

Legal Briefings

Side-letter perspectives in Cayman subscription financing

The subscription finance market has grown substantially in recent years, driven by growth of private capital funds (including private equity, credit and real estate) and the funds' wider adoption of subscription facilities (also sometimes called capital call facilities, or sub lines). Subscription financing or sub lines are loans taken out by private capital funds that must be repaid over a period of time. These lines are backed by limited partners' committed capital to the fund with an interest rate range depending on the size of the sub line, time of repayment, and the limited partners invested in the fund. One of the key benefits of these sub lines to the fund is to provide faster liquidity for the fund (e.g. with a drawdown within a business day or two) than a capital call from the fund's investors might yield (drawdown from capital calls served on investors usually take 10 business days or more).

Providers of subscription financing will typically undertake extensive due diligence on an investment fund and its investors prior to providing new financing. The sub line will be based on a borrowing base underpinned by an assessment of the value of pledged commitments of investors satisfying specified eligibility requirements and other factors e.g. the credit quality of relevant investors.

This Briefing examines the most important issues pertaining to side letters to the limited partnership agreement (LPA) of a Cayman Islands private capital funds structured as an exempted limited partnership (ELP), which are relevant to a lender looking to advance a subscription facility.

ELPs remain the vehicle of choice for subscription financing transactions. The following are examples of side letter provisions that a lender will typically scrutinize:

1. Limitations on the incurrence of debt and collateral support

Side letters should not prohibit, restrict or impose limitations on the incurrence of debt, the giving of a guarantee and/or the granting of security, if that cuts across the terms of the proposed subscription financing. To the extent that an investor wishes to include such provisions in a side letter, carve-outs should be included to accommodate the financing transaction.

2. Excuse rights

An investor may wish to be excused from honouring a drawdown notice with respect to immoral investments, or in geographies or industries to which the investor is politically sensitive. These types of rights are relatively common, and are typically accommodated by most lenders. However, a lender will usually seek to exclude such an excused investor from the relevant ELP's borrowing base, and may insist on a default event if the excused commitments exceed a specified threshold. This is typically negotiated, as excuse rights are investor-specific and generally unrelated to the creditworthiness of an investor.

3. Confidentiality restrictions

Any restrictions that prevent the disclosure of investor information are likely to lead the lender to exclude

the applicable investor from the relevant ELP's borrowing base because a lender may not be able to enforce its security if it does not have details of the investor, or be in a position to satisfactorily complete legally required "know your customer" checks. A compromise may be to agree to disclosure on a default, or to reassure investors that the lender has robust confidentiality safeguards.

4. Limitations of direct obligations to a lender

A lender will usually take issue with a provision which provides that an investor only owes direct obligations to the fund parties, as this may undermine its ability to enforce any security. If an investor is concerned about granting broad powers or rights to a non-fund party, such as a lender, a compromise may be to make clear that any limitations are not intended to prohibit or limit a lender from taking enforcement action on a default.

5. Limitations on documents from an investor

An investor may wish to receive side letter comfort that it will not have to sign or provide any documentation to a lender in connection with a subscription financing. Provided that the LPA includes customary representations and covenants that prospective financiers have the benefit of, this may prove sufficient from a lender's perspective. The LPA could impose an obligation on the relevant ELP to use its best endeavours to avoid any requests to investors.

6. Sovereign immunity

A lender may exclude an investor that has the benefit of immunity from the relevant ELP's borrowing base, but that will ultimately depend on the specific credit analysis that is undertaken. As a minimum, an investor that has such benefit will usually be asked to confirm that its obligations to the ELP are not subject to such immunity.

7. Transfers to an affiliate

An investor may wish to have the option to transfer its interest in the relevant ELP to an affiliate specified by it. A lender may seek to exclude such an affiliate from the relevant ELP's borrowing base from a credit perspective. A compromise may be to permit transfers to affiliates, as long as this does not breach the ELP's borrowing base.

8. Most favoured nation (MFN) provisions

As a final point, it is important to note that any adverse consequences for a lender of side letter terms may be multiplied if MFN provisions are included. A cost-friendly solution may be to include a carve-out with respect to provisions that detrimentally impact a lender in a subscription financing.

Further Assistance

This publication is not intended to be a substitute for specific legal advice or a legal opinion. If you require further advice relating to the matters discussed in this Briefing, please contact us. We would be delighted to assist.

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