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FUND FINANCE FRIDAY

Can I Get Some (Credit) Support?

July 28, 2023

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With the recent wave of displacements occurring in our industry, we have been fielding a higher level of calls from clients looking for a "cheat sheet" that they can pass along to their new credit officers who have varying levels of understanding of the credit support of the subscription loan product. While most of these fundamentals are contained in prior *Fund Finance Friday* editions, the goal of this article is to not only summarize those prior articles (with linked references that provide a deeper dive if desired) but also to target the discussion to a credit audience that may be somewhat new to the underpinnings of subscription finance.

Regardless of the form of instrument, the foundation of any debt transaction is the credit support the borrower provides (and the lender relies upon) for repayment. The particular credit support provided varies in form and complexity on a deal-to-deal basis. However, the goal with each loan is to provide the lender risk-appropriate confidence that recourse is available upon a default of the loan.[1]

The use of the term "credit support" instead of "collateral" is intentional. Whether a loan is secured or unsecured, the borrower still owes the money to the lender. However, the question is: How difficult will it be for the lender to obtain repayment from a borrower that can't or simply won't be able to repay a loan?

The best means for a lender to assure that its loan will be repaid is to receive collateral as its primary credit support. Collateral is an asset a borrower pledges to a lender as security for a loan. If a borrower defaults on a loan secured by collateral, the lender can repossess the collateral and sell it to repay some or all of the outstanding obligations. While not typically the case with subscription loans, not all lenders require collateral as a form of credit support for a loan. Those loans are given on an unsecured basis without collateral. In those cases, the credit support isn't pledged collateral, but instead the credit support is derived from the borrower's general creditworthiness and promise to repay. Unlike a loan secured by collateral, if a borrower defaults on an unsecured loan, the lender cannot repossess and sell the pledged assets to repay the loan. As discussed below, that isn't to say that an unsecured lender is without remedies. The borrower owes the money, with or without collateral, so the lender always has the option to take the borrower to court to get a judgement that can be used to invoke supplemental remedies, such as seizing assets not already pledged to other creditors.

In the fund finance universe, lenders typically receive various forms of collateral to secure the loans provided to borrowers in case of default, ensuring the repayment of the loan. This article attempts to provide a concise overview of common types of credit support provided in fund finance transactions: (i) collateral, (ii) guaranties, (iii) equity commitment letters, (iv) keepwell agreements, (v) comfort/support letters and (vi) general unsecured claims against a fund borrower.

Credit Support – Collateral (Uncalled Capital)

For subscription credit facilities, the primary credit support is typically a collateral package that includes a first priority security interest in (i) the borrower fund's rights to the unfunded capital commitments of the fund's limited partners, (ii) the rights of the general partner of the borrower fund to call on and enforce the limited partners' obligation to fund their unfunded capital commitments to the borrower fund and (iii) the borrower fund's rights in the deposit account where the respective limited partner's capital contributions are received (collectively, "Tier 1 Collateral").

Some fund-level facilities can be secured by a pledge of all or a portion of the borrower fund's rights in its underlying investment portfolio, so if the fund defaults, the lender can take control of the pledged equity interests and sell them to repay the loan. However, for any number of reasons (including equity assets being unavailable since they have been pledged to a different lender providing leverage at that level of the fund's capital structure), subscription credit facilities tend to exclude an equity pledge from the collateral package unless the particular credit profile warrants additional secured collateral.

Credit Support – Guaranties

Other than Tier 1 Collateral, the most common fund finance credit support vehicle is a guaranty.

In the context of a loan, a guaranty is an agreement by an entity in favor of a lender to support the repayment by a principal obligor of its obligations to a lender. In our context, a guarantor contractually promises to fulfill the obligations of a fund borrower to the lender if the fund borrower defaults on its underlying obligations. The guaranty is made directly in favor of the lender, who can enforce against the guarantor (without necessarily going after the borrower first) should the fund borrower fail to repay its loans.

What is an example of when a lender should also seek credit support in the form of a guaranty? Often, certain limited partners of a borrower fund have tax or regulatory sensitivities that limit their ability to commit capital directly to the borrower fund. In those cases, the borrower fund will typically establish one or more feeder funds that would be direct limited partners of the borrower fund. The tax or regulatory sensitive limited partners would fund their capital into a feeder fund – not the borrower fund. The applicable feeder fund would then pool the funds received from those particular investors and contribute those same funds to the borrower fund (in the feeder fund's capacity as a limited partner of the borrower fund).

The credit support problem for a lender in the above feeder structure is that the uncalled capital obligation to the borrower fund is owed by the feeder fund itself (as a limited partner), not from the limited partners of the feeder fund. Thus, the lender does not have direct access to the limited partners (of the feeder fund) that have the actual "checkbooks" to provide the capital contributions to repay the loans. As a result, with a feeder structure, the lender doesn't have Tier 1 Collateral credit support from the feeder fund, unless it can obtain a guaranty from the feeder fund that is secured by the Tier 1 Collateral of the feeder fund. Stated differently, without a secured guaranty from the feeder fund, the lender has the ability to call capital from the feeder fund, but not the ability to call capital from the limited partners of the feeder fund. By obtaining a secured guaranty from the feeder fund, the lender obtains direct access to the uncalled capital (the "checkbooks") of the limited partners of the feeder fund.

The above example of credit support in the form of a guaranty is the most typical and simple, but certainly there are countless other applications of guaranties up and down a fund structure, including the use of a "cascading pledge" to get to a similar place when a feeder fund cannot provide a direct guaranty to a lender.[2]

Credit Support – Equity Commitment Letters

In the context of a loan, the function of an equity commitment letter ("ECL") is to demonstrate to the lender that the borrower has sufficient resources to meet its repayment obligations under the credit facility – apart from, or in lieu of, Tier 1 Collateral or a guaranty.

Although more frequently used in the context of mergers and acquisitions, an ECL can serve as a useful credit support tool in the subscription finance space. One example is to use an ECL to encourage a lender to give a borrower fund borrowing base credit for an otherwise thinly capitalized limited partner that functionally serves as a funding vehicle for a well-capitalized parent investor. Another ECL use is where a parent fund of a fund borrower is unwilling or unable to assume direct indebtedness or guaranty the obligations of a subsidiary fund, such as where its formation documents prohibit the guaranty of debt of a subsidiary and can only make "investments" in subsidiaries.[3] In that example, instead of a parent fund providing a guaranty to pay the lender should the borrower fund be unable to meet its payment obligations to the lender, an ECL may provide a solution. Ultimately, an ECL functions as an agreement whereby the borrower fund can require the parent fund to contribute capital to it on demand in exchange for additional equity of the subsidiary. The lender's loan agreement with the borrower fund would likely require the proceeds of the additional equity be forwarded to the lender.

Substantively, ECLs are quite involved (including the amount of equity to be invested, the timeline for providing the funds, etc.) and "mini guaranty" like (including waivers of defenses, counterclaims, offset, etc.). Further, it is important to note that not only is the substance of an ECL dependent on the facts and circumstances of the situation it's intended to address but also the shortcomings of such arrangements with respect to a lender. One such shortcoming is that, unlike a guaranty that is issued directly in favor of a lender, an ECL is an agreement by the parent fund that only directly runs in favor of the subsidiary (fund borrower). As a result, for it to provide credit support to the lender, the lender must be either an express third-party beneficiary or granted the subsidiary's (fund borrower's) rights against the parent fund as collateral for the loan.

Credit Support – Keepwell Agreements

In the context of a loan, similar to an ECL, a keepwell agreement acts as a credit enhancement mechanism for a fund borrower, providing the lender with an additional layer of security by having the parent fund's financial strength backing the fund borrower's obligations to the lender. Generally, in a keepwell agreement, a parent fund promises to "keep well" the fund borrower by ensuring it has the financial capacity to meet its debt obligations to the lender when they become due. Similar to ECLs, keepwell agreements could also be used in the context of encouraging a lender give a borrower fund borrowing base credit for an otherwise thinly capitalized limited partner that functionally serves as a funding vehicle for a well-capitalized parent investor.

Although keepwell agreements can take many forms, in fund finance, whereas an ECL is viewed as a commitment by the provider to contribute capital to the recipient upon specific terms, conditions and amounts, keepwells often speak to general statements of support and not an actual commitment by the parent fund to financially support the recipient. As a result, a keepwell agreement would not rise to the level of offering a formal guaranty that a lender will be repaid.

Despite falling short of being a guaranty or an ECL, a keepwell agreement is nonetheless enforceable as a contractual obligation of the parent fund, up to the amount of support the parent fund has agreed to provide. Further, unlike an ECL which typically runs between a parent fund and a subsidiary (fund borrower), keepwell agreements are usually between the parent fund and the lender. If that is not the case, then, similar to an ECL, for it to provide credit support to the lender, the lender must either be made an express third-party beneficiary or granted the fund borrower's rights against the parent fund as collateral for the loan.[4]

Credit Support – Comfort/Support Letters

Comfort letters are a form of credit support which can offer assurances to a lender via affirmation of the relationship between the parent fund and the borrower fund.[5] However, unlike an ECL or even a keepwell agreement that provide varying levels of committed or quantifiable levels of enforceable support to the lender, substantively, comfort letters are merely statements of intent rather than a binding contract. This means that in case of financial distress or other issues, the parent fund is not legally required to fulfill the promises or statements made in the comfort letter. While weaker in terms of enforceability than an ECL, comfort letters can still be valuable as they provide factual credit linkage from an unrated subsidiary or SPV investor to a rated or well-capitalized parent entity (*e.g.*, an endowment fund or a sovereign wealth fund).

Similar to ECLs and keepwells, comfort letters can take many forms, but typically the function is for the issuer to express confidence in the borrower fund's financial position, business operations, or other aspects that may be of interest to the lender.

In summary, the key difference between a keepwell agreement and a comfort letter lies in their legal enforceability and purpose. The keepwell agreement is a legally binding contract used to support debt obligations and enhance creditworthiness, while the comfort letter is a non-binding statement of reassurance and support issued to provide confidence to the lender, but without creating legal obligations.

Credit Support – General Unsecured Claim

Lastly, while most lenders might not view a general unsecured claim against a borrower as credit support, it nonetheless can be a source of repayment. However, as for the question of how difficult and/or successful will this avenue be for a lender seeking repayment, there is a reason why this source of credit support is mentioned last.

As mentioned above, whether a loan has credit support in the form of Tier 1 Collateral, collateral beyond Tier 1 Collateral (*i.e.*, some version of an "all assets" pledge), a guaranty, an ELC, a keepwell and/or a comfort letter, the borrower owes the money to the lender. As a result, a lender always has the option to take the borrower to court to get a judgement. Many lenders refer to this option as a "secondary source of repayment."

However, that option (as well as the other options it might have available) goes to the question of how difficult and/or successful will a lender lacking the above-referenced forms of credit support be in obtaining full repayment from a borrower that can't or won't repay a loan? The answer is dependent on whether a borrower has a secondary source of repayment. Stated differently, a lender can get a judgement that states that the borrower owes the lender the amount due on the loan, but a judgement does not equate to payment – far from it. A judgement (whether in connection with a loan or in any other context) can be used by a judgement holder to invoke supplemental remedies, such as garnishment, seizing assets not already pledged to other creditors, etc. However, if there are no other assets available for the "general unsecured creditors" of the borrower (because they have been pledged to secured lenders or there simply aren't any other assets), there is no secondary source of repayment.

In light of the above, some subscription lenders seek to expand their collateral reach beyond Tier 1 Collateral to capture any other residual value a borrower fund may have. Alternatively, short of expanding their security interest, other lenders seek to preserve residual value via the use of covenants limiting the amount of indebtedness and/or liens a borrower fund can incur. By limiting the amount of other debt and/or liens to other creditors, a lender can try to ensure that to the extent a borrower fund has residual value, should they ever need to rely on this form of credit support, there will be few or any other creditors at the table seeking their share.

Conclusion

Regardless of the form of instrument, lenders make loans expecting to get repaid. That expectation hinges on the credit support the borrower provides for repayment. The particular credit support varies on a deal-to-deal basis. As noted above, sometimes credit support can be simply knowing that the borrower will certainly repay the loan. However, lenders (and lending lawyers) are in the "what if" business. As a result, the deal-to-deal, risk-appropriate analysis must begin with the question: For this borrower fund, in light of its structure, its track record, its investor composition, its investors' track records, etc., if a "what if" situation should occur, which of the above-referenced forms of credit support do I need to obtain repayment if that borrower can't or simply won't be able to repay the loan?

[1] While there are debt instruments that are non-recourse, a discussion of non-recourse indebtedness is beyond the scope this discussion, since that concept is mostly (if not completely) inapplicable to the subscription loan product.

[2] The concept of a “cascading pledge” is beyond the scope of this article, but for an excellent discussion of additional uses of guarantees for credit support in fund finance as well as concepts of limited liability, fraudulent conveyance, guaranties of payment versus collection, etc., please see: "Get Well, Keep Well" in the January 15, 2021 issue of *Fund Finance Friday* **here**.

[3] Because of the derivative aspect of ECLs, lenders have been able to obtain back-stop put agreements with parent funds who are prohibited from guaranteeing the debt of a borrower fund and can only make investments. The put agreement would provide that the lender could put its defaulted, borrower fund debt to the parent fund (to buy as an investment) if the necessary equity commitment to the borrower fund did not occur after a set number of days.

[4] For a more in-depth discussion of suggested provisions to be included in a keepwell agreement please see: "Get Well, Keep Well" in the January 15, 2021 issue of *Fund Finance Friday* **here**.

[5] Similar to ECLs and keepwell agreements, comfort letters could also be used in the context of encouraging a lender give a borrower fund borrowing base credit for an otherwise thinly capitalized limited partner that functionally serves as a funding vehicle for a well-capitalized parent investor.