

Sowing Seeds for Success: Subscription Facilities for Funds with Seed Investors

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In the context of a subscription-secured credit facility (also frequently referred to as a capital call credit facility) entered into by a private capital fund (a “**Subscription Facility**”)¹, the right of a seed investor to redeem and cancel its capital commitment can be highly problematic. During the early stages of the fund life, the borrowing base for a Subscription Facility may be almost entirely (if not entirely) based on the seed investor’s capital commitment. As a result, Lenders need to make sure that the credit facility documents and constituent documents address the unique risks associated with a seed investor’s redemption and cancellation rights and the initial borrowing base concentration.

This article outlines the risks associated with lending against a seed investor in a Subscription Facility, and the mitigants that can be built into the fund’s partnership agreement or the seed investor’s side letter (collectively, the “**Constituent Documents**”) and credit facility documents to facilitate a Subscription Facility that works for all parties.

Seed Investors Generally

To help attract subsequent investors and facilitate the making of early investments, some funds utilize a “seed investor” concept at the time of formation, typically before the fund has any other investors or any investments. A seed investor is often the first limited partner admitted to the fund that is willing to take risks in exchange for higher returns and an option of an early exit from the fund. Compared to a regular investor in a closed-end fund (to which a redemption right or withdrawal right is generally unavailable except for regulatory reasons), a seed investor often enjoys the right to redeem its capital contributions and cancel its capital commitment upon the occurrence of certain specific events (the “**Trigger Events**”). These Trigger Events often include that subsequent investors close into the fund with capital commitments adding up to a defined threshold amount.

Risks Associated with Lending against Capital Commitments of Seed Investors

From a financing perspective, lending against the capital commitment of a seed investor presents unique challenges due to both the special treatment a seed investor often receives and the potentially concentrated investor base on which the lender will rely for repayment of the loans until the investor pool diversifies.

a. Redemption Risk

In exchange for being a seed investor, the seed investor usually receives special treatment in the Constituent Documents. Typically, a seed investor will have redemption rights upon a host of the Trigger Events which entitle the seed investor to (i) receive a return of capital when subsequent investors close into the fund, and a cancellation of the seed investor’s capital commitment equal to the returned amount (plus an amount equal to agreed interest), or (ii) cancel its capital commitment

in its entirety and exit from the fund on or before the date when the last investor is admitted into the fund, if not earlier. If subsequent investors are deemed creditworthy by lenders and their capital commitments are added to the borrowing base in an amount sufficient to support the facility amount, the seed investor's exit may be a non-event for the lenders. However, the creditworthiness of subsequent investors will not be known if the Subscription Facility is closed with only the seed investor in place. Therefore, lenders want to ensure the timing of redemption and exit provide an opportunity to first call on the seed investor while it still has a capital commitment sufficient to repay the Subscription Facility.

b. Concentration Risk

A seed investor being the only (or primary) investor in a borrowing base can create a concentration risk, as the Subscription Facility would be heavily reliant on the performance and financial stability of the seed investor. In many cases, the parties anticipate that the borrowing base will become diversified once additional investors close into the fund, but funds should recognize that lenders may be constrained by risk exposure limitations depending on the lender's credit policies and/or regulatory requirements at the point when the borrowing base relies only or primarily on the seed investor. This risk is similar to the issues impacting a Subscription Facility for a separately managed account or a single investor vehicle (a "**SMA Facility**")², and therefore may affect pricing of the Subscription Facility.

Risk Management

a. Constituent Documents:

Whether or not a seed investor ultimately exercises its redemption right, lenders should understand the terms and impact of such redemption right and its potential effect on repayment of a Subscription Facility. The fund can help facilitate a Subscription Facility and proactively mitigate key concerns of lenders by addressing the following when drafting the Constituent Documents when a seed investor is contemplated:

- **Threshold for Redemption and Investor Diversification.** If the Constituent Documents prohibit the seed investor from exercising its redemption right until the amount of the aggregate capital commitments of the other investors reaches a certain threshold (the "**Threshold**"), the fund may then work with the lender to include the capital commitments of additional investors in the borrowing base in substitution for the capital commitment of the seed investor, permitting the Subscription Facility to remain in place after (full or partial) redemption by the seed investor. The fund retains the risk that the additional investors may not be sufficiently creditworthy to be included, but delaying redemption provides time for the fund and lender to assess the potential borrowing base and make adjustments if necessary.
- **Control Over Redemption.** In the partnership agreement, the fund's general partner should retain a degree of control over when the seed investor can initiate a redemption of its capital commitment. Ideally, the partnership agreement should require general partner's or lender's consent be obtained for any capital redemption of the seed investor. If no express consent is required, the Constituent Documents should include an explicit agreement that prior to exercising such redemption right, the seed investor will make any capital contributions required to remedy any borrowing base deficiencies that will result from the redemption. Such requirements increase the potential for a replacement borrowing base that will provide sufficient collateral support for the repayment of the loans, eliminating reliance on the seed investor and thus the risk to lenders in the event the seed investor redeems its capital commitment.

If the circumstances permit, lender's counsel should review and provide comments to the Constituent Documents before they are finalized, in order to ensure acceptable mitigants are in place to address the risks associated with the capital redemption of the seed investor or, if this is not the case, work with the borrower's counsel on mutually acceptable solutions.

b. Credit Facility Documents:

In addition to incorporating protective measures in the Constituent Documents, Lenders may mitigate the risks of lending against the capital commitment of a seed investor in the credit facility documents in a number of ways, including as follows:

- **Notices and Reporting.** Lenders may want to expand the reporting covenant to expressly include requirements that the fund (i) notify the lenders as soon as any Threshold or Trigger Event has occurred or is scheduled to occur, (ii) notify the lender of any plan of capital redemption and obtain the lender's consent (to the extent applicable) prior to the occurrence of any redemption; and (iii) deliver a pro-forma borrowing base certificate to show there is no borrowing base deficiency after taking into account such redemption.
- **Mandatory Prepayment.** The standard language for this provision should already contemplate every scenario when there is a borrowing base deficiency, but lenders and their counsel will want to analyze and tailor this provision to include the borrowing base deficiency caused by the capital redemption of the seed investor, which will provide lenders an opportunity to call capital contributions from all investors (including the seed investor) for the repayment of the loans before the redemption takes place.
- **Exclusion Event.** Any Trigger Event or other notice of redemption of the seed investor's capital commitment should be an exclusion event. If the exclusion of the capital commitment (or the portion subject to redemption) from the borrowing base will cause a borrowing base deficiency, the mandatory prepayment provisions will be triggered. The exclusion event trigger should provide sufficient time before the actual redemption in order that the capital call and receipt of capital contributions occurs while the seed investor remains obligated to contribute capital.
- **Events of Default.** At all times the seed investor is the only (or primary) borrowing base investor, bankruptcy of the seed investor, repudiation of its obligation to make capital contributions or failure to timely fund a capital call, material breach of any representation or warranty or any other material default by the seed investor under the Constituent Documents or any other events that will materially affect its obligations to make capital contributions should trigger an event of default under the credit agreement. These events will already be defined as "Exclusion Events" under the credit agreement, but should be explicitly added to the events of default (and are typically defined as Specified Exclusion Events).
- **Investor Letter.** An investor letter, delivered by the seed investor to the lender, can help address certain deficiencies in the Constituent Documents that intersect with the Subscription Facility, by documenting mitigants that are not addressed in the Constituent Documents, and obtaining relevant acknowledgments and agreements from the seed investor. Investor letters are typically required in single managed account or single investor deals and the same logic applies to seed investor scenarios.
- **Other Mitigants.** Lenders may also consider requiring a guaranty from the parent of the seed investor, limiting the initial size of the Subscription Facility, or structuring the Subscription Facility with a shorter initial tenor, all to reduce its risk exposure at the initial closing of the Subscription Facility to a borrowing base concentrated in the seed investor, with options to modify advance rates, facility size, and tenor, once there is a more diverse pool of creditworthy investors.

Conclusion

Seed investors are admitted into funds via bespoke agreements and with different expectations, all of which need to be taken into account when a Subscription Facility is contemplated, because the terms negotiated by a seed investor in the Constituent Documents often introduce atypical risks for lenders. Lenders need to identify the risks, determine how they may affect the borrowing base and repayment, and negotiate mitigants in the Constituent Documents and the credit facility documents. For some funds, the existence of a seed investor may be critical to their success, and omitting the investor from the borrowing base is not a feasible solution from the fund's perspective and lenders in the market recognize this need and routinely work with borrowers on acceptable solutions. By collaborating early in the process, lenders and funds will likely be able to structure the Subscription Facility to address the needs of both the fund and lenders alike.

¹ Subscription-secured facilities are secured by the capital commitments of the investors in a fund, and by the general partner's and fund's rights to call on the unfunded capital commitments, to collect capital contributions, and to enforce the payment thereof.

² For more information relating to a SMA facility, please see *Structuring and Diligence Considerations for Separately Managed Account Subscription Credit Facilities* (available [here](#)).