LOEB & LOEB LLP

Finance

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Subscription Lenders – Beware of Investor Opt-Out

by Peter Seiden, Partner and Bryan Petkanics, Chair

Subscription lenders to a private equity fund base their credit decisions on the quality of the fund's investors whose capital commitments to the fund are pledged to secure the credit extensions. Inherent in the lender's acceptance of this risk is an understanding that the investors' commitments are subject to limited and quantifiable risks of not being honored upon a capital call by the fund. Therefore, a review of all contingencies to such funding in the fund's governing documents, or any side letter agreements between an investor and the fund, is a standard part of the lender's due diligence process.

For instance, funds have long recognized the issues surrounding certain investors and their concerns over, among other issues, UBTI (unrelated business taxable income). Accordingly, the governing documents for a fund account for the possibility that an investor in these circumstances may not participate in a particular investment.

As investors become more sophisticated, and more governmental entities invest in private equity funds, the restrictions on the types of investments these investors will participate in have grown. Recently, some funds have dealt with issues surrounding certain investors' concerns over existing investments. In one case, a fund that was invested in an arms manufacturer had to segregate that investment into a separate vehicle, and allow investors to divest such vehicle. Another fund that invested in a payday lender had to deal with a government pension fund investor from a state that did not permit payday lending.

Because of these situations, investors may increasingly try to include in a fund's governing documents or their side letters with the fund an escape route from objectionable investments. A fund's governing documents and/or particular side letter agreements could begin to include more opt-out language than has previously been seen. Lenders will need to be aware of these types of provisions. If a lender has made an advance based on the unfunded commitment of investors that can decline to fund a capital call because they do not wish to or cannot legally participate in the investment, that lender could be out of luck if other investors do not have the capacity to make up the short-fall.

Should you have any questions, please do not hesitate to contact either Peter Seiden or Bryan Petkanics, or any other member of the Loeb & Loeb Finance Practice.

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