

ALLEN & OVERY

Fund financing offering

Luxembourg Fund Finance practice



The Luxembourg fund industry and fund finance landscape

Overview

The Grand Duchy of Luxembourg is widely recognised as the European centre for investment funds. The world's most prominent fund managers are present in Luxembourg with platforms for distributing funds across Europe and beyond.

During the past decade, Luxembourg has become one of the most important hubs for alternative investment funds (ie private equity, real estate, infrastructure, debt, special situations, multi-strategy funds, etc). It is fair to say that the word "alternative" is a bit of a misnomer. The alternative space has become the mainstream space over the last few years: every year huge amounts of capital are raised and deployed via Luxembourg.

For more than 50 years, finance and banking have been at the heart of Luxembourg's economy and have largely contributed to the success of the investment fund industry. The banking and funds industries have a tradition of working together. Consequently, Luxembourg has become the jurisdiction of choice for fund finance transactions. Lenders and fund sponsors recognise the legally robust and stable political and business environment, the close access to authorities and government, and an internationally recognised finance and fund structuring toolbox.

Market trends and toolbox

Brexit – the UK's decision to leave the European Union has created some uncertainty for overseas investment funds players with respect to EU market access. It resulted in Luxembourg reinforcing its position as a jurisdiction of choice to set up alternative funds and to maintain access to the European single market in the post-Brexit world. Luxembourg was the second jurisdiction for funds (after the U.S.) by AuM long before Brexit. Brexit (and the AIFMD before that) have accelerated the development of alternative investment funds in Luxembourg because off-shore funds face restrictions when raising capital in the EU.

Fund financing – fund financing ranges from subscription line financing (also called capital call or equity bridge financing: loans made by a bank to a fund, secured against investors' committed capital) to hybrid (ie asset and investors' commitment-backed facilities) and NAV financing (ie asset-backed facilities), each relevant at a different life stage of the fund (eg NAV facilities are generally used after the end of the investment period where most of the capital commitments have been deployed and distribution proceeds are not yet available for reinvestment). The popularity and volume of subscription lines have steadily increased over the past few years in Luxembourg and this trend is here to stay. There is also an increased appetite in the funds market with respect to hybrid and NAV financings as most alternative investment funds based in Luxembourg establish master holding companies in Luxembourg.

Choosing Luxembourg law – Luxembourg law is increasingly prominent and selected by market players as the law for their financing arrangements. Aligning the law that governs the financing arrangements and the law applicable to the borrowing vehicle tends to facilitate processes and reduce costs from a sponsor's perspective. Lenders generally acknowledge the creditor-friendly legal environment in Luxembourg. In relation to cross-border financing arrangements we advise on the choice of the governing law of such financing arrangement in the most relevant way for our clients taking into account the specificities of each transaction.

The Luxembourg collateral and guarantee toolbox – the Luxembourg act of 5 August 2005 on financial collateral arrangements, as amended (the **Collateral Act 2005**), is regarded as one of the most lender-friendly frameworks for security interests among European jurisdictions. The Collateral Act 2005 provides for liberalised rules for creating and enforcing financial collateral arrangements and the protection of financial collateral arrangements from insolvency rules. The Luxembourg law of 10 July 2020 on professional payment guarantees (the **Professional Payment Guarantee Act**) introduces into Luxembourg law a new personal guarantee tool. This regime is aimed at allowing for extensive contractual freedom to structure personal guarantees while strengthening legal certainty. In addition to the newly created professional guarantee tool, Luxembourg law features suretyships and autonomous guarantees as traditional credit support instruments.

Luxembourg funds and fund structures at the heart of the fund finance landscape

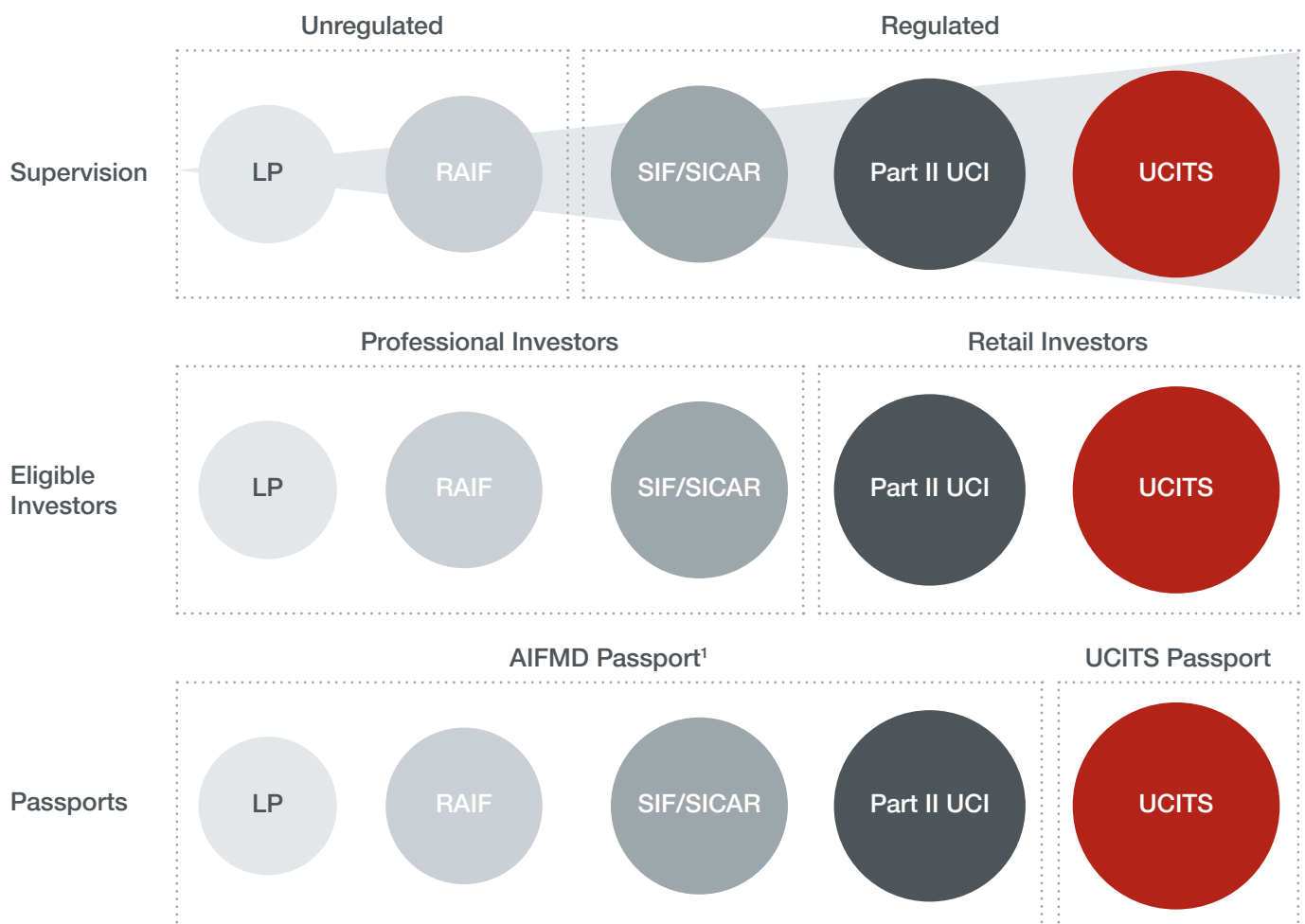
The Luxembourg investment fund toolbox offers a large choice of fund structuring options ranging from highly regulated to unregulated funds, including corporate or contractual forms, transparent or opaque vehicles, standalone or multi-compartment funds, one-tiered or two-tiered structures.

This toolbox allows fund managers to accommodate their own needs and constraints and those of investors and to come up with tailor-made solutions.

Understanding the fund structure is key, as it will determine how the fund financing will be implemented (at fund level, HoldCo level, cascading pledges, joint and several liability, cross-collateralisation, etc).

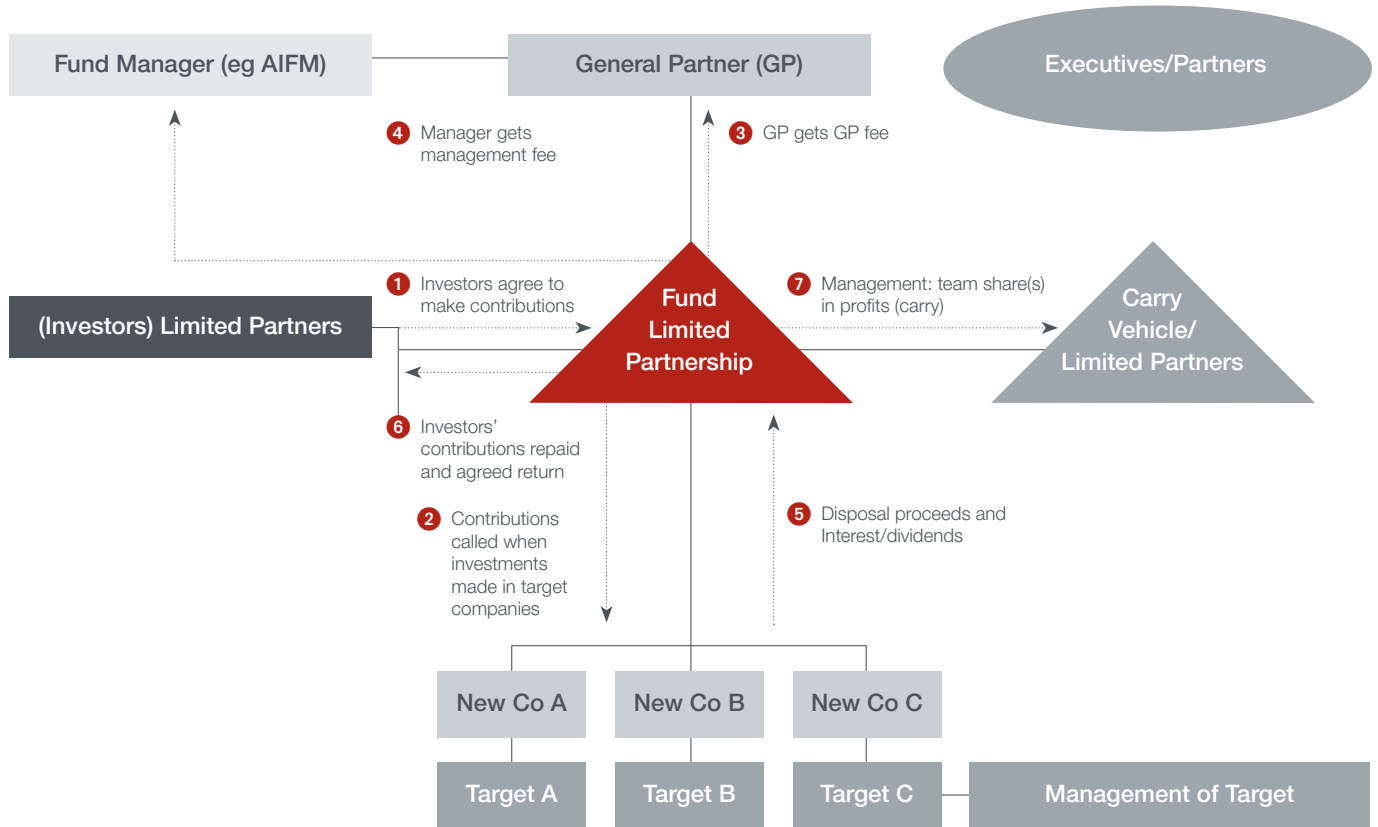
We outline below the main features of Luxembourg alternative investment vehicles and structures.

Luxembourg fund vehicles

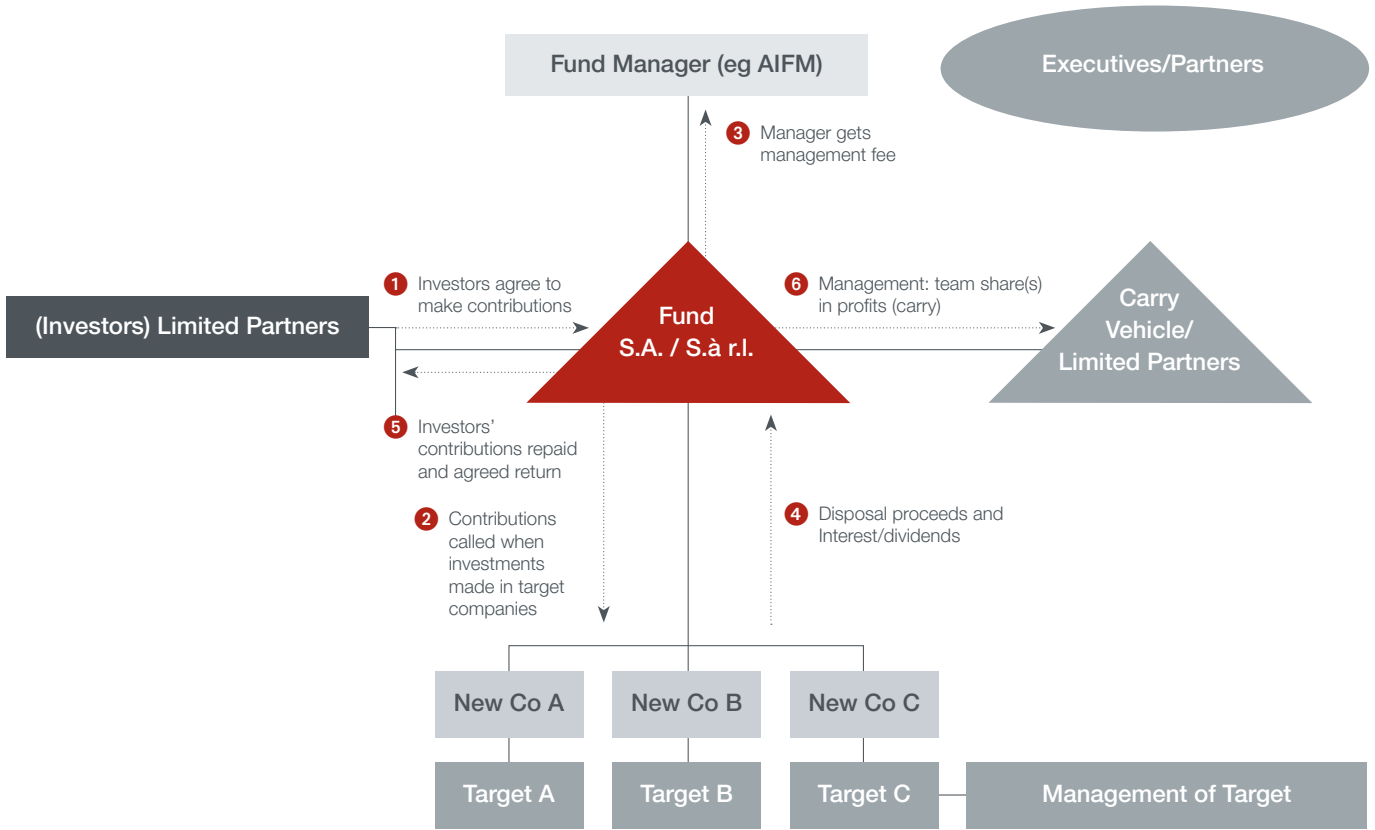


¹ Only available if relevant fund complies with AIFMD

Typical Luxembourg Limited Partnership structure

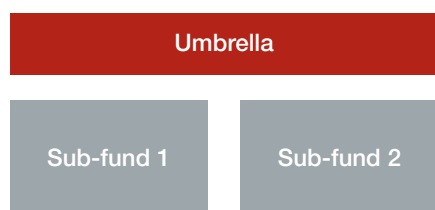


Luxembourg fund structures without GP



Fund-specific features: sub-funds

- Not available for unregulated LPs (but for the Reserved Alternative Investment Fund (**RAIF**))
- Sub-fund/compartiment = segregated portfolio of assets and liabilities (ring-fencing) unless otherwise provided for in fund documents (rare)



Umbrella

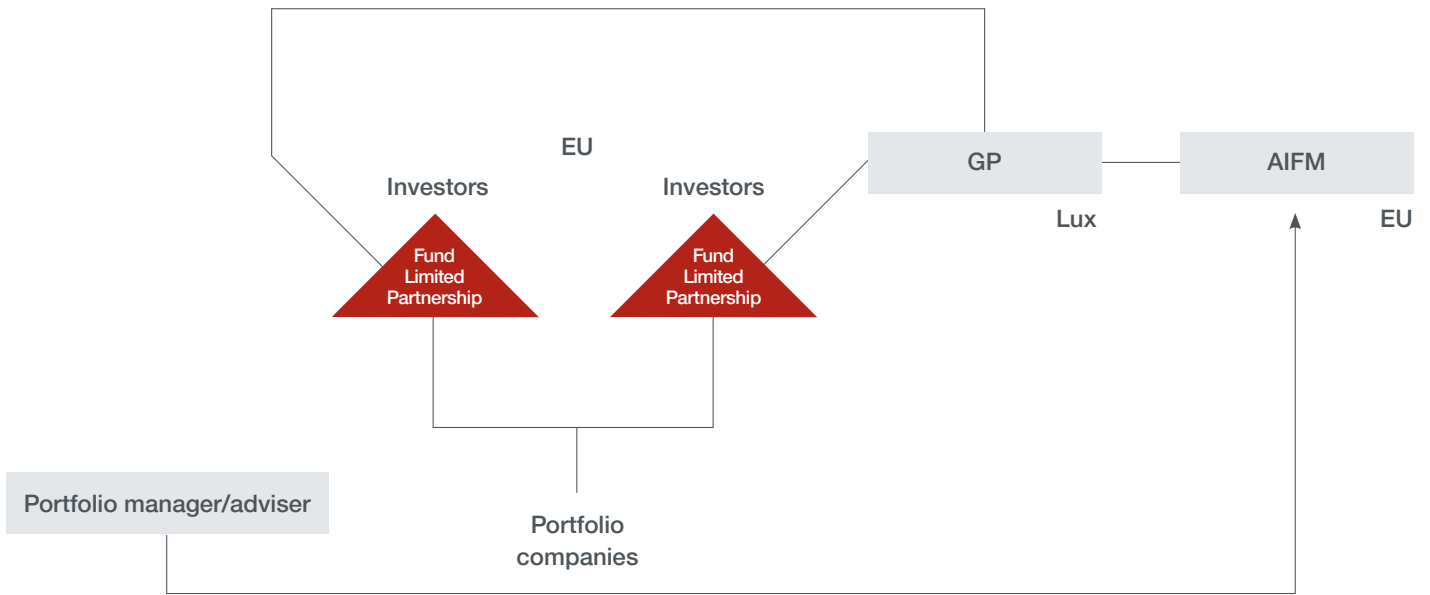
- Same GP/managing body
- Same depositary, administrative agent and auditors
- Same AIFM (but potentially different portfolio managers or investment advisers)

Sub-funds

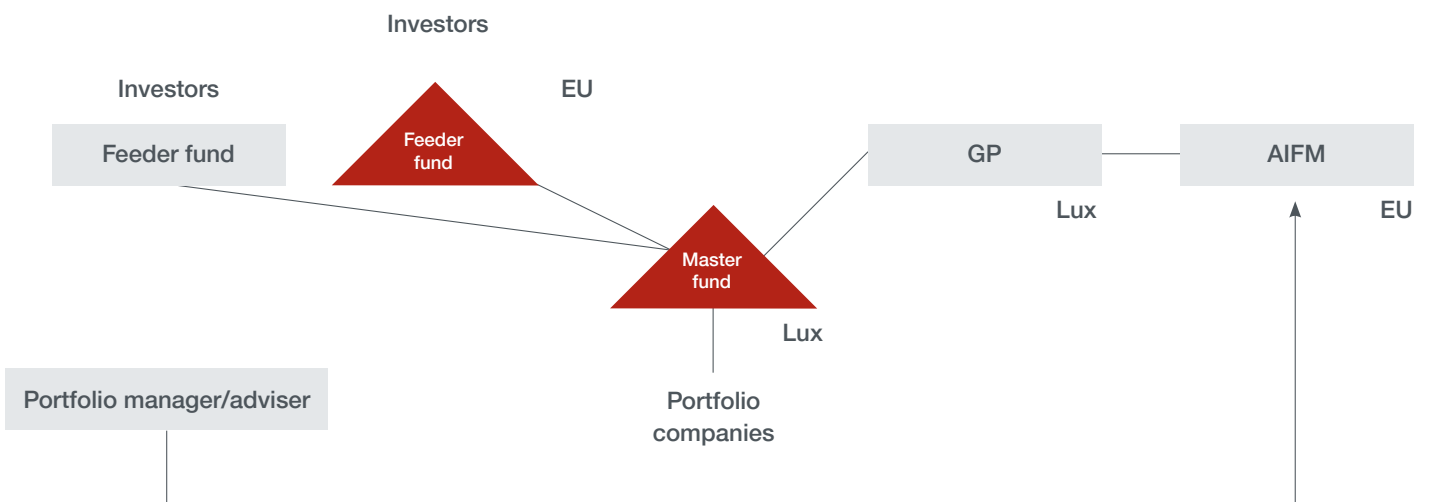
- Specific investment policy
- Specific rules regarding issues/redemptions of securities (open-ended vs. closed-ended, drawdown capital structure or upfront payment, etc)
- Specific rules on term (limited vs. unlimited term)
- Different portfolio manager or investment advisers
- Specific fee structure or distribution waterfall



Parallel funds structure



Master-feeder structure



How A&O can assist you

Allen & Overy's Fund Finance practice has extensive experience in advising lenders, alternative investment fund managers and fund investors on a broad range of upstream and downstream facilities.

Our lawyers bring in-depth technical and commercial knowledge to an extensive fund structuring toolbox and a wide range of lending structures across the fund finance spectrum, which ranges from subscription line financing to hybrid financing, NAV financing and GP facilities.

Working alongside our private equity, real estate, venture and infrastructure, tax and regulatory specialist lawyers in Luxembourg and abroad, we offer an exceptional breadth of expertise. As a result of this unique cross-practice and cross-border collaboration, our clients benefit from our knowledge of the current legal and commercial issues relevant to all parties in fund finance transactions.

We accompany clients during the **structuring stage** to establish the proposed key features of a facility and related fund documentation aspects to ensure the accuracy and completeness of finance and fund documentation.

Due diligence is a critical part of any fund finance transaction. Our assistance with **due diligence on fund documentation**, including subscription agreements and side letters, aims at ensuring that the finance documentation is prepared concomitantly and takes into account all relevant features of the fund terms.

Our **local and cross-border deal management and implementation capacities** are key when it comes to preparing and co-ordinating the review and preparation of finance documents, satisfaction of conditions precedent to meet our clients' deal timeline to drawdown, and closing.

Over the **lifetime of the financing**, our teams assist with any relevant questions raised by our clients.



What is subscription line financing and why is it attractive?

Subscription line financing is by far the most common type of fund financing.

Subscription line financing is a type of bridge facility, usually short or mid-term, entered into by the fund in order to bridge capital calls from the fund's investors. In other words, a subscription line allows fund managers to deploy capital quickly when an investment opportunity arises and to defer the capital calls from investors to a later stage to repay the facility.

On top of the traditional short-term bridging purpose, subscription lines have evolved in recent years to develop into a broader cash management tool for funds, meaning that they are often repayable over longer terms.

The lender's risk is on the creditworthiness of the fund's investors and will generally include security over the undrawn investor commitments and the related bank account into which those commitments will be paid. Subscription line financing is an established product in the U.S. and Europe with a history spanning over 30 years and has grown rapidly in the APAC region over recent years.



Secured by:

- the undrawn investor commitments of the investors of the fund
- the fund's right to call for capital contributions from investors of the fund
- the proceeds of capital contribution
- the account into which capital contributions are paid

Why is subscription line financing attractive?

Attractive for Lenders

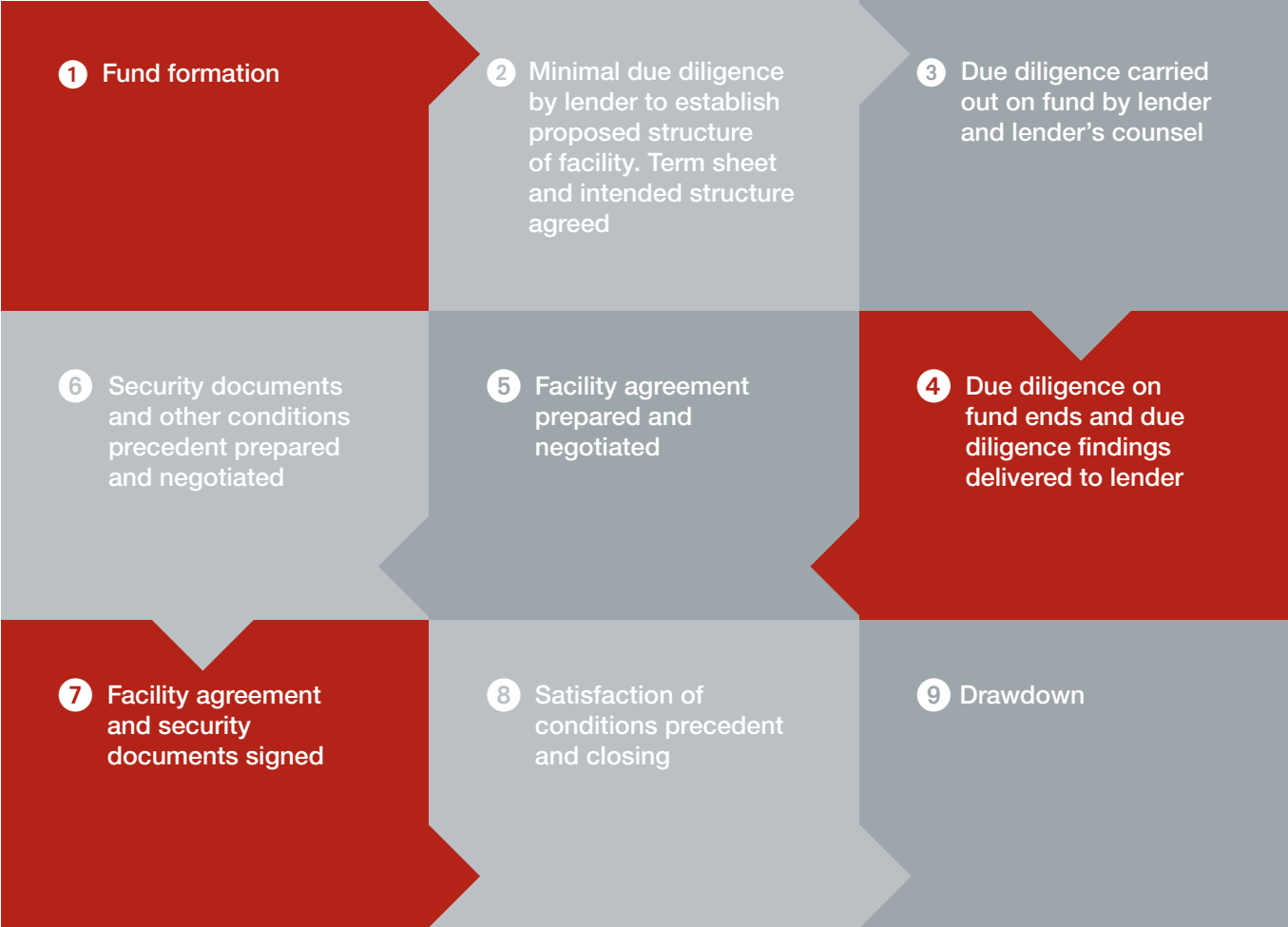
- Perceived low risk for the lenders
- Lenders can club together to lend if fund size is large
- Higher relative return (vs. investment grade product) and generally short-term commitment (1-5 years)
- Relationship building – cross-selling opportunity

Attractive for Funds

- Cashflow management (for GP and LPs)
- Reduction of administrative burden
- Improved competitiveness in bids/auction
- Low financing costs



Timeline of a subscription line financing



Key issues in subscription line financing: approach to finance documentation

Subscription line finance documentation is invariably tailored to a given fund structure.

The legal status of the fund/parallel funds (including its corporate form and/or regulatory status), as much as the envisaged finance product, ultimately drive content. Typically, documentation is based on European loan market standards but may also be prepared based on U.S. or other market standards. Luxembourg law generally allows for rather broad contractual flexibility in a commercial lending context.

Collateral framework

The Collateral Act 2005 provides for an attractive and robust legal framework for security interests, liberalised rules for creating and enforcing financial collateral arrangements, and protection of financial collateral arrangements from insolvency rules. With respect to Luxembourg funds, the usual approach is to have the security interest over the undrawn investor commitments (and related capital call right) being governed by Luxembourg law (to the extent such commitments and rights are governed by Luxembourg law). The governing law of the security interest over the fund's bank account into which investor commitments are paid from time to time will depend on the location of the relevant account. In the case of a Luxembourg-located account, Luxembourg law will apply equally to any security interest over this account. The typical security package of a financing into a Luxembourg fund will therefore benefit from the safeguards provided by the Collateral Act 2005.



Key features of the Collateral Act 2005 in the context of subscription line financing can be summarised as follows:

Wide scope

- financial collateral is taken over claims and receivables, including over undrawn investor commitments and related cash in bank accounts, and any accessory rights (such as any capital call right)
- most commonly the financial collateral takes the form of a Luxembourg pledge over the undrawn investor commitments (and capital call right), and, depending on the fund structure, a transfer of title by way of security might also be an option (eg in the context of cascading security in the presence of a master/feeder fund)
- financial collateral may be granted to a security agent or a security trustee for the benefit of third-party beneficiaries

Robust protection against insolvency

- bankruptcy remoteness of Luxembourg law financial collateral arrangements (such as Luxembourg law pledge agreements over undrawn investor commitments and over Luxembourg bank accounts into which the commitments are paid from time to time)
- safe-harbour provisions of the Collateral Act 2005 apply also to similar non-Luxembourg financial collateral granted by Luxembourg collateral provider (eg foreign law collateral granted by a Luxembourg fund over an account located abroad into which undrawn investor commitments are paid from time to time)
- no hardening period or claw-back provisions apply

Flexible creation/perfection

- under Luxembourg law the pledge over undrawn investor commitments is perfected through the mere execution (conclusion) of the pledge agreement by the fund as collateral provider and the collateral taker
- notice of pledge to the investors is market standard (no specific form of notice required under Luxembourg law)

Flexible and straightforward enforcement

- free choice of enforcement trigger by the parties (beyond payment default, can be any breach of contractual obligations, any financial event, any corporate event, etc)
- no prior notice required
- no prior court approval required (except for the judicial enforcement procedure)
- in the presence of a subscription line financing with collateral taken over the undrawn investor commitments (subject to any restrictions contained in the relevant fund documents):
 - the typical enforcement method is the direct exercise by the collateral taker of the right to call, and the request for payment of, amounts owing by the investors under the undrawn commitments to (or as directed by) the collateral taker
 - private sale to a third party is generally not an option in light of the nature of the collateral assets (undrawn investor commitments)
 - out-of-court appropriation (if retained as an enforcement method) should proceed at a price equal to the amounts ultimately received by the collateral taker under the undrawn commitments with an obligation of the collateral taker to return the residue of the undrawn commitments to the collateral provider following discharge of the secured obligations

Key issues in subscription line financing: approach to finance documentation

Recourse

- Lender's effective recourse in economic terms is to the investors
- No security over portfolio companies or investment assets
- No recourse to the sponsor

Covenants package/EoD

- Similar to a corporate-style loan covenant package
- Fund level restrictions (ie the partnership and the GP only)
- No distributions/ carried interests if EoD is outstanding (plus Return of Capital Notice)
- Information undertakings (capital commitment report, call/drawdown notices) (plus undertaking to make capital call at least once a year, for example)
- Undertaking to pay contributions into pledged account
- Undertakings to address events affecting capital commitment (eg suspension termination/cancellation of capital commitments, failure to honour capital calls, exclusion events, amendments to key fund documents) (eg LPA, Offering Circular/Memo, AIFM Agreement, Depositary Service Agreement, Side Letters and Subscription Documents)

Prepayment/ drawstop triggers

- Key person event (cf. LPA)
- Change of control (typically at GP and AIFM/Fund Manager level)
- GP events
- Breach of facility limit
- Termination events
- Transfer of undrawn capital commitments

Prepayment/ drawstop triggers

- Ratio of Debt to Undrawn Capital Commitments of Included Investors
- Ratio of Investment Value to Investment Cost
- Ratio of Debt to Investment

Specific CPs

- Need for some form of approval from the AIFM (or the person to whom the AIFM has delegated its portfolio and risk management roles): market practice tends to be (i) AIFM (upfront) approval letter or (ii) corporate approval (instead of AIFM signing the facility agreement and security documents itself) but it is not set in stone
- Check fund documentation and adapt your conditions precedent documents accordingly!
- Importance of service of notice of security on investors

Key issue in subscription line financing: due diligence on the fund

Lender's perspective

Due diligence on fund documentation (conducted by lawyers)

Review of fund documents:

- Limited partnership agreement (direct rights of lenders to call? Lender-side: avoid PoAs)
- Side letters
- Form of subscription agreement
- Management agreement
- Constitutional documents of the GP

Focus on:

- Ability to provide, and limits on, borrowings, guarantees and security
- Powers of the GP and Fund Manager (eg to call capital to repay debt, delegation)
- Term and Commitment Period
- Excuse, cancellation, opt-out and transfer rights
- Ability and limits on an overcall

Due diligence on investors (conducted by lenders)

Key criteria:

- Understand the nature and structure of the fund (eg co-investment fund, parallel fund or feeder fund)
- Due diligence on borrowing vehicle if not the fund
- Assess current amount of fund level debt
- Check creditworthiness of the investors whose capital contributions are the primary recourse of the facility
- Decide on the scope of the “borrowing base” and which investors are the “Included Investors”
- KYC and AML checks on fund, GP, Fund Manager and investors

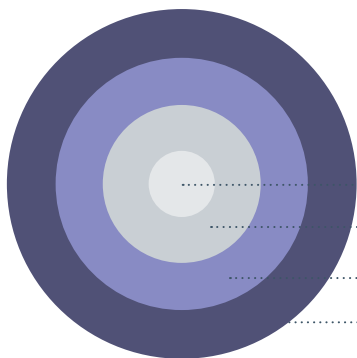
Key issue in subscription line financing: borrowing base



Borrowing base is the lesser of:

- the facility amount and
- the aggregate of each Included Investor's undrawn capital commitment multiplied by advance rate

Concentration level cap may apply when calculating borrowing base



..... Borrowing base (taking into account the **concentration level caps**)

..... Undrawn capital commitment of Included Investors **multiplied by advance rate**

..... Undrawn capital commitment of **Included Investors only**

..... **Undrawn capital commitment** of all investors



Key features in subscription line financing: typical Luxembourg security package

Account pledge

- First ranking pledge over the fund's account into which capital commitments are paid
- Account holding bank's pre-existing own right of pledge – needs to be "waived" or "subordinated" as long as the lender's account pledge is in place (notice of pledge and acknowledgement letter)
- Undrawn commitment will be paid to the account and costs, expenses and management fees will be paid from the account
- Lender as account bank gives greater control but not always practicable
- Monies credited to account post-insolvency of the fund?

Typical Luxembourg security in a subscription line financing

Pledge over commitments and related capital call rights (and/or security assignment (in limited circumstances))

- Security over undrawn commitments of all investors (including Excluded Investors) – require to call on a pro rata basis
- Notice to each investor
- No specific form, sometimes included in quarterly reports sent to investors
- Evidence of delivery of notice as CPs
- In some jurisdictions, investor's acknowledgement required for perfection
- Applicable law regarding effectiveness against third parties?
- Cost-benefit analysis (in light of investor (=debtor) location)

Other types of fund financings

Asset-backed facilities (NAV-based or NAV financing)

A facility provided to a fund which is intended to have full recourse to the underlying investments (and the cashflows and distributions related to them) of the fund. A NAV facility will be backed by the assets of the relevant fund, which may be the equity or other partnership interests it owns (for example, for secondary funds or “fund-of-funds” borrowers) or its underlying loan portfolio (in the case of a direct lending fund). Lending to a direct lending fund may have many similarities to a Collateralised Loan Obligation structure and we are familiar with the issues where such a facility is to be structured as a securitisation.

NAV financing – smooth to implement, easy to use

Due diligence before implementation:

- On the underlying investments (and any related financing on those investments)
- On the constitutional documents of the fund(s)

Limited sharing of financial return, no sharing of control over strategy:

- The lender’s remuneration is based neither on the performance of a single underlying investment nor on the performance of all underlying investments (as a whole)
- The lender has no control over the investment strategy of the fund (unlike a minority investor brought in at a later stage in an existing deal)

Quick and simple to draw:

- Drawdown notice periods under a NAV financing are much shorter than notice periods given to investors
- Conditionality of drawing is to be discussed but main condition is the “loan to NAV” ratio

Purpose of the NAV financing:

- Making investments to underlying investor (no test whether the investment is defensive or offensive)
- Making distributions to investors without making further investments in portfolio companies, ie anticipating future distributions

NAV financing – NAV as collateral, the driving force

Granting adequate collateral:

- Where there are several co-investing vehicles, can these vehicles cross-guarantee/provide cross-collateralisation?
- Are the existing underlying investments structured to allow for security to be taken by NAV financing lender?
- Need to segregate collateral for “equity bridge” lenders and for “NAV financing” lenders, if both financings are available at the same time
- There are technical solutions to all these issues, if need be

Monitoring the collateral:

- At the time of drawing/at the time of making distributions
- Financial tests:
 - Loan to collateral value
 - NAV test
 - Diversity score test

Agreeing on the value of the collateral:

- Utmost importance of confidentiality for the fund
- Starting point: quarterly reporting of the GP to its investors
- Right of lending: lender to challenge the valuation of underlying assets; to be negotiated on an ad hoc basis (trigger points, valuation principles, identity of third-party experts, contractual consequences attached thereto)

Other types of fund financings

Hybrid facilities

A facility which looks down at the underlying assets (as for an asset-backed facility) as well as requiring there to be headroom in the undrawn commitments of investors.

These can be:

- “true” hybrid facilities, including full security and credit analysis on the investors, the fund’s assets and underlying cashflows or
- a variant on a subscription line facility with an additional net asset value covenant inserted which will take effect once the ratio of undrawn investor commitments to financial indebtedness reaches a particular level.

Umbrella facilities

A facility whereby a lender provides separate loans to multiple borrowers under one facility agreement thereby allowing the parties to agree just one set of documents for numerous facilities. This is likely to be of use for individual borrowers who are under common management and/or are part of a wider fund structure. Many of the terms of the facility will be common to all borrowers but investor-specific terms (such as advance rates, concentration limits and loan amounts) can be different. Each borrower will usually be severally liable for its own borrowings under these facilities.

GP facilities

A facility that finances the management team’s commitment to fund capital contribution.



Our experience

We have extensive experience in advising both lenders and fund sponsors on their fund finance transactions. This experience includes advising the likes of, among others:

- An Asian-based banking institution in the context of a capital call facility provided to an open-ended infrastructure fund.
- A Dutch multinational banking institution in the context of a capital call facility provided to a renewable energy fund investing in Asia.
- A London-based financial institution in respect of a capital call facility provided to a Luxembourg-based fund investing in European and U.S. infrastructure assets.
- A German financial institution in respect of a capital call facility provided to a Luxembourg-based fund investing in debt instruments issued by mid-cap European companies.
- A Hong Kong based financial institution in respect of a capital call facility provided to a Luxembourg-based fund, acting as parallel fund to an Australian fund, investing in Asian real estate.
- A Dutch multinational banking institution in the context of a capital call facility provided to Dutch and Luxembourg master-feeder buy-out funds.
- A Dutch global financial services institution in respect of capital call facilities for a Luxembourg fund vehicle managed by a Dutch private equity asset manager.
- A Polish multinational banking institution in the context of a GP financing provided to a Luxembourg general partner.
- A Luxembourg investment fund in respect of a subscription line credit facility granted by an American multinational banking institution.
- A Dutch global financial services institution in respect of capital call facilities for a Luxembourg fund vehicle managed by a Dutch private equity asset manager.
- An Australian multinational banking institution in the context of a GP financing provided to Australian and Luxembourg master-feeder debt funds investing in Asia.
- A London-based financial services institution in respect of the provision of credit facilities to multiple Luxembourg funds managed by the asset management arm of another leading financial institution.
- An American multinational multi-strategy asset management firm on a subscription line credit facility for its Luxembourg-based European real estate fund, granted by a Japanese multinational banking institution.
- An American multinational multi-strategy asset management firm on a subscription line credit facility for its Luxembourg-based Iberian residential fund, granted by the Irish branch of a UK multinational banking institution.
- A Dutch multinational banking institution in the context of a capital call facility provided to Dutch, U.S. and Luxembourg parallel revolving credit facility funds.
- A French management firm on a subscription line credit facility for its revolving credit facility debt fund, granted by a Spanish multinational financial institution.
- A real estate asset management firm on a subscription line credit facility for one of its European real estate funds, granted by an American multinational banking institution.
- The asset management arm of a multinational financial services institution on a subscription line credit facility for one of its global infrastructure funds, granted by a Japanese multinational banking institution.
- A Germany-based alternative asset management firm on a subscription line credit facility for its real estate debt fund, granted by an American multinational banking institution.

“As a global law firm, deeply rooted in Luxembourg, we are strategically placed to advise our clients on all areas of law. Our aim is to stay ahead of legal trends, anticipate business needs and provide clients with innovative solutions.”

Patrick Mischo, Office Senior Partner, Luxembourg



Fund Finance team

Investment Funds



Jean-Christian Six
Partner
Tel +352 44 44 5 5224
jean-christian.six@allenoverly.com



Yannick Arbaut
Partner
Tel +352 44 44 5 5521
yannick.arbaut@allenoverly.com



Miao Wang
Partner
Tel +352 44 44 5 5521
miao.wang@allenoverly.com



Joanna Pecelik
Counsel
Tel +352 44 44 5 5224
joanna.pecelik@allenoverly.com



Vittoria Faraone
Counsel
Tel +352 44 44 5 5224
vittoria.faraone@allenoverly.com



Lisa Klemann
Counsel
Tel +352 44 44 5 5224
lisa.klemann@allenoverly.com



Pierre Schleimer
Partner
Tel +352 44 44 5 5437
pierre.schleimer@allenoverly.com



Frank Mausen
Partner
Tel +352 44 44 5 5434
frank.mausen@allenoverly.com

Finance



Andreas Hommel
Partner
Tel +352 44 44 5 5437
andreas.hommel@allenoverly.com



Bénédicte Kurth
Counsel, Head of Knowledge
Tel +352 44 44 5 5437
benedicte.kurth@allenoverly.com



François Guillaume de Liedekerke
Counsel
Tel +352 44 44 5 5152
francoisguillaume.deliedekerke@allenoverly.com



Sandy Mammola
Counsel
Tel +352 44 44 5 5152
sandy.mammola@allenoverly.com



Lukas Vondrich
Counsel
Tel +352 44 44 5 7139
lukas.vondrich@allenoverly.com



Diana Konrad
Counsel
Tel +352 44 44 5 5437
diana.konrad@allenoverly.com

“The team has been fantastic. Intelligent lawyers and a quality outfit in the most general sense – I am comfortable giving the firm any work.”

Chambers and Partners



For more information, please contact:

Luxembourg

Allen & Overy
5 avenue J.F. Kennedy
L-1855 Luxembourg
PO Box 5017
L-1050 Luxembourg

Tel +352 44 44 55 1
Fax +352 44 44 55 222

Global presence

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