is another entity type that will frequently appear on a fund structure chart. In credit agreements, parallel funds (“Parallel Fund”) aren't often defined (for the reasons discussed below) but are generally referred to as an investment vehicle that will invest proportionately in portfolio investments at the same time and on the same terms as the main fund vehicle, and will typically share proportionately in expenses. The ability for the Main Fund to offer investors in the Parallel Fund the same terms depends on applicable tax, regulatory and legal concerns. The ultimate goal is for the Parallel Fund to invest “side-by-side” with the Main Fund. When used in the credit agreement context, a Parallel Fund generally refers to entities to the side of the Main Fund (brother/sister entity to the Main Fund) on a structure chart.

AIVs and Parallel Funds can be confused, since they are essentially doing the same thing – *i.e.*, making direct SPE portfolio investments. From the perspective of the source of funds, while an AIV's funds are typically coming from the same investors in the Main Fund, the funds to a Parallel Fund are coming from a different set of investors. Further, different from an AIV, a Parallel Fund typically invests “parallel” to the Main Fund for the life of the fund, on a pro-rata basis and on the same terms. An AIV isn't generally established to invest “side-by-side” but

rather to make specific investments for tax purposes, regulatory reasons and legal issues. One example of a Parallel Fund is an “employee, friends and family fund” that may have an agreement with the Main Fund that allows for its Parallel Fund to invest “side-by-side” for up to a certain percentage of the overall portfolio investment.

A Lender’s Perspective

Since the lender’s primary focus from a collateral perspective is on direct access to the uncalled capital of the investors in the Main Fund, the requirements imposed by a lender under a credit facility vary depending upon whether the entity is an SPE, AIV or Parallel Fund.

For the most part, Parallel Funds are irrelevant to a lender and are not governed by a credit agreement, since, from a credit standpoint, they are not entitled to the uncalled capital of the Main Fund and thus are essentially unrelated to the Main Fund. The only exception would be if the Main Fund would be seeking borrowing base credit for a Parallel Fund, which, as well as other issues, would raise multiple questions as to the joint and several nature of the obligations that would need to be addressed.

As noted above, since SPEs mostly fall below the Main Fund on a structure chart and are not directly entitled to the uncalled capital of the Main Fund, they are less regulated by a lender under a credit facility. But that is not to say they are universally ignored, since, depending on the credit profile, some lenders may require that SPEs are subject to additional requirements, such as financial reporting or even a net asset value test with respect to one or more SPE’s/portfolio investments owed by the Main Fund.

On the other hand, since an AIV is entitled to the uncalled capital of the Main Fund (the collateral of the Main Fund), an AIV must be joined to a credit facility – or an alternative credit chain must be established via a “cascading pledge” to give the lender direct access to the uncalled capital of the investors to the AIV. For all intents and purposes, if any entity in the structure of the Main Fund has access to the uncalled capital of the investors, that entity will be viewed no differently than the Main Fund. As a result, as a distinct legal entity, an AIV with the ability to call capital will require the same level of diligence as the Main Fund and the same security package as well, which introduces additional cost in the form of regular diligence, UCC filings, legal opinions, etc.

What is a Qualified Borrower?

What is a qualified borrower? While not an AIV or a Parallel Fund, there is another lending structure that can be utilized by a lender and a Main Fund to get funds to an SPE portfolio investment. This avenue avoids having the Main Fund making either an equity investment or interfund loan by the Main Fund to get needed capital to its SPE. In credit agreements, qualified borrowers (“QB”) are often defined as “an entity in which a borrower or another credit party owns a direct or indirect ownership interest, or through which the borrower or another credit party may acquire an investment, the indebtedness of which entity can be guaranteed by such borrower under their constituent documents.” From a credit perspective, the QB structure isn’t much different from a lender making a loan to the Main Fund directly. There is still a loan, but the loan is made directly to the SPE/QB of the Main Fund instead of to the Main Fund itself. The loan to the QB is not secured by the assets of the QB or the uncalled capital of the QB (since it doesn’t have any uncalled capital), but it is secured by a guaranty of the Main Fund,

which is no different than any other loan to the Main Fund, since each loan is secured by the unfunded capital commitments of the investors of the Main Fund and the collateral accounts into which capital is called.

Apart from likely tax benefits for the deductibility of interest expense by the QB (something that wouldn't be available if the capital was provided via a debt or equity contribution by the Main Fund to the QB), the QB alternative allows for capital to be received by a QB without the diligence requirements associated with an AIV. This often allows for a QB to quickly meet its capital needs for transactions on a short timeline, reducing administrative and organizational burdens on the Main Fund.

While a QB requires less deliverables than an AIV joining a credit facility, there are still organizational and legal costs, since the QB will be required to deliver certain deliverables, such as execution of a promissory note, formation documents, and resolutions authorizing borrowings. However, unlike an AIV, a QB will not be required to deliver a full security package because the lenders are relying on the underlying guaranty from the Main Fund. Apart from the execution efficiencies, QB loans have the added benefit of allowing a QB to borrow pursuant to the same terms (interest rate, etc.) as the Main Fund – which likely would be at a much lower interest rate, since the lenders are relying on the credit support from the Main Fund via the guaranty, not the credit profile of the QB. Further, a QB is usually not subject to financial covenants connected to its financial performance.

Of course, no different than a loan to the Main Fund, borrowings by a QB reduce availability under the credit facility. From a formation document perspective, as a part of the diligence process, the borrowing fund's formation documents may place limitations on the ability to provide blanket guarantees of debt (e.g., the fund's limited partnership agreement might place a direct constraint on giving guaranties or an indirect restriction on guaranties as part of its overall leverage limitations). The limitations may also be in the form of leverage limitation percentages or clean-down periods for any debt of a qualified borrower that is being guaranteed.

Conclusion

Fund borrowers and lenders are constantly trying to accommodate each other's needs to not only provide funds with the structural flexibility to run their business but also give the lenders essentially the same credit support and protections they would have in a "vanilla" fund structure. The alternatives discussed above are just some examples of the type of accommodations that fund borrowers and lenders have worked together to provide the "win/win" that each desires. While the first time through an alternative structure may seem complicated or even overwhelming, rest easy. The market, with respect to multiple investment vehicles, has become quite sophisticated and, as a result, the process has become somewhat routine – so long as the players involved understand that, from a lender's perspective, the point is to get to the same credit support structure as they would see in a "vanilla" fund structure.