CADWALADER

The Other Green Scene: Sublines for Evergreen Funds

June 16, 2023

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It’s Not Easy Being (Ever)Green

June 16, 2023

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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.

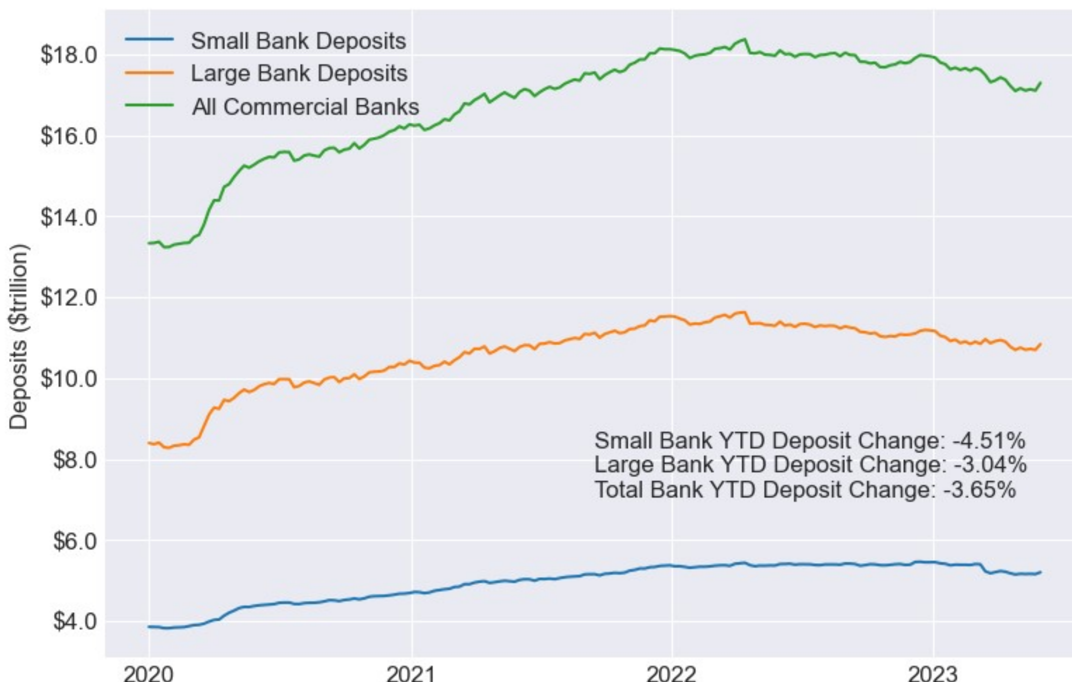
When Deposits Don't Travel with Loans

June 16, 2023

By Chris van Heerden
Director | Fund Finance

In a March 16 hearing before the U.S. Senate Finance Committee, Treasury Secretary Janet Yellen explained that uninsured deposits would be guaranteed only following a determination that "the failure to protect uninsured depositors would create systemic risk and significant economic and financial consequences." Not surprisingly, given this systemic risk qualifier, deposit uncertainty persists at funds and among institutional bank clients generally, and a move towards severing the lender-depository relationship by borrowing from one institution and maintaining the collateral accounts elsewhere continues.

Exhibit 1: Deposits Are Leaving Small Banks Faster



Note: Large banks are defined as the top 25 U.S. commercial banks.

Source: Federal Reserve H.8 Release and Cadwalader, Wickersham & Taft LLP

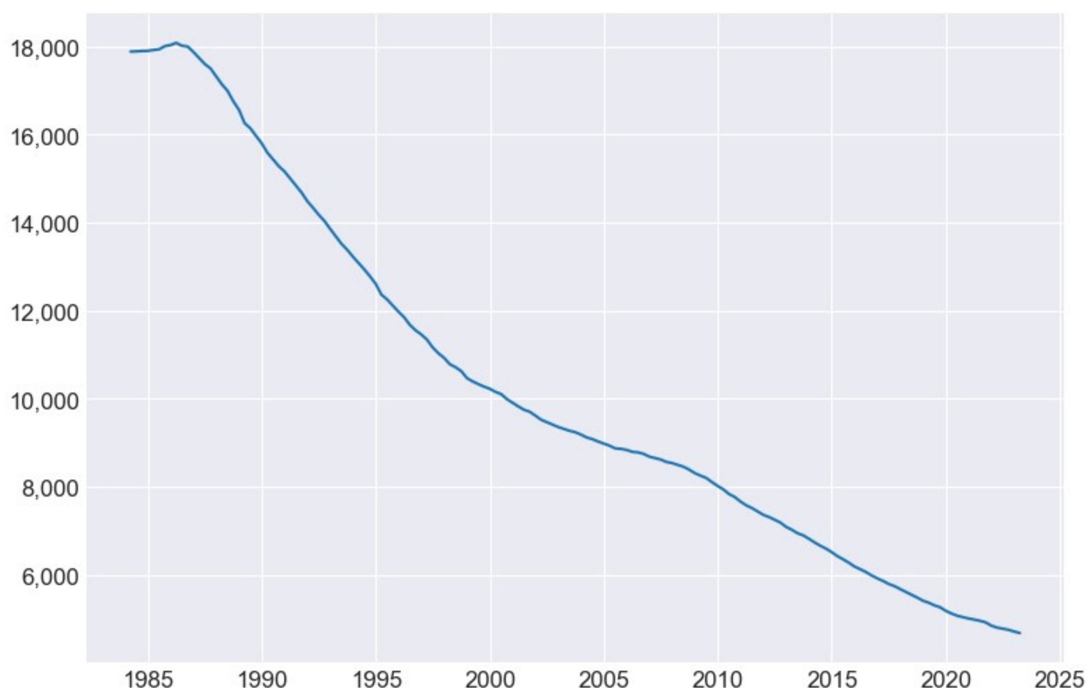
This deposit alienation trend is problematic at an institutional level but also for the industry as a whole. At the institutional level, a bank originating a loan is adding an asset to its balance sheet. Without the benefit of the associated deposits, the bank now becomes marginally more reliant on higher cost wholesale funding. In addition to the adverse cost-of-funds impact, the natural correlation between its assets and liabilities deteriorates.

There are a few nuances to bring into the discussion. In the fund finance context, deposit duration is short and the institutional impact of losing deposit accounts limited by how quickly funds are cycled out of the collateral account. But if deposit account migration is a broader trend across commercial borrowers and bank verticals, the aggregate institutional impact becomes more material. There is also a credit facet: moving the collateral account to a third party means that enforcement under a cash control event becomes dependent on timely compliance by an outside institution.

This separation of deposits from loans doesn’t affect all institutions equally. Wherever the loan is sourced from, borrower preference is to place deposits at a GSIB. As this plays out over time, the largest banks will continue to gain a competitive advantage by competing for loans from a lower cost funding basis while smaller institutions are left with unequal access to deposits.

This was already the trajectory in the industry prior the 2023 bank turmoil. In Q1 the top 10 banks held 45% of total U.S. bank deposits. The benefits of scale in a highly regulated industry has for decades driven consolidation and suggests deposits will become more concentrated in the future.

Exhibit 2: Number of FDIC Insured Banks and Savings Institutions



Source: FDIC and Cadwalader, Wickersham & Taft LLP

The good news is that bank lenders can pass along the higher cost of funds to borrowers when deposits are severed from loans. The BHC Act anti-tying provisions provide an exemption for

“traditional bank products” such as loans and deposits, meaning that in the event a borrower wanted to house its deposit account at a different institution, the lender would not be prohibited from including a price toggle in the loan documents or otherwise addressing the scenario in its loan terms at origination or amendment.

Of course, there are two sides to the loan transaction. The lender’s approach to deposit alienation has to be one that is palatable to the borrower. From the borrower’s perspective, the risk of loss or delayed access on its uninsured deposits will outweigh a few basis points adjustment in margin. But while the borrower is unlikely to be persuaded to maintain its accounts at the lending institution, the lender doesn’t have to give this right away as a free option to the borrower.

Playing this out over time, the inescapable reality is that institutions with higher cost liabilities will have to make higher interest rate loans. In the fund finance world, pricing has historically been relatively consistent between lenders, with the notable exception of a few prime-indexed lenders. Going forward, it may become increasingly important for non-GSIB lenders to hone a distinctive competitive edge other than price.

What We're Reading

May 19, 2023

Institutional investment allocations, sponsor consolidation, bank-private equity origination partnerships, NAV volume − plenty of long-term themes in this week's private market news. Here's what we're reading.

- NAV transactions totaled an estimated $21 billion in 2022 even as broader loan market origination struggled, according to Rede Partners' recent ***NAV Financing Market Report.*** An overwhelming majority of lenders report seeing more inbound NAV opportunities in 2022 than in 2021 even as loan margins widened.
- Calpers is going into an extensive portfolio review next month with an appetite to increase its allocation to private equity from $52 billion currently. See the *Financial Times'* "**Calpers signals 'appetite' to increase bets on private equity**."
- Falling interest rates and expanding liquidity over the past decade obscured just how much beta has contributed to investment performance. That dynamic is changing, and future institutional asset allocation practices will develop to better separate out beta in core equity and fixed income allocations with a greater share of allocations in the future going to equity and fixed income alternatives, such as private credit, asset-based financing and hybrid equity, according to views published in an ***Apollo Investor Presentation*** in mid-May. In the private market, wealth management channels are expected to be a key driver of AUM growth for Apollo.
- Strategic M&A among private sponsors faces many obstacles ranging from culture fit and integration to valuing and financing an acquisition. Not surprisingly, tie-ups have historically been relatively rare compared to the number of sponsors in existence. In 2021, strategic transactions perked up and consolidation will likely increase further from here, according to Bain & Co.'s ***Is Strategic M&A Finally Catching On in Private Capital?*** Aside from the compelling reasons for consolidation cited in the Bain report − AUM growth and the benefits derived from scale − we think middle market sponsors may find access to fund finance more challenging in the year ahead, which could add another reason to consider making a deal.
- Blackstone is open to partnering with regional banks as a participant in loan originations, according to the *Financial Times'* "**Blackstone in talks with US regional banks over lending partnerships**.*"* Discussions with banks are reportedly focused on partnerships using the existing infrastructure at banks to originate loans that are ultimately channeled to insurance company balance sheets.

On the Move – New Team at The Huntington National Bank

June 16, 2023

On the Move

The Huntington National Bank has announced the addition of a fund finance banking team.

The team is led by senior managing director Brad Boland, a well-known pillar of the fund finance community who was previously managing director of Signature's Fund Banking Division and has had prior leadership roles at Wells Fargo and Bank of America. Seasoned fund finance bankers Charlie Owens, based in Charlotte, and Brian Schneider, based in New York, also join as senior managing directors. Will Runkle joins the team as a managing director and head of portfolio management and will be based in Charlotte, as will director Brian Williams. Vice presidents Kevin Castellano and Kaylin Searles are based in New York, as is treasury relationship manager Kevin Chiu, senior associate Frank Castiglione and associate Steven Zuckerman. Each member of the team was previously part of Signature's Fund Banking Division.

You can read the full press release **here**.

New Additions to the FFA Board

June 16, 2023

Congratulations to Joe Rocco, Sammy Asoli and Jill Wilson on their appointment to the FFA Board of Directors. And a "job well done" to Jeff Maier and Nick Mitra, who are leaving the FFA Board as part of the normal FFA Board rotation process and will be joining the FFA Advisory Committee as of the end of June 2023.

In its announcement of the Board membership changes, the FFA said that these changes are intended to help the organization "evolve with our ever-changing market." Added the FFA: "Each new board member is a senior leader in their organization, bringing a wealth of experience and knowledge to the role, and each has supported the fund finance industry and the FFA over many years in their respective jurisdictions within both the lending and manager space. We are confident they will each be a great asset to the Board and are excited about all future endeavors."

Joe will be the FFA Board's first-ever Fund General Partner. A Managing Director and Head of Treasury Capital Markets at Blackstone based in the U.S., Joe manages risk, liquidity, and funding for Blackstone's corporate balance sheet as well as leading Fund Finance and Risk Solutions initiatives across the Blackstone platform.

Sammy is Managing Director & General Manager, Global Head of Fund Finance Solutions at Sumitomo Mitsui Banking Corporation and is also based in the U.S.

Jill, a Managing Director and Global Head of Financial Sponsors at Lloyds Bank Corporate and Institutional Banking, is based in London, with the Lloyds business operating across both European and U.S. markets.

In thanking Jeff and Nick for their Board service, the FFA said: "We would like to thank Jeff and Nick for their strong leadership and dedicated service on the FFA Board. We are the exceptional global association we are today because of their hard work, dedication, and contribution. We look forward to their continued participation in the FFA through the Advisory Committees."

In addition, the FFA announced that it plans to organize small executive sub-committees to support the Board in different areas, including fundraising, sponsorship, nominations and governance.

You can read the full FFA announcement **here**.

FFA Honors Wes Misson, Chris Montgomery and Joe Zeidner

June 16, 2023

The Fund Finance Association announced its 2023 awards, and Cadwalader was very well represented, with U.S. practice head Wes Misson selected for a prestigious "Annual Contribution to the Industry" award and special counsels Chris Montgomery and Joe Zeidner named "Rising Stars."

The Annual Contribution to the Industry Award is presented to individuals "who have gone above and beyond the call of duty during the prior year and demonstrated outstanding overall contribution to the Fund Finance industry, their firms and their clients, with an emphasis on professional contributions focused on excellence in client service, product and service innovations, diversity and inclusion, career development, training and mentoring, networking and community service."

In addition to Wes, FFA acknowledged the contributions of U.S. Bank Managing Director Mike Henry and KKR & Co.'s Micaela Mastrogiannis.

In selecting Wes, FFA noted that he "leads the largest and most experienced team in the U.S. market and has served as lead counsel on thousands of transactions, including many of the largest and most sophisticated fund financings ever consummated." The FFA added that his "innovative work and commercial approach has had a profound impact on the fund finance industry, an impact which has earned this year's award." The published profile also pointed out that, working collaboratively with UK fund finance head Samantha Hutchinson, Wes "oversees a diverse and growing team of nearly 80 fund finance practitioners that cover the full spectrum of modern day fund finance, including NAV-Facilities, Hybrids, Pref Equity Structures, GP Financings, Venture Debt and Capital Relief and Risk Transfer Trades."

You can read the profiles on Wes, Mike and Micaela **here**.

The Rising Stars program recognizes leaders in the fund finance industry with less than 10 years of experience. Recipients are selected "based on their outstanding overall contribution to the fund finance industry, their firms and their clients, the FFA, the NextGen Network and/or WFF, with an emphasis on professional contributions focused on excellence in client service, product and service innovations, diversity and inclusion, career development, training and mentoring, networking and community service."

The profiles of Chris and Joe include work-related information and some fun facts. For example, Chris continues to be inspired by his grandfather, the "hardest-working person I have ever met and just an incredibly fair and decent man." And Joe talks about his love for travel – he has visited 42 countries outside the United States, with the number one spot on his bucket list being Machu Picchu.

You can download the full Rising Stars booklet **here** and read the profiles of Chris, Joe and all the other honorees.

Congratulations to all!