

FUND FINANCE FRIDAY

A Waiting Game ...

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One of the core principles of subscription finance is the ability of the lender to call capital upon a default for repayment of the loan. Nearly every deal permits an immediate right of the lender to do so following an event of default, or at least following a short standstill period that permits the fund to make the initial call before the lender steps in. One issue that threatens to limit this enforcement mechanism and potentially delay repayment of the loans via capital calls is the annual capital call limit. This is typically a limit prescribed by the fund's LPA that prohibits capital calls, on an aggregate basis, during an annual period that exceed a certain percentage of total commitments – usually set in a range of 20-40% of total capital per year. Fortunately, this issue appears with low frequency. Even more fortuitous for lenders is the fact that even when it does rear its head on occasion, the provision is often drafted in a manner that carves out calls made for the purpose of repaying any liabilities that become due during such annual period. But what if it's a flat and absolute limit?

In practice, such a limitation would mean that lenders could call a default and have to wait up to 364 days before the investors have *any* obligation to fund an additional capital call for repayment (or any purpose, for that matter). This hypothetical assumes the fund calls down the full limit on day one and then leaves nothing for the remainder of the year. As unlikely as it seems, it's very likely that the limit could be approached or even exceeded with a substantial stub period remaining in the year. Any period extending beyond the typical 10-15 days to call capital is not a delay that any lender knowingly signs up for. It's a waiting game.

In our experience, no lender in this market has accepted such a risk of delayed enforcement. If an LPA amendment is not feasible under the circumstances, then there are a couple of different ways to manage the risk. A borrowing base haircut could be applied to limit available uncalled capital (prior to applying advance rates and concentration limits) to only the portion of total capital that could be called during such period. So when capital is called, the availability reduces in a corresponding amount and the lender is never advancing against collateral that is subject to delay. The second and somewhat more popular method, given that it does not reduce the borrowing base, is to include a negative covenant that manages the issue. The

covenant would say something like: the fund shall not call capital in an amount during any annual period (e.g., calendar year or other applicable period as set out in the LPA) such that the total amount called during such period *plus the principal obligations outstanding* would exceed the threshold limit set forth in the LPA (e.g., 40% of total commitments) for such period. This effectively sets forth a reserve requirement on the fund to ensure that capital is always available during any day of the annual period to repay the obligations if needed. This appropriately shifts the risk to the fund and eliminates the waiting game.

In many cases, however, the fund can override the limit with advisory committee approval. In this case, pre-approval or a floating limit that springs into effect upon such advisory committee approval may be appropriate to give the fund additional flexibility and capacity on the line. As this issue comes in many flavors and can have unintended consequences on structuring a facility (and potentially usage thereof), funds counsel should examine this issue closely when preparing LPAs and negotiating these limits with investors. Nobody likes to wait.