FUND FINANCE FRIDAY

It's Not Easy Being (Ever)Green

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Is evergreen the new black? It may be. Each day new limited partnership agreements come across our desks, sent to us by our bank clients who ask us to read and analyze these documents alongside them to determine the most critical question in fund finance: is it bankable? While the majority of the fund structures hitting our desks in our subscription finance practice are traditional closed-ended private equity fund structures, we are seeing many more funds with open-ended features. Here we break down for you how these structures differ from a typical closed-end fund, why this structure is attractive to certain investors, and what lenders will want to be thinking about if they are putting together a financing for an evergreen fund.

If you have ever been the addressee of a *Cadwalader LPA Checklist* (the work product we produce after our review and analysis of a limited partnership agreement), you know that one of the first questions answered in the diligence of a fund is, "When does the investment period end?" In the majority of funds, the answer is a definite date. An increasing number of checklists recently have a shorter, yet more nuanced response to this question: "N/A." This article will take you down the open-ended path, when the investment period has no end.

Unlike a closed-end fund that has a finite fundraising period and a finite investment period, an open-ended fund has a perpetual investment period (evergreen structure) as well as a continuous fundraising period. Investors in open-ended funds are able to continuously subscribe for equity interests and are able to redeem their interests in the fund at any point after the expiration of a "lock-up period." The "lock-up" operates as you may imagine: the partnership interests of an LP are "locked" and not eligible for unilateral redemption until certain conditions are met. As redemptions are typically priced at the NAV of the fund, the lock-up

period allows the fund to invest without the cost and liquidity demands of redemption distributions.

To mitigate the risk that all investors would seek to redeem simultaneously, open-ended funds often have a queue system that operates as “first-in, first out.” Redemptions in these funds are subject to restrictions that vary greatly based on the structure of a particular fund. Redemption may be staggered based on a variety of criteria, and a subscription credit facility will be responsive to the particular mechanics of the fund at hand, as redemption eligibility could be allowed only once a certain period of time has passed – generally upon the two-year anniversary of an investor becoming a partner or the date the LP funded its capital commitments (in which case, partial redemptions may be a consideration as well). Earlier investors are traditionally eligible for redemption prior to later investors. A fund may also include redemption mechanisms that allow an investor to cancel its remaining unfunded capital commitment in connection with its redemption, so lenders will want to ensure credit documentation is responsive to the particular features of the fund at hand. (While always a critical step in a facility, parties should ensure the due diligence process has been thorough with respect to the constituent documents.)

Why Do Investors Want This Structure?

As is typically the case, fund documents are responsive to, among other things, the investment prerogatives of the investors in the fund. Some investors want to be able to continue to reinvest interest and principal over a longer term, or even in perpetuity, and an evergreen structure allows for that. On the other hand, there are other investors who demand access to liquidity. These investors may be generally cautious or uncertain about where the economy is headed, and these investors do not want their money locked up in a closed-end fund for a typical period of about a decade (or more).An evergreen structure is also responsive to a desire for the flexibility to be able to withdraw investments after a shorter period, which in turn gives investors the ability to reallocate their investments. There are also economic factors at work, including rising interest rates, making alternative assets attractive to new types of investors coming into the asset class. Private credit is a good example, with investors moving from fixed income to private credit given the returns to be had. These investors find the evergreen structure to be quite comfortable.

A Distribution Reinvestment Program (“DRIP”) is another key feature of open-ended funds, as investors may elect into the DRIP, whereby investment returns are constantly reinvested rather than distributed to investors. Lenders in a subscription financing will want to confirm whether or not deemed capital contributions made pursuant to the DRIP reduce an investor’s uncalled capital commitment under the terms of the fund’s limited partnership agreement in order to properly adjust a borrowing base. Savvy fund formation counsel may also include explicit language in a fund’s constituent documents confirming that any amount reinvested pursuant to the DRIP may be used to repay indebtedness.

In Line for What?

Another feature of this fund structure is that investors may be grouped based on the date they closed into the fund and placed into tranches based on the date they closed (an “Investor Tranche”). A fund may have sequential funding mechanics requiring the unfunded capital commitments of an entire Investor Tranche be fully called down to $0 before any capital may be

called from a subsequent Investor Tranche. The majority of funds call capital from investors on a pro rata basis, so the queuing feature with respect to capital calls of the Investor Tranches requires a bespoke and tailored structure in the deal documentation. While this is indeed a complexity that banks do not encounter in a typical subline to a closed-end fund, but there are workable solutions here, which we discuss below.

While a fund will normally also limit the timing of redemptions to certain periods (*i.e.*, quarterly) for administrative ease, the ebb and flow of investors is still a hefty consideration for a subline's borrowing base. The mechanics of a lock-up period often vary from fund to fund, so finance counsel will work with fund formation counsel to ensure the mechanics are captured in the financing documentation.

The constant inflow of investors also makes for additional complexity in the diligence required to be performed by lender's counsel, making for a more continuous need to be hands-on, given that the work is never done with unremitting investor side letter negotiation and a nuanced MFN process.

Open-ended funds also may require an investor to fully fund its capital commitment at the time of its subscription or involve a full funding of all uncalled capital commitments on a future date. In the case of a full drawdown of capital commitments on a set date, the tenor of a subscription facility must not go beyond that date and should have a maturity date that occurs prior to such date. If capital commitments are fully funded in connection with an investor closing into the fund, there will be no uncalled capital for a borrowing base or collateral package so the financing may include a term loan to offer liquidity to the fund from day one. Once investments are made, a NAV line can be implemented later in the life of the fund.

What These Fund Structures Mean for Your Deal Documents

One of the most fundamental ways in which fund finance lawyers provide value to their lender clients is to be thoughtful about the specific issues that a fund's LPA, side letters, and other documents present and to weave lender protections that are responsive to those issues into the credit agreement. The following are some examples of ways in which credit agreement provisions are responsive to the particular issues presented in a financing for a fund with an evergreen fund structure. Many of these concepts are familiar items that we see in a subline for a closed-end fund but are drafted in a way so as to specifically contemplate the evergreen fund structure and the way the fund documents operate.

- Investor Tranches – this feature requires a bespoke and tailored structure in the deal documentation.
    - One solution for this feature is to create multiple borrowing bases, with each Investor Tranche assigned its own borrowing base, much like each fund group in an umbrella facility would have its own borrowing base.
    - As is always an integral step in the process of building a borrowing base (or multiple!), side letter review is critical here as well. Redemption rights will often be negotiated in the side letters of an open-ended fund and may contain waivers of lock-up periods (or contain more burdensome redemption restrictions in the case of an Anchor Investor) or impose additional requirements on funding mechanics (which may be MFN-able as well). These negotiated side letter provisions may modify the operation of a queue, which is further

complicated by the side letters that come with the continuous investor closings that are a trademark of open-ended funds.

- Exclusion Events – if an investor is to submit a redemption request it will be excluded from the borrowing base.
- Mandatory Prepayment Provisions – in the event that an investor redemption creates a borrowing base deficiency, a mandatory prepayment may be required prior to the date that the redemption is effective.
- Information Covenants/Notice Requirements – the fund borrower is often required to report on redemptions, as that will affect the borrowing base and collateral package.
- Covenants – the following covenants are generally negative covenants, meaning that if they are violated, they may result in an automatic event of default:
    - The fund may not allow redemptions or payment of redemption proceeds at any time there is a cash control event (this is generally without regard to any right of discretion granted to the general partner provided in the applicable partnership agreement).
    - There is often a suite of NAV covenants which would require that the fund at certain times or at all times have a minimum NAV.
    - In some deals the fund needs to have a minimum amount of assets under management either at certain times or at all times.
    - In the context of a subline, there is generally a prohibition against borrowing on the line to satisfy redemptions and/or payment of redemption proceeds. We note that in the context of a NAV deal, the covenant package can be quite different, and the deal documents will indeed allow a fund to borrow in order to pay these amounts to investors.
- There is often an event of default or trigger to cause the occurrence of the stated maturity date of the credit agreement if the amount of redemptions trip a certain percentage threshold.

Conclusion

While most funds still have a traditional closed-end structure, as the alternative investment landscape continues to evolve and sponsors look for greater flexibility when it comes to aligning with investor appetite and in respect of approach and timing with respect to monetizing investments, fund structures continue to evolve right along with them, and evergreen fund structures play an important part of that. The foregoing is just a general overview of some of the issues to be aware of when it comes to evergreen fund structures. As always, Team Cadwalader is more than happy to answer specific questions or offer our analysis of any evergreen or other fund structure a lender may be evaluating and give advice as to how lenders best structure their deal documents when transacting with those parties.