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# The Impact of COVID-19 on Fund Finance Facilities: What to Consider Now and What to Do Next

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The novel coronavirus (COVID-19) global pandemic presents significant challenges for private investment funds and their sponsors. While the situation is constantly evolving, we have set out below some key areas for funds to consider in connection with their existing subscription and asset-based (NAV) credit facilities.

**Staying ahead of potential defaults**

There are a number of provisions under subscription and NAV facilities that may be triggered as a result of the economic effects of COVID-19. A fund's ability to meet its payment obligations under a subscription facility, particularly for a fund that has imminent clean down requirements, may be adversely affected by the unwillingness or inability of investors to fund capital contributions on a timely basis. While we have not seen evidence of widespread investor defaults, current market conditions may cause some funds to issue pre-emptive capital calls to pay down debt in anticipation of diminished investor liquidity. These prepayments also free up borrowing capacity under subscription facilities, giving funds the flexibility to deploy borrowings at an appropriate time in the future to support portfolio companies or engage in strategic acquisitions of attractively priced assets. For funds with NAV facilities, it will be important to project how decreased cashflows from underperforming assets will affect the fund's ability to meet interest payments and any amortization requirements, as well as the borrowing base considerations discussed below.

In addition, under certain facilities, events of default may be triggered by a material adverse change (MAC). We have set out more information on MAC-related issues below in relation to conditions to funding. While the occurrence of an event of default is problematic in itself (giving the lenders the right to accelerate the facility and enforce remedies), potential or future defaults may also have adverse consequences, including by preventing the fund from further borrowing under the facility.

Further, in connection with seeking to amend credit facilities to avoid defaults, fund sponsors should consider whether such amendments will result in tax consequences. In particular, if changes to an existing credit facility result in a "significant modification" for U.S. federal income tax purposes, a fund borrower may recognize "cancellation of indebtedness" income.

**Conditions to funding (including no MAC)**

Funds looking to request borrowings under their subscription or other revolving facilities in the near term should review the conditions precedent to funding under the relevant facility agreement. Typical conditions precedent to funding include, among other things, absence of any default and bring-down of representations and warranties in the facility documents as of the date of each advance. Where the representations that must be brought down include a representation that there has been no MAC since the most recent financial statements were delivered, fund sponsors need to consider whether the effects of COVID-19 may constitute a MAC. A MAC is generally considered to only include events that are extremely serious, but the specific determination of whether an event constitutes a MAC will ultimately depend on how a MAC is defined in the relevant facility agreement and the facts and circumstances relating to the fund. There is little case law, if any, that is directly on point as to what a court would deem a MAC in a financing transaction context. However, in the context of M&A transactions, courts have found that the determination of whether or not a MAC has occurred requires a fact-based inquiry as to whether there has been an adverse change to the target's business which substantially threatens its overall earnings potential in a durationally significant manner. We recommend that fund sponsors consult with counsel to review the definition of MAC in the relevant facility agreement, if applicable, and confirm that the related representation can be brought down.

**Monitoring the borrowing base**

In addition to looking out for potential defaults and draw restrictions, fund sponsors should be aware of how the effects of COVID-19 may impact assets forming part of the fund's borrowing base. Shortfalls in the borrowing base may lead to lack of availability when funding is most needed. In addition, if the borrowing base decreases below the level of outstanding debt (or if a specified financial covenant level, such as loan-to-value ratio, is breached), mandatory prepayment requirements will be triggered.

Under a subscription facility, the borrowing base is comprised of undrawn investor commitments of the included investors. Investors will become excluded upon the occurrence of certain exclusion events. The exclusion events most likely to be triggered by the current situation are those linked to (1) decreases in the net value or net worth of investors and (2) the inability or unwillingness of the investor to meet payment obligations. In extreme circumstances, exclusion events based on actual non-payment and insolvency events may also be relevant. The occurrence of an exclusion event will decrease the borrowing base immediately, so funds without a significant buffer between their outstanding debt amount and the borrowing base will need to actively monitor their ability to comply with potential mandatory prepayment requirements.

For NAV facilities, the borrowing base is comprised of the relevant underlying assets (e.g., loans in the case of a debt fund and portfolio companies in the case of a private equity fund). Adverse events in relation to such assets may lead to borrowing base shortfalls, so understanding the methodology and timing for valuations is key. In particular, given that valuations under most facility agreements will be tested quarterly, the full impact of COVID-19 is unlikely to be felt until the financial statements from the end of June are delivered. Further, fund sponsors should pay close attention to whether the lender has rights to challenge or supplement the fund's valuation methodology and whether such rights have been triggered. Where borrowing base issues are likely to arise (either by requiring mandatory prepayments or through triggering defaults), it would be prudent for fund sponsors to consider whether cure options are available. This may involve calling capital from investors to reduce debt levels (where undrawn investor commitments remain available).

**Amendments to fund documents**

In light of the current market uncertainty, fund sponsors may be considering amendments to their funds' partnership agreements (e.g., by increasing flexibility to recycle additional capital, extending the fund's investment period and/or expanding the investment strategy to take advantage of opportunities arising from the crisis). Fund sponsors should consider such funds' credit facilities and should be aware of the extent to which lender consent will be required for amendments. Allowance for certain amendments will generally be included in the facility agreement (particularly amendments that are not materially adverse to the interests of the lenders), but proposed amendments will need to be analyzed on a case by case basis.

**Compliance with information requirements**

Credit facilities will almost always have a comprehensive set of information undertakings obligating the fund to notify the lender of certain events. Of particular relevance in the present circumstances, funds will likely need to give notice of events affecting the borrowing base assets. For example, debt funds may need to give notice of defaults by underlying borrowers, and private equity funds may need to give notice of credit events affecting portfolio companies.

In addition, credit facilities typically require the delivery of annual audited and quarterly unaudited financial statements of the fund. NAV facilities to private equity funds are also likely to require delivery of portfolio company financial statements. We expect that auditors may find it difficult to provide timely sign-off on financial reports in the current circumstances or may find it necessary to include a "going concern" or similar qualification. This may make it difficult for funds to comply with the reporting obligations under their facilities at a time when lenders will be particularly focused on understanding the financial position of their borrowers (and, where relevant, their underlying assets).

**Qualified Borrowers**

Funds may wish to seek amendments to their facility agreements to permit the accession of portfolio companies as borrowers (typically referred to as "Qualified Borrowers"). A portfolio company which is a Qualified Borrower under a fund level facility does not grant security over its assets, so any borrowing incurred by it under such facility would be unsecured debt. Instead, the fund grants a guarantee in support of the borrowing by the portfolio company. Structuring a facility in this way may allow the refinancing of portfolio level debt with (presumably) cheaper debt under the fund level facility. However, funds will need to ensure that they adhere to any restrictions on indebtedness and guarantees in the relevant partnership agreement when considering pursuing this strategy.

**Uncommitted facilities**

As opposed to a committed facility, uncommitted facilities are made available on the basis that the lender is not obligated to fund a borrowing request, but will determine at the time of each such request whether the lender, in its sole discretion, will advance the loan. Uncommitted facilities have become relatively popular as a form of subscription facility in recent years given the lower overall cost of the facility and the perception that, under normal market conditions, the risk of a large financial institution electing not to fund a borrowing request is very low. However, we recently became aware of a few instances of an uncommitted lender indicating to the fund borrower that it had elected not to fund a borrowing request for a specific time period. Funds should discuss with their lenders well in advance of requesting uncommitted facility borrowings to ensure that, as a fallback, they can obtain funds from investors in sufficient time to meet any applicable deadline for investment or deployment of such funds.

**CARES Act**

The Coronavirus Aid, Relief, and Economic Security Act (CARES Act) will provide approximately $2.2 trillion in financial assistance to businesses and individuals to combat the effects of the COVID-19 pandemic. We are currently awaiting the publication of rules and regulations which are expected to provide further clarity on the operation of the CARES Act and the implications for funds and their portfolio companies. In the meantime, please see our alerts on Title I[1] and Title IV[2].

Proskauer's market leading international fund finance practice has experience acting for funds in relation to all types of fund finance products, both in the US and in Europe. We will continue to provide updates as the COVID-19 situation develops. In the meantime, please contact us if we can be of assistance.

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[1] Link to https://www.proskauer.com/alert/small-business-administration-gets-very-big-sba-loan-programs-under-title-i-of-the-cares-act

[2] Link to https://www.proskauer.com/alert/the-booster-shot-federal-reserve-liquidity-programs-for-eligible-businesses-under-title-iv-of-the-cares-act

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