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Subscription Financings Offer Speed, Efficiency

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Real estate investment funds have become major players in global real estate markets over the last 20 years. Two previous articles have explored economic and non-economic issues that arise in negotiations between fund sponsors and investors.1 This article focuses on a form of financing that has increasingly been used by real estate funds (as well as other private equity funds) with investment-grade and other creditworthy investors. These financings, which are made on a revolving basis with interest rates based on LIBOR or a similar index or occasionally on the lender's cost of funds in the commercial paper market, are secured not by the assets of the funds but by the capital commitments of their investors (i.e., the investors' obligation to provide capital when requested by the fund in accordance with its partnership agreement or other organizational documents). This security interest gives the lender the right, if it is not paid in a timely manner as required by the loan documents, to step into the shoes of the fund's general partner and call on the investors to contribute capital to the fund in order that the fund may meet its obligations to the lender. This article describes the key features of these "subscription" facilities and some of the issues that arise in their negotiation.

Subscription facilities, which are typically made by bank syndicates acting through an agent, offer several advantages for real estate investment funds. Most importantly, because they can be drawn on upon short notice (two business days is typical) and from a single source, they provide a means for meeting the fund's cash needs quickly and efficiently. They therefore serve as an effective bridge either to capital contributions from the fund's multiple investors (who often have a period of 10 days or 10 business days to meet their capital calls) or to more permanent property-level financing. This feature is particularly important when the fund must produce cash quickly or in the case of expenses—for example, fund-level operating expenses or progress payments on a construction contract—that require frequent disbursements or small outlays of cash for which capital calls may be an unwieldy funding mechanism. Subscription financings also avoid encumbering the fund's underlying real estate assets, thereby enabling the fund to incur mortgage debt on a property-by-property basis.

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Borrowing Base

Because the lender under a subscription facility is relying on the investors' capital contributions to satisfy its loan, the commitment of the lender is generally limited to a borrowing base equal to a designated percentage of the unfunded capital commitments of certain "eligible" investors. The percentage of each investor's commitment that is included in the borrowing base will depend on the credit quality of the investor. For example, the borrowing base may consist of 90 percent of the unfunded capital commitments of "Included Investors"—that is, investors who meet certain objective credit standards or are otherwise determined by the lenders to be sufficiently creditworthy—and a lower percentage (for example, 65 percent) of the unfunded capital commitments of investors who do not qualify as "Included Investors" but are nonetheless determined by the lenders to be worthy of inclusion in the borrowing base. In order to qualify as an "Included Investor," an investor will typically require specified Moody's and S&P's ratings, a specified Best's rating (in the case of an insurance company) or, in the case of a pension fund, both a sponsor with a specified credit rating and a minimum funding ratio (which may vary according to the credit rating of the pension fund's sponsor). Large university endowments and foundations will often also qualify as "included investors." In some cases, in order to mitigate the risk to the lender of a decline in the credit quality of the investors who have made the largest commitments to the fund, the loan documents will provide for concentration term limits reducing the percentage of an investor's capital commitment that would otherwise be included in the borrowing base if that investor's commitment constitutes too large a share of the total commitments—for example, the loan documents may provide that an investor's capital commitment will be taken into account in computing the borrowing base only to the extent its commitment does not exceed a stated percentage (which may vary according to the credit rating of the investor) of the total capital commitments.

Though the components of the borrowing base calculation differ from those of a standard asset-based credit facility, the result is the same: the borrowing base enables the lender to match its exposure to the quality of its collateral. The borrowing base regulates itself as changes occur within the investor pool and among the investors' unfunded commitments: should an investor withdraw from the partnership or no longer qualify as an eligible investor for purposes of calculating the borrowing base, the borrower is required to prepay the loan to the extent necessary to eliminate the borrowing base deficit. Similarly, a prepayment may be required if investors make capital contributions to the fund for purposes other than the satisfaction of the loan, as these contributions reduce unfunded commitments and therefore the amount of capital available to pay off the facility.

Collateral and Priority

The collateral package for a subscription borrowing includes a pledge by the fund and its general partner of the investors' capital commitments, the right to make capital calls on the investors and the right to exercise remedies against the investors in the event they fail to make required capital contributions. The lenders also require that the borrower maintain a separate bank account into which its investors fund their capital commitments; this account is then pledged to the lenders as additional collateral and amounts in the account are included in the borrowing base. So long as there is no event of default under the financing, the borrower is permitted to withdraw funds from the account provided that the withdrawal does not cause the outstanding amount of the loan to exceed the borrowing base.

Each investor in the fund is required to deliver to the agent bank a letter acknowledging the borrower's assignment of the capital commitments and the agent's right to issue capital calls to repay the debt. Each investor also agrees that it will fund its advances for capital calls only into the collateral account while the credit line is outstanding, that it will not amend or terminate its capital commitment obligation without the lenders' consent and, in some cases, that it will not transfer its interest in the fund without the lenders' consent. If the proposed form of investor letter is available before the fund is formed, the investors should be asked to execute the form at the time their subscriptions are accepted. Investors may also be required to provide the lender with legal opinions relating to the due authorization, binding effect and enforceability of their capital commitments, as well as certain financial information (which may be required to be delivered not only at the inception of the loan but also on an ongoing basis during the term of the loan).

If the general partner of the fund or its affiliate is receiving management or similar fees from the fund, it will typically be required to subordinate payment to the obligations under the loan agreement. Indemnity and other claims of partners and their IAB affiliates are also subordinated.

Lender Review

If the lender has been identified prior to the closing of the fund, it is prudent to have the lender review the fund's partnership agreement in order to ensure that the agreement is acceptable to it. Areas of potential concern to the lender are the termination of the investors' obligation to contribute capital after the end of the fund's commitment period (the lender will require an exception for contributions made to make payments on the loan) and provisions which allow investors to be excused from making capital contributions under certain circumstances (the lender may require that such excuse provisions not apply with respect to capital contributions called to make payments on the loan). The partnership agreement should, in any event, contain an acknowledgement by the investors that the fund may enter into a subscription financing and an agreement by the investors to deliver an investor letter, opinions and financial information to the lender. The fund sponsor should also consider providing that any subscription financing will not be taken into account in applying any leverage restrictions to which the fund is subject, as such financings are not based on (or secured by) the fund's cash flow or assets.

Restrictions on Transfer

One of the more highly negotiated provisions in a subscription financing is the extent to which the lender should have the right to approve transfers of investors' interests in the fund. Although the identity and creditworthiness of the investors go to the heart of the lender's collateral and, accordingly, the lender is rightfully concerned with seeking some control over assignments of partners' interests, an unlimited consent right may be inconsistent with more liberal transfer rights negotiated between the general partner and particular investors. One solution is to require that the lender be given advance notice of any assignment and, if the financial condition of the assignee results in a reduction of the borrowing base, to require the appropriate prepayment prior to the assignment.

Covenants

Because the lender in a subscription financing is relying for repayment on the capital commitments of the fund's investors and not on the assets or performance of the fund, the financing documents generally contain very few covenants that would impinge on the borrower's business. There are generally no financial covenants or restrictions on asset-level debt, and few if any restrictions on the operation of the fund's asset-owning subsidiaries. Most of the negative covenants in the documents consist of prohibitions that relate directly to the value and quality of the lender's collateral—for example, restrictions on amending provisions in the fund's partnership agreement that deal with capital contributions and, as stated above, restrictions on transfers of interests in the fund. It is also not unusual to impose limitations on additional debt or guaranty obligations at the fund (as opposed to the subsidiary) level. In connection with any such limitations, borrower's counsel should attempt to carve out exceptions for completion guaranties, "non-recourse carve-out" guaranties, environmental indemnities and other parent-level obligations that may need to be incurred in connection with property-level debt. The loan documents also impose financial reporting requirements and obligate the fund to provide certain information in its possession regarding the financial condition of its investors.

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ERISA Issues

If there is significant private pension plan participation in the fund, both lender and borrower will want to ensure that the loan transaction does not constitute a "prohibited transaction" under ERISA. This will require that the fund qualify as a "venture capital operating company" ("VCOC") or a "real estate operating company" ("REOC") within the meaning of the ERISA regulations. The lender may require an annual opinion to the effect that the borrower should qualify as a REOC or VCOC. ERISA counsel should be consulted whenever investors in the borrowing fund include pension plans, especially as additional issues could arise if an affiliate of the lender has a fiduciary or other special relationship to one or more pension fund investors or their investment managers.

Tax Issues

Like any other debt incurred to acquire fund assets, subscription financings create the risk that income generated by the assets will produce "unrelated business taxable income" ("UBTI") to tax-exempt investors in the fund. Because the debt is incurred at the fund level and secured by capital calls, UBTI may be generated even if corporate "blockers" between the fund and its operating subsidiaries have been set up to shield the investors from UBTI associated with asset-level mortgage debt. Although UBTI may be avoided if loan advances are repaid with capital contributions within a sufficient period of time before the financed investments begin generating income, it may be difficult to successfully manage the timing of loan advances and repayments in order to produce this result. If there are tax-exempt investors in the fund and the fund's general partner has agreed to take steps to minimize UBTI, tax counsel should be consulted in connection with any subscription financing.

Limitations

Fund investors, who want to see their capital invested rather than simply committed, frequently insist that the fund's partnership agreement contain provisions designed to insure that the subscription facility will be used solely for operating expenses and short-term bridge financing (i.e., as a bridge to either capital contributions or permanent asset-level financings) and not as a long-term substitute for calling capital. Such provisions may require that the facility be used only for specified purposes or may limit the period of time during which loan advances may remain outstanding. In some cases, investors have required that they be paid an amount, calculated in the same manner as interest, on any subscription facility advances that remain outstanding after a specified period.

Conclusion

Subscription facilities represent an attractive means for real estate investment funds to bridge their capital calls and obtain short-term financing. Sponsors of real estate funds with high-credit investors should consider subscription facilities as a supplement to permanent asset-based mortgage debt.

1 See Mitchell L. Berg and Peter E. Fisch, "Significant Players," NYLJ, May 31, 2006; and Mitchell L. Berg and Peter E. Fisch, "Market Players: Multiple-Investor Funds Play Significant Role," Nov. 30, 2005.