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Fund Finance in Luxembourg: the essentials

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Luxembourg - overview

Luxembourg ranks as the largest EU fund domicile jurisdiction and the second largest fund domicile jurisdiction globally.

The EU Directive 2002/47/EC on financial collateral arrangements (the **Directive**) was implemented in Luxembourg with the law of 5 August 2005 on financial collateral arrangements (the **Financial Collateral Law**). In enacting the Financial Collateral Law, Luxembourg seized the opportunity to implement a modern security interests law with a scope broader than the Directive and with enhanced creditor protection, a move which has led to emergence of Luxembourg's reputation as a secure, global domicile for financing transactions.

The result is an attractive, secure legal framework that works strongly to the benefit of secured finance parties in transactions involving Luxembourg obligor corporate and fund structures granting security and, consequently, fund promoters seeking investment financing solutions.

What is a subscription credit facility?

While originally developed as a mechanism for funds to 'bridge' a funding gap when making an investment, thereby eliminating the risk of any shortfall and providing the fund with certainty that the requisite funds would be available to it at the moment of investment, they are increasingly used in a broader investment context for more general purposes, such as providing debt or bridging debt refinancing, funding follow-on investments or bridging co-investments.

Subscription credit facilities are attractive to both lenders and funds for a variety of reasons, the most notable advantages being:

- they historically have a low track record of default;
- the credit risk of a lender is not dependant on the value of the underlying assets of the fund/group, but on the uncalled capital commitments of the investors of the fund, which offers the lender a lower credit risk and greater degree of comfort;
- they allow for enhanced certainty of and quick access to funding, as the fund does not need to wait until drawdown following a capital call to investors to obtain funds needed to capitalise on an investment opportunity;
- they reduce the administrative burden of the fund (and investors) by reducing the need for and frequency of capital calls;
- they allow for more advantageous pricing, lowering the cost of borrowing for the fund, as subscription credit facilities are typically uncommitted facilities with no commitment fees payable to the lender; and
- they can be used to enhance the returns of the fund.

The key characteristics of a subscription credit facility can be summarised as follows:

- the facility is usually short term (2 - 3 years) and aligned with the fund's investment period;
- the facility is normally a senior, secured revolving credit facility;
- the facility agreement will contain specific representations, warranties, covenants and events of default tailored to the structure of the fund and any regulatory compliance requirements related to the fund;
- the size of the facility will be based on the so-called 'Borrowing Base', which is typically set at

90% of the total uncalled capital commitments of the fund and which is dependent on (i) the quality of eligible investors of the fund (ii) the number of eligible investors determined, in accordance with the terms of fund documents, as included investors and (iii) the amount of the included investors commitment;
- the facility will be secured by a security assignment in favour of the lender over the uncalled capital commitments.

Due diligence

The due diligence to be carried out in subscription credit facility transactions by the lender and the fund should be carried out thoroughly, as there are many considerations on both sides. For the purposes of this briefing we are focusing predominantly on lender considerations.

Fund structure

The legal structure of both regulated and unregulated Luxembourg fund investment vehicles should be taken into consideration, their legal framework and particular characteristics carefully analysed. Depending on the type of investment vehicle, certain regulatory restrictions on borrowing (e.g. bridge/warehousing loans only) or on the ability to grant security or guarantees may apply.

An overview of the different types of regulated and unregulated Luxembourg fund vehicles can be found at Appendix 1.

Fund Documents

A comprehensive due diligence review of the fund documentation is essential, particularly from the lender's perspective, and should cover the limited partnership agreement (**LPA**), the subscription agreements, side letters, private placement memorandum (**PPM**) and any management agreement.

Power to enter into the finance documents

The LPA and PPM (if any) should be checked to ensure that the fund is permitted to borrow and, as the case may be, to guarantee the obligations arising under the finance documents. It should also be verified that there are no contractual restrictions on the ability of the fund to grant security under the LPA or PPM.

In addition, it should be confirmed that the general partner has the power, acting on behalf of the fund, to grant the security required by the lender and whether such powers have been delegated to a third party. If the general partner's powers have been delegated, a due diligence should be carried out on the terms of delegation and the powers delegated. In particular, if a manager (such as an alternative investment fund manager) has been appointed by the general partner, the manager should also be made a party to the subscription credit facility agreement and must also grant security to the lender over its own rights against investors.

The ability of the general partner to issue and deliver drawdown notices as well as the general powers of enforcement of the general partner should be reviewed to ensure that the lender will have adequate powers of recourse against investors in an event of default.

Investor's funding obligation

Provision should be made in the LPA and/or the subscription agreement that the investors' obligation to fund the capital calls is absolute and irrevocable, with no defence, counterclaim or offset of any kind. The LPA should also inform investors (and require them to acknowledge) that the fund may enter from time to time into a subscription credit facility and grant security by way of assignment over the uncalled capital commitments of the investors as collateral, and it should stipulate that investors are required to cooperate with the lender and provide any such financial information/documents as may requested to the lender.

Such undertakings of investors may be captured by way of a consent letter in favour of the lender or expressly in the fund documents themselves.

Eligible investors

The Borrowing Base making up the facility is calculated as a percentage of the total uncalled capital commitments of all included investors. The determination of who will classify as an included investor is in turn dependent on the eligible investors of the fund. It is therefore crucial that the lender determines the criteria which constitute an eligible investor, perform due diligence on and assess the creditworthiness of all such investors when defining included investors.

Excuse, cancellation, transfer rights

The LPA may allow for circumstances under which an investor may be excluded from making a called capital contribution, may transfer or may cancel their commitment. Such rights of investors can have a significant impact on the lender's security and also, consequently, the Borrowing Base. The impact of any such excuse, transfer or cancellation rights in the LPA should therefore be carefully analysed by the lender.

Term and investment period

It is important for the lender to ascertain the term and investment period of the fund as this will impact upon the maturity of the facility.

Side-letters

All side-letters with investors should be reviewed by the lender to check for any specific excuse, transfer or cancellations rights, as well as for any different penalty provisions or "Most Favoured Nation" clauses (especially regarding included investors).

Exclusion events

Specific events which, if they occur, may have the effect of turning an included investor into an excluded investor should be identified and flagged in the LPA and/or PPM, as this will impact on the lender's security as well as the Borrowing Base. Such exclusion events could include the bankruptcy of an investor or default on payment of a capital call by an investor.

Security

The security package normally granted by the fund in a subscription credit facility will include:

- a security assignment of the right of the general partner to call the uncalled capital commitments of the investors and to enforce any associated rights; and
- a bank account pledge over the deposit account into which the investors deposit the proceeds of the capital call.

Creation

The creation of such security in Luxembourg is governed by the Financial Collateral Law. As such, it is not subject to any particular formalities other than that the attachment of the secured collateral is capable of being evidenced in writing.

Notification and perfection

The security assignment of the right to call the uncalled capital commitments is perfected by the mere conclusion of the security assignment between the fund and the lender and the inclusion of the list of investors and the amount of their respective amount of uncalled capital commitment as a schedule to the agreement.

However, an investor may nevertheless validly discharge his obligation under the subscription agreement as long as he has no notice of the assignment. Notification of the assignment (at least to investors representing, say, 80% of the total uncalled capital commitment of the fund) is therefore recommended even if not required for perfection purposes.

In relation to the perfection of the bank account security, the account bank must be notified of the pledge and asked to relinquish any rights of set off, combination of accounts or first ranking pledge in the respect of the account collateral which would otherwise apply in standard account bank terms and conditions. The account bank in subscription credit facility transactions will however often be the lender itself and the perfection requirements can be dealt with in the security assignment directly.

Enforcement

Under the Financial Collateral Law, enforcement may be carried out by the lender as a secured party by way of private action, without requiring any court order or the involvement of any public or judicial officer or notary.

Upon an enforcement event, the lender will be entitled to exercise the right of the general partner to the uncalled capital commitment of the investors, to issue and deliver the related drawdown notices to the investors, to receive the proceeds of the resulting capital contributions and to enforce those rights against investors if necessary. The lender may also take control of the bank account security pursuant to the bank account pledge agreement.

Capital calls made on enforcement should be carried out on a pro-rata basis, pursuant to the provisions of the constitutional documents of the funds and the relevant subscription agreements and taking into account any existing investor excuse rights under the LPA.

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