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FFF From Home

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Fund Finance: What's Happened, What Hasn't and What We See Happening Next

March 20, 2020 | Issue No. 69

By Michael Mascia
Partner | Fund Finance

Like every industry, Fund Finance evolved extensively this week, and for the first time since the disruption commenced, included a fair bit of misinformation. Like we will every Friday, below is a comprehensive update of what we observed and what we forecast for the immediate future.

What We Did Not See

- We received multiple inquiries this week asking if lenders had refused to fund borrowing requests in committed subscription facilities. We did not. Nor did we see any lender decline to fund a borrowing request in an uncommitted facility. Every lender we talked with this week reports operating normally as to their lending and treasury operations. Many continue their new deal sourcing efforts, including some being opportunistic trying to get in front of new borrowers needing financing.
- The PEI article *FFF* has cited in a link this week set off a number of questions. The article indicates that funds are calling capital from LPs earlier than planned in case LPs have liquidity challenges in the future. We, on the other hand, did not observe or hear of any funds calling capital this week out of concerns around future LP liquidity. We also circled with the FFA Board, and nobody on the Board reported seeing any fearful "early call"-type activity.

What We Did See

- The week of March 18th was very active. A number of our slow-burn matters ramped up this week and closed and, by closing count, it was likely a record week for us. Many of our existing deals were active, and we closed a fair number of facility upsizes and extensions.
- Banks talked a lot this week about adjusting pricing. With net interest margins compressing, spreads moving wider in virtually all other asset classes, and significant disruption in the commercial paper market, internal cost of funds allocated to subscription desks is likely to increase. We saw several voluntary upsizes/extensions price wider than the original margin this week. We also saw repeated comments come in requesting LIBOR floors above zero.
- Multiple new deals went under mandate this week, at a pace at least consistent with if not higher than our 2019 average. In several cases, they were on term sheets that had been largely final since before the disruption. Those terms held; they were not adjusted based on recent events.
- Some borrowers did borrow this week, simply to have extra cash on their balance sheet, effectively absorbing negative arb in exchange for the comfort of cash.

- Not everything was perfect. We did see several deals die and our forward indicators trended downward, although not badly (new LPAs to review did come in).

What We Forecast

- The LBO market, especially for public companies, is effectively closed. We expect funds to increasingly use the "Qualified Borrower" mechanics under their subscription facilities to find a liquidity solution for portfolio companies. We expect to see a lot of requests for "QB Joinders" in the near future. We also expect to see fund requests for equity-commitment facilities to kick up; it will be interesting to see if the banks will be open to lending into this structure.
- Jocelyn Hirsch, who leads the sponsor finance practice at Kirkland, forecasted to me this week that a lot of fund borrowers are going to be challenged to meet their deadlines for delivery of financial statements because the accounting firms are going to need extra time to complete the audits. If this becomes widespread, some sort of industry-wide solution might be optimal, as opposed to deal-by-deal waivers. We expect more on this. We also suspect it will be challenging in the NAV-facility market, where lenders are both rightfully nervous of value declines and highly focused on the marks in the borrower financials.
- With quarter end approaching, a lot of capital calls will be going out and be due around the 31st, including many to pay down facilities in accordance with LPA clean down requirements. Based on anecdotal feedback, we are not forecasting delinquencies. But it will be the first more widespread test of liquidity and credit wherewithal since the disruption started.

Giving Back

Like many of you, I've been 100+% focused on work this week, but doing so with my daughters running around me and interrupting my calls. I hear many of your kids in the background of conference calls as well. My girls do not seem overly concerned about sovereign pension liquidity. Watching them treat this week like an awesome vacation has been good for context: as challenging as the current environment is, we are still incredibly lucky. I can only imagine what things are like right now for displaced, low-income families. While I am sure the federal government is working hard on relief packages, it is just going to take a long time for federal aid to reach struggling individuals.

With that in mind, Cadwalader's Charlotte office, led by my partner Joe Beach, started a project this week to fund the Second Harvest Food Bank of Metrolina, aiming to assist families in need of food (especially children displaced from meals at school). I was pleased to contribute and, if the cause resonates for you, the donation link is **here**. Additionally, on Monday, the United Way of the Central Carolinas, the Foundation for the Carolinas and the City of Charlotte announced the formation of a COVID-19 Response Fund to help individuals most impacted by the pandemic. Shout out to LendingTree and CEO Doug Lebda for donating a $1 million leadership-level gift to seed the fund, which has now raised over $5 million in less than a week. If you are interested in donating, the fund's website is available **here**.

Cadwalader moved to WFH this week, like many other law firms. Our Managing Partner, Pat Quinn, had us stress tested and prepared well in advance; we feel good that our service

capacity is fully functional. If we can do anything to be helpful, we are here and happy to try, so please call.

Contractual Considerations in Uncertain Times

March 20, 2020 | Issue No. 69

By Joe Zeidner
Associate | Fund Finance

The widespread outbreak of COVID-19 as a global pandemic has rocked the financial sectors and challenged the way we do business. Like many, we view this as a short-term event and believe the long-term outlook for fund finance remains more than promising. Yet it is in these rare times that we find ourselves more closely considering contractual terms to govern uncertainty. We outline here three key topics to address the current disruption: electronic signatures; contractual time limits; and managing potential breaches.

<u>Electronic Signatures</u>

As travel restrictions tighten and firms' work-from-home operations commence, there is a need to provide flexibility and ease in executing legal documents. In the United States, the major regimes that govern electronic signatures are the federal Electronic Signatures in Global and National Commerce Act (ESIGN Act), the Uniform Electronic Transactions Act (UETA), and New York's Electronic Signatures and Records Act (ESRA). Europe has the eIDAS Regulation and the United Kingdom's Electronic Communications Act 2000. These statutes assure the effectiveness and enforceability of electronically signed agreements while providing for their retention and reproducibility.

The ESIGN Act was passed by Congress in 2000 to help spur ecommerce by giving electronic contracts identical legal standing to hand-signed agreements. As a federal law, it regulates business in all 50 U.S. states and interstate commerce. The Act stipulates that although state laws need not mirror the federal legislation, they must give equal protection for electronic documents and signatures. Currently 47 states have adopted the UETA to do just that.

New York's ESRA treats e-signatures similarly to the ESIGN Act and the UETA. While each mandates that an electronic signature must be linked to an electronic record, they do not require a particular method or means for doing so. Instead, the choice of technology or application is left to each business to decide. The most critical consideration is to ensure that you use a secure technology that is not easily manipulated or forged. The second is to inform your counterparties of any restrictions your firm may have on the modes of e-signatures it can accept.

For greater certainty in contracting, parties to an agreement may choose to add an express provision permitting electronic signatures. Often this will be placed in the interpretative section or the counterparts signature section of a primary agreement, such as a credit agreement or limited partnership agreement, and be made to apply to all related documents. The verbiage should indicate that electronic signatures are as binding as manually executed signatures.

These clauses can be constructed broadly but take into account any requirements or limitations that an organization might have in the form or format of e-signatures that it can accept.

Contractual Time Limits

Legal documents are filled with timelines: from payment dates to notice periods, from consent timeframes to grace periods. But when is a day not a day? When it's not a "Business Day" as defined in the contract. In the context of COVID-19, market participants should assess the impact that forced business closures could have on contractual time limits. With the proliferation of the present contagion, certain jurisdictions have already begun to announce additional public holidays. And there's no telling if this may recur as the virus spreads.

A customary definition for "Business Day" refers to any day other than a Saturday, Sunday, or other day on which banks are authorized or required to close. Parties should evaluate the effect of potential work stoppages on their obligations under their legal documents. Whether a required payment or disbursement falls on one Business Day or another, and any extension of time that a party may ultimately have to satisfy such obligations, could be lengthened by government-induced shutdowns. On the flip side, a contractual deadline determined by days rather than Business Days may necessitate discussions between the parties to avoid a breach if a cutoff time cannot be met during a business lockout.

For syndicated financings, obtaining required consent or waiver is more complicated than for bilateral deals. Timing issues to keep in mind that could impact such actions include (a) the percentage and number of lenders required to vote, (b) any deemed acceptance or deemed rejection provisions for not providing consent or waiver within a certain timeframe, and (c) any grace periods if requisite lender agreement is not received in time.

Force majeure provisions may also see increased scrutiny. Such clauses are intended to provide temporary or permanent relief to parties for significant adverse situations that are objectively unavoidable. Causes may include earthquakes, floods, extreme weather, computer system malfunctions, civil disorder, labor difficulties, pandemics and other acts of God. While it is uncommon to see these terms in fund finance loan documents, we have recently seen these negotiated into investor side letters and account control agreements.

There are two primary types of force majeure clauses. The first provides for an indefinite period of delay in performance by a party. The second allows a party to completely abdicate performance. The distinction is critical. For example, if such a clause were in an investor's side letter, we would not view the former formulation as fatal because it only provides additional time to act – it could give the applicable investor extra time to contribute capital. Whereas the second formulation would be of greater concern for a fund or its lender, because it could give the investor a right to cease funding altogether.

Although it might be better to have a specific timeline with the first form of force majeure (for example, no more than five Business Days), this would be quite uncommon, as force majeure clauses are intended to cover situations where the timeline is uncertain. Still, we would generally expect the time period to be relatively short for most types of force majeure events. This is especially the case in the fund finance context, where the parties tend to be sophisticated entities like funds, institutional investors, banks, and law firms with enhanced technology and work-from-home capabilities. Since money moves electronically, most delays

should be on the scale of days or maybe weeks but likely not much longer except in the most extreme types of force majeure.

Managing Potential Breaches

Fund finance parties should assess the impact of coronavirus on a borrower's ability to comply with its covenants. Affirmative covenants that require a borrower to take certain actions tend to have grace periods. Negative covenants, which require a borrower to refrain from particular activities, usually do not. The parties may wish to evaluate the likelihood of a breach ahead of time. It would be prudent to have a waiver in place prior to any breach occurring, to avoid acceleration of the loans and risk of triggering any cross-defaults elsewhere.

If a market participant might be unable to perform a contract as a result of the current pandemic, it would be sensible to assess when it could realistically resume compliance. Communicate early on a good-faith basis with your counterparty to attempt to resolve the situation. Review of the terms for breach in the loan documents should give some direction. Determine if part of the contract can still be performed. Lenders may expect more consent and waiver requests to be submitted, considering the evolving situation, and might want to prepare to deal with such situations on a prospective basis for when they appear.

Some Thoughts on the Near-Term Impact of the Current Developing Situation on Funds and Fund Finance

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By Mike Newell
Partner | Financial Services

As the black swan event – in the form of COVID-19 – rips through our world and the impacts on health, society and the economy pile up, we offer some thoughts on the current and likely near-term impact on funds and the fund finance market. We do so with full knowledge that it is impossible to predict the future ... but in the hope that this will help to stimulate your own thoughts.

In terms of business generally, the most immediate and obvious impact on all parts of the fund and fund finance world (as with everything else) are the restrictions on travel, meetings and the switch to working from home. Although there is plenty of virtual contact being maintained, it is inevitable that the lack of face-to-face meetings will slow down fundraising timetables, in particular. This is likely to hit smaller and first-time managers harder and increase the notable bifurcation in the industry between the bigger managers, who typically fundraise quicker and more successfully (and have stronger ongoing relationships with their LP base and perhaps require less facetime for the time being), and the rest. Managers face challenges in hanging onto and converting identified pipelines of investments if there is a delay in fundraising and in their ability to demonstrate that they have the dry powder to potential vendors. On the financing side, we would expect to see a corresponding increase in the demand for warehousing arrangements, including related debt facilities, to bridge any gap between a fund being fully invested and the first close of the successor fund.

The current situation will also have a heavy impact on investors and their teams' ability to work at the same pace, with inevitable disruption to people's working patterns. Investors also face crises across various allocations in their portfolio and may need to reallocate resources away from longer dated alternative investments to ensure they can meet more immediate income requirements. Should all of this result in investment committees making fewer commitments for the time being, again, on the funds side, this potentially favours the larger managers with strong track records. On the finance side, this may lessen demand for some typical fund finance products (perhaps particularly subscription/capital call finance) but at the same time trigger greater demand for more bespoke funding solutions to allow funds to finesse their portfolios.

However, as always in defensive markets, there are likely to be certain niche strategies for funds that look attractive this year. It is likely that infrastructure and renewable energy strategies will be in demand. In the real estate world, we expect that it will once more be asset classes with infrastructure-like characteristics that are in vogue, particularly logistics (especially given the increasing uptake of home delivery services which we are now witnessing), healthcare and quasi-government-backed strategies such as social housing. We are likely to see less focus on development outside of such strategies but, no doubt, an uplift in

opportunistic mandates. In private equity, we expect to see cleantech, fintech and biotech strategies continuing to be popular, but there may well be a retreat from emerging market strategies. For more mainstream strategies in developed markets, managers will need to convince investors that there are sufficient solvent targets to ensure deployment of commitments in accordance with current models. We also expect to see an increase in opportunistic strategies for credit, but investors will have concerns about possible impairments to the portfolios of existing funds and credit quality moving forwards in these markets.

We would expect new financing demand to follow and support these niche strategies, but it would be difficult particularly in the current economic climate to predict the extent of any lender's appetite to provide such support. We would also expect to see the defensive nature of the markets mirrored too in existing fund facilities, with funds possibly looking (depending where they are in the cycle) either to repay some subscription/capital call facilities early or (particularly if earlier in the cycle) for these facilities to be more fully utilised. We may also see some increased demand (again, not necessarily reflected in a lender's appetite to provide) for new or extended subscription/capital call or asset lines to fund and protect existing investments, not least to bridge the potential fund raising gaps referred to above.

And, finally, as in all times when things get difficult, there will be opportunities, as well as a need for all parts of the industry to focus on the specific terms of their funding and financing arrangements, to keep communication lines clear and open, and to seek solutions to the difficulties that will inevitably come together.

GPs Weigh Early Facility Repayments in Some Cases — PEI

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***PEI* reports** that some GPs may move to call capital to pay off outstanding balances on subscription lines to stay ahead of any potential liquidity challenges at LPs. A proactive approach may be particularly relevant to funds nearing the end of a clean-down period. Where it's being considered, the process is aimed at moving to the front of the queue for LP funds given the public equity market selloff, a possible slowdown in distributions from funds amid slower exits, and a potential uptick in capital calls as funds look to put capital to work in new and existing investments.

LPs Aim to Look Through 'Denominator Effect' — WSJ

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Private equity holdings have increased in portfolio weight for LPs after the declines in public markets, according to a *Wall Street Journal* **report**. Even though portfolios may now appear to be overweight private investments, LPs are mindful of not missing out on potentially attractive entry points, according to the report. The 2008-2009 vintage of buyout funds have posted meaningfully better returns than the preceding vintages, but many investors were not set up to take advantage of the investment opportunity at the time. A significant share of institutional investors see relative value in private equity amid the market dislocation, according to a survey cited in the article. Investors' ability to position accordingly is being managed in the context of liquidity demands and an uncertain outlook.

On the Move — Fund Finance Tidbits

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On the Move

Trey Burdick has joined Charlotte-based Fund Finance Partners ("FFP") as an Associate.

Prior to joining FFP, Trey worked in private debt strategy for a $3 billion Charlotte-based alternative asset manager investing in lower middle-market companies across a range of industries. Trey began his career at Nashville-based Lead Capital Partners, a private equity firm investing in healthcare companies in the lower middle-market.

Trey received his Bachelor of Arts in Economics with a minor in Business from Sewanee: The University of the South.

Recommended Reading

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- Increased use of NAV lending for the purpose of recapitalizing investments or pursing new opportunities may be a possible response to the coronavirus outbreak. Additionally, GPs may consider paying down credit lines early in case LPs encounter liquidity issues, according to a **recent article** published by *PEI*.

- Navigating potential conflicts of interest, fiduciary duties, regulations and ethical considerations are among the reasons funds may consider involving an advisor in vetting the financing process and deal terms, according to a recent **write-up** by Fund Finance Partners.

- PE and VC funds will most immediately be focused on protecting existing portfolio companies and investments. Certain lenders may already be proactively reaching out to borrowers to assess and service their capital needs. LPs may not be fully prepared for the operational demands of increased capital call activity, which may require funds to telegraph capital calls well in advance. More on these points **here** in a report by attorneys at Taft Stettinius & Hollister LLP.