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12 NOVEMBER 2024

WHAT TO KNOW ABOUT PRO RATA CAPITAL CALL REQUIREMENTS IN SUBSCRIPTION CREDIT FACILITIES

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Subscription credit facilities usually require the ability to make, receive, and enforce capital calls on a pro rata basis, whether directly or indirectly through a cascading pledge structure, on 100% of the pool of capital commitments comprising the collateral. In addition to maintaining a broad source of repayment via the subscription collateral, this structure is preferred because it ensures that capital calls to repay subscription credit facility indebtedness can be made in accordance with applicable limited partnership agreements ("LPAs"), which typically require pro rata capital calls in the ordinary course of business.

Even where the underlying LPAs do not contain a pro rata capital call requirement, general market expectations of equitable treatment support the case for the ability to make pro rata capital calls. Otherwise, there is a heightened risk that investors may dispute their obligation to fund capital calls to the extent they perceive the capital call to be contrary to the LPA's terms or unduly burdensome for a certain subset of the broader investor group.

REQUIREMENTS FOR PRO RATA CAPITAL CALLS GENERALLY

As a general rule, most LPAs require pro rata capital calls on all investors in the structure, including across feeder fund vehicles, with limited exceptions for specific overcall rights, payment of management fees, expenses attributable to specific investors, regulatory issues, and specific investment excuse rights. In each case where non-pro rata capital calls are contemplated, the investors have expressly agreed to the exception to the general pro rata norm. In addition to these express LPA exceptions to the general pro rata capital call requirement, sponsors also may request that lenders accommodate a non-pro rata structure for various other structural reasons, primarily centered around the treatment of feeder funds.

Even where LPAs are silent or affirmatively permit non-pro rata capital calls, there is a market expectation among investors favoring pro rata calls from an equitable treatment perspective.

Pro rata capital call requirements in LPAs may not fully align with customary "no setoff, counterclaim, or defense" provisions, which generally provide that investors will not assert any defenses to funding capital calls (particularly for the repayment of subscription credit facility indebtedness), but this friction is as-of-yet untested in the context of non-pro rata capital calls made for the repayment of subscription credit facility indebtedness.

SUBSCRIPTION CREDIT FACILITY CONSIDERATIONS

Collateral packages and enforcement remedies in subscription credit facilities should not contravene the

applicable requirements of the underlying LPAs, including the ability to make pro rata calls to repay subscription credit facility indebtedness. In instances where the underlying LPAs require pro rata capital calls, a lender that agrees to a collateral structure that deviates from this standard is taking the risk that one or more investors may assert that the capital call made to repay subscription facility indebtedness was not in accordance with the LPA (and therefore is not enforceable).

Even where the LPAs do not contain an express requirement to make pro rata capital calls, capital calls should still be made on a pro rata basis, wherever possible, to promote general market expectations consistent with the industry standard course of dealing (and thereby minimize the likelihood of a funding dispute by investors on such grounds). Since there is a strong market expectation and established course of dealing between private equity funds and their investors that capital calls will be made on a pro rata basis, any deviations from that practice will be viewed with skepticism.

For these reasons, when lenders review fund structures in connection with a subscription credit facility, they must carefully consider the risks associated with a collateral structure that does not allow for pro rata capital calls for the repayment of subscription credit facility indebtedness. Otherwise, lenders could find themselves in a situation where investors are disputing the enforceability of capital calls made for such purpose (either because they do not comply with the LPA or because they are perceived to be unjust).

Although there are strong arguments in favor of pro rata capital calls, there are certain circumstances in which lenders may be comfortable agreeing to a structure that does not contemplate pro rata capital calls. One frequent argument raised against pro rata capital calls arises when a particular set of investors will not receive borrowing base credit, at which point borrowers may request to also exclude those investors from the collateral pool. This runs contrary to the fundamentals of the typical subscription credit facility structure, but this accommodation does exist in the market and may be particularly tempting when the cost of obtaining the collateral is significant and complex (perhaps due to jurisdictional concerns, regulatory limitations, or because the commitments are structured as note commitments as opposed to equity commitments). When assessing a request to accommodate a structure that would require non-pro rata capital calls, to the extent expressly permitted by the LPAs, lenders should next consider where such a structure falls on a spectrum of equitable treatment.

At one end of the spectrum is a potential situation where employee co-investment vehicles benefit from a subscription credit facility while simultaneously being excluded from the collateral pool (and, therefore, are outside the lenders' ability to force a capital call to repay subscription facility indebtedness). To accommodate non-pro rata calls in this example, a lender would have to be comfortable making the argument that third-party investors outside of the employee co-investment vehicles are obligated to fund (including overcalls), even when the employees and potentially the private equity firm founders themselves are not required to do the same in connection with repaying the subscription credit facility indebtedness from which they all benefitted ratably.

Contrast the employee co-investment vehicle with an investor that is a high net worth ("HNW") aggregator controlled and managed by an independent third party and comprised of hundreds of high-net-worth individual investors with relatively small capital commitments to the HNW aggregator. In a perfect world, lenders expect this HNW aggregator to make pro rata capital calls on its investors if/when called upon to fund its capital commitment to satisfy its funding obligations. However, because the sponsor does not control the HNW aggregator in this example, the most the borrower may be able to agree to is to make a capital call from the borrower to the HNW aggregator. There may be no way for the borrower to force the third-party HNW aggregator to perform and it may not be possible to ensure that capital is called on a pro rata basis through the HNW aggregator. While this is another example of a non-pro rata capital call (albeit on a look-through basis for the HNW aggregator), it falls towards the other end of the spectrum from an equitable

perspective.

When faced with a request to allow for non-pro rata capital calls lenders must first assess whether the underlying LPAs contemplate the proposed structure and, if so, whether the structure is equitable under the circumstances. Any exceptions to the general rule favoring pro rata capital calls in the LPA should be explicit and read narrowly by subscription credit facility lenders to reduce the chance of confusion or disputes.

THREE TAKEAWAYS WHEN STRUCTURING SUBSCRIPTION CREDIT FACILITIES

Parties to subscription credit facilities, including lenders and sponsors, should consider the following regarding pro rata capital calls:

- **Ensure the collateral structure and available enforcement remedies are consistent with the requirements of the applicable LPAs.** Doing so will promote efficiency of repayment and minimize the risk of costly and time-consuming disputes.
- **Consider whether the structure of the subscription credit facility and the collateral adhere to the industry standard/course of dealing with respect to equitable principles.** If the contemplated structure does not allow for pro rata capital calls to repay indebtedness, these provisions should align with market expectations around equitable treatment of investors.
- **If capital calls to repay subscription credit facility indebtedness will not be able to be made on a pro rata basis, be aware of risks.** There may be business justifications for entering into subscription credit facilities that do not allow for pro rata capital calls to repay subscription credit facility indebtedness, but those should be entered into with a complete understanding of the incremental risk associated with the structure.

Lenders that do agree to deviate from a collateral structure with pro rata capital calls for repaying subscription credit facility indebtedness should only do so when there is a strong business rationale and enter into these structures with an understanding of the additional risk.

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