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FUND FINANCE

Luxembourg

LEXOLOGY

Fund Finance

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STRUCTURE AND PURPOSE OF FUND FINANCINGS

Financing structures
What types of financing structures are common in your jurisdiction? Are other types of credit facilities available for funds? What are the purposes of each (eg, management fee facilities, general partner financings)?

Subscription line financing, also known as capital call financing, stands out as the predominant fund finance tool in use among Luxembourg funds. This financing is implemented in the early stages of a fund's life cycle and serves the purpose of bridging capital calls from the fund's investors. This tool allows a fund to deploy capital at short notice when needed, primarily to make investments, while deferring and consolidating investor capital calls at a later stage.

Additionally to subscription line financings, net asset value (NAV) facilities are used in the middle or towards the end of a fund's investment period, once the fund has achieved significant levels of investment. These facilities allow fund managers to borrow against the value of their portfolio investments, providing them with flexible and efficient access to additional capital.

Hybrid products combining subscription financing features and NAV financing features have also gained popularity among fund managers looking for a single financing available through the fund's life cycle.

At management entity level, financing products range from:

- general partner (GP) facilities made available to general partners to support their capital contribution obligations;
- co-investment facilities offered to certain employees of a sponsor to invest in one or more of the sponsor's funds; to
- management line of credit used by the management entity of a sponsor to bridge management fee payments (which are often due on a quarterly basis).

Law stated - 31 August 2024

Fund structure
What does a typical fund structure look like and where might different types of financing sit in a typical fund structure? How are the various entities within a fund group structured? Are financing techniques used as a fund-raising vehicle in your jurisdiction?

Luxembourg fund structures vary widely, from single fund structures or separately managed accounts funds to more complex fund structures comprising feeder funds, parallel funds, alternative investment vehicles, blocker vehicles or umbrella funds (ie, a fund comprising separate compartments or sub-funds, the assets and liabilities of which are segregated from one another).

Subscription facilities typically sit at the level of the fund entities, while NAV facilities can either be established at the level of the fund or a special purpose vehicle held by the fund. GP or co-investment or management facilities sit, respectively, at the level of the general partner, the employees of a sponsor (or the carry vehicle) and the sponsor management entity.

Law stated - 31 August 2024

Financing considerations for fund formation

What financing considerations are particularly relevant during fund formation?

When establishing a fund structure comprising Luxembourg funds, it is crucial to ensure that the fund documents anticipate and allow the entry into financing arrangements. This proactive approach avoids the need for subsequent amendments when setting up a financing. In particular, it should be ensured that the entities can borrow, provide guarantees and grant security interests (including on a joint and several basis or cross-collateralised basis with the other fund vehicles of the structure). To pre-empt any difficulties with the investors at the time a subscription financing needs to be put in place, it is now standard practice to include in advance lender-friendly provisions in the fund documentation (notably the partnership agreements or the subscription arrangements), such as:

- investors' acceptance of the possibility for the fund and its general partner to borrow or pledge the available capital commitments;
- the lenders' right to initiate and enforce capital calls;
- waivers of set-off rights and defences to funding;
- provisions allowing the lenders to give instructions to the investors upon the occurrence of an event of default; and
- subordination of the investors' claims.

Particular attention should be paid to the 'no third-party right' provisions in limited partnership agreements. Lenders should be expressly mentioned as third-party beneficiaries to avoid any interpretation issue as to whether they may benefit from the waivers of the investors' defences and set-off rights, and other 'bankable' financing provisions included in the fund documentation. In addition, if the investors' capital commitments are structured as obligation to subscribe for units or shares, a specific undertaking of the investors to fund their commitments, even if it is impossible for the fund to issue such units or shares (notably in the case of insolvency), should also be included in the fund documentation. Such undertaking is also important in the case of suspension of the NAV calculation of the fund, which may result in an inability to issue units or shares in certain cases. In the case of investors' commitments structured as debt commitments, specific waivers and subordination provisions may be needed.

Law stated - 31 August 2024

Use of proceeds

What are the proceeds of fund financings most typically used for? Has this evolved in recent years?

The main purpose of subscription line facilities' proceeds is to finance investments and cover fund and organisational expenses, in anticipation of receipt of capital contributions from investors.

NAV facilities may be used to address liquidity constraints or drive value creation (eg, to finance investments or add-on investments, make investor distributions, provide additional liquidity for distressed portfolio companies or for working capital purposes).

GP financings are liquidity tools to support the capital contributions' obligations of general partners. Co-investment facilities allow a sponsor to provide its employees access to liquidity in order to fund their capital contributions in one or several funds. Management lines are used for working capital purposes.

Law stated - 31 August 2024

TRANSACTION PARTIES

Credit support
Which entities within a fund group provide collateral and guarantee support for the different types of financings? Are there restrictions on which entities are permitted to provide such support for each type of financing?

Regarding subscription financings, all fund vehicles of a fund group (other than carry vehicles) will in principle be involved. In master/feeder structures, the borrower entity is usually the master fund, while the feeder fund provides collateral and guarantee support to secure the borrowing obligations of the master fund. In certain circumstances, a fund entity (often a feeder fund) may be prevented from granting pledges and guarantees directly in favour of lenders. In such a case, a cascading security structure is set up. If a blocker vehicle sits between the feeder fund and the master fund, such vehicle may need to sign a blocker acknowledgement, pursuant to which the blocker vehicle undertakes to feed the master fund in an amount equal to the amount received by it from the feeder fund.

Alternative investment vehicles are usually required to accede to subscription line arrangements to which their main funds are parties, due to available investor commitments leakage risks.

As to net asset value (NAV) financings, if the borrower entity is a special purpose vehicle (SPV) held by the fund, the latter will often be required to grant security over the equity interest issued by the SPV and may be required to provide guarantee support. The SPV borrower will be asked to provide collateral and, if borrowing is made on a joint and several basis with other entities, guarantee support. If borrowing is on a joint and several basis with other entities, the constitutional documents of the relevant obligors must contain provisions allowing such credit support.

General partners, management entities or carry vehicles are usually required to provide collateral and guarantee support for general partner (GP) facilities, co-investment facilities and management facilities. The fund entities (other than carry vehicles) are in principle not required to provide any collateral or credit support for these types of financing.

Law stated - 31 August 2024

Recourse

Are fund financings typically fully recourse to the obligors? Are there credit parties against whom recourse will ordinarily be expressly limited, whether for regulatory reasons or by virtue of customary practice?

Even though subscription financing, NAV financing and GP or management financing are not secured by all assets of the relevant obligor, the lenders' recourse to the obligors is usually not limited to the collateral.

In a subscription line facility, all obligors or fund entities are typically fully liable, meaning that subscription lenders could enforce a claim as unsecured creditors against all investments and other assets of the fund. Although the general partner is usually not an obligor, it remains liable for the fund's debts at all times by virtue of its statutory unlimited liability as general partner.

In addition, certain management fees financings may involve a regulated entity, such as an authorised alternative investment fund manager (AIFM) within the meaning of Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on alternative investment fund managers directive, implemented in Luxembourg by the Law of 12 July 2013 (https://www.cssf.lu/wp-content/uploads/L_120713_AIFM_eng.pdf), as amended, on alternative investment fund managers (AIFM Law). Particular attention should be paid as to whether any regulatory requirement (such as regulatory capital requirements) should be taken into consideration while structuring a security package involving a Luxembourg AIFM.

Law stated - 31 August 2024

Liability

Where multiple fund entities are borrowers or guarantors, is joint and several liability typical, or is each entity liable only for its own obligations?

Joint and several liability is typical in subscription line facilities within a same fund group. However, there should be no joint and several or cross-collateralisation between different fund groups party to the same umbrella facility arrangement.

Subscription line facilities (in particular US law-governed arrangements) may provide for the possibility to add 'qualified borrowers' (ie, holding companies controlled by the fund). The recourse of the lenders against such borrowers will be limited. Qualified borrowers are usually only liable for their own borrowings and do not grant any security or credit support. The fund entities will, however, guarantee and secure such borrowings.

Depending on the constitutional documents of the borrowers, the local law of the borrowers and certain tax and regulatory aspects, co-borrowers under NAV financings may be able to borrow on a joint and several basis.

Law stated - 31 August 2024

Lenders

What types of lenders typically provide fund finance products? Does this vary for different fund finance products? Are there any recent trends in the types of lenders entering or stepping back from the fund finance space?

Fund finance was historically dominated by traditional bank lenders. With the growth of the fund finance market and in light of the recent challenging economic conditions, new lender types such as private pension funds, private credit funds, insurance companies and other non-bank lenders have significantly increased their presence in the market for all fund finance products. Although certain financial institutions have decided to reduce their subscription line activities, traditional banks are still strongly present in the fund finance market.

Law stated - 31 August 2024

DUE DILIGENCE

Constituent documents
What are the typical fund constituent documents that require diligence? What are the most important issues to be considered in reviewing these?

The starting point of any lender due diligence with respect to a Luxembourg fund is the limited partnership agreement (or the equivalent governing documents). When reviewing limited partnership agreements, subscription and net asset value (NAV) lenders will ensure that the relevant entity is allowed to take part in the envisaged financing arrangement (ie, whether the fund is allowed to borrow (including on a joint and several basis), to grant guarantees (including, if applicable, for the obligations of other entities) or to grant security (including, if applicable, on a cross-collateralised basis) over the uncalled capital commitments or underlying investments, or both (as applicable)).

Subscription line lenders must also carefully analyse:

- the capital call mechanism (notably, determining who is the holder of the right to make capital calls, the purpose for which the general partner or relevant management entity is permitted to call capital, the impact of excuse provisions, whether there are overcall provisions to cover defaulting investors and whether capital calls will still be permitted if the commitment period is suspended or terminated); and
- whether the typical lender friendly provisions (waiver of investors' rights of defence and of set-off and subordination provisions) are included.

Lenders should pay particular attention to (1) the fund's term to ensure that the termination date of the credit facility falls before the term of the fund and (2) the fund's commitment or investment period to ensure that the fund will still be able to draw investors' commitments to repay its borrowings and indebtedness, following the termination or suspension of the commitment or investment period.

Lastly, lenders should assess whether the limited partnership agreement requires that a prior consent is obtained from an advisory committee (composed of limited partners) before the fund can take part in the relevant financing arrangement

Private placement memoranda are also part of the due diligence as they comprise the investment strategy of the fund. In certain cases, the memorandum may govern the fund and be binding on investors, including when a Luxembourg fund is subject to one of the following Luxembourg laws (together, the Fund Product Laws):

- the law of 23 July 2016, as amended (RAIF Law), on reserved alternative investment funds (RAIFs);
- the law of 13 February 2007, as amended (SIF Law), on specialised investment funds (SIFs);
- the Luxembourg law of 15 June 2004, as amended (SICAR Law), on risk capital investment companies (SICARs); and
- Part II of the law of 17 December 2010, as amended (UCI Law), on undertakings for collective investment (UCIs).

In addition, funds that are subject to a Product Law may be established as umbrella funds (ie, funds comprising separate compartments, the assets and liabilities of which are segregated from one another). In such a case, the private placement memorandum of the umbrella fund will comprise separate specifications per compartment, containing the terms and investment strategies of a specific compartment, as well as indebtedness provisions and limitations applicable to the compartment.

In the context of subscription line facilities, subscription agreements will also play an essential role, given that it is through these agreements that investors' commitment towards funds is created. It is therefore essential that due diligence by subscription line lenders extends to these agreements, to obtain information about the investor and its capital commitment. Lenders should ensure, among other things, that there are no detrimental provisions in the subscription agreements and that each subscription agreement has been properly signed by the investor and accepted by the general partner (or relevant management entity). The commitment amount of each investor should also be checked.

Law stated - 31 August 2024

Side letters

Are side letters between the fund parties and investors typical? What side letter provisions most commonly raise issues that may affect financings?

Side letters between Luxembourg funds and their general partners and investors are typical and are reviewed during the due diligence phase to ensure that they do not include provisions that could be prejudicial to the lenders' interests. Such is the case where side letter provisions limit the possibility for a fund to incur indebtedness, prohibit the contracting of direct obligations towards lenders, restrict the granting by the fund and general partner of pledges over their uncalled commitments, grant immunity to investors, impose stringent confidentiality restrictions, grant investors excuse rights that would cut across the expected transaction or regulate the form and content of drawdown notices. Most favoured nations provisions must also be treated carefully since these can result in problematic side letter provisions extending to other investors.

Law stated - 31 August 2024

Investors

What is the typical scope of diligence performed on investors? Do investors commonly provide investor letters or other deliverables for the benefit of lenders? If so, in what context would this be expected?

Given that the collateral in the case of subscription line facilities consists of the investors' undrawn capital commitments, the investors' creditworthiness must also be considered by subscription line lenders, in addition to the review of the subscription agreements and side letters, in order to assess whether there are any risks of investors' defaults upon the calling of capital contributions.

In terms of investors' deliverables, investors are usually not requested to sign or deliver any document at the time a subscription line is set up. However, there are scenarios where the investors will be required to sign an investor letter, notably in the case of separately managed account funds, due to the concentrated risk that these funds represent or if the fund documents do not contain the necessary lender friendly provisions (waiver of investors' rights of defence and set-off and subordination provisions, notably).

Law stated - 31 August 2024

Other areas of due diligence

Are there other areas that merit due diligence considerations? What salient issues are relevant to each?

Luxembourg funds qualifying as alternative investment fund (AIF) within the meaning of the alternative investment fund managers directive and the Alternative Investment Fund Manager (AIFM) Law must appoint an AIFM, entrusted with the portfolio management and risk management of the AIF as well as a depositary, in charge of the safekeeping and supervision of the fund's assets and the control over the transactions of the fund (including compliance with investment policies and monitoring of the cashflows).

The terms of the AIFM agreement should be reviewed to determine whether and how the AIFM needs to be involved in the financing. The general partner of the fund may have delegated to the AIFM the power to issue drawdown notices to the investors or the power to enter into financing arrangements on behalf of the fund. In other cases, the fund documents may provide that the AIFM has to consent to the fund's financing arrangements or the security interests over the fund's assets. In addition, it may be that the AIFM has itself delegated its portfolio management functions to a portfolio manager, pursuant to the terms of a portfolio management or delegation agreement. Such agreement should be reviewed, in the same way as the AIFM agreement.

The depositary agreement should also be reviewed by lenders to check whether the depositary has to be notified of, or provide its consent in relation to, the financing transaction or the related security package. Depositary agreements may also contain a pledge granted by the fund over its assets in favour of the depositary. In this case, it must be assessed whether such pledge conflicts with the financing arrangements and, if so, a specific release or waiver of such pledge will be required.

Law stated - 31 August 2024

CREDIT SUPPORT – GUARANTEES, SECURITY AND COLLATERAL

Guarantors – subscription facilities
Which entities are typically obligors in the case of subscription facilities?

Typically, all the entities of a fund group, in particular, the master fund, any feeder fund (subject to regulatory considerations), any alternative investment vehicle, and any parallel fund are obligors or security providers. It is common for the lenders to request an additional covenant in the facility agreement with respect to the mandatory accession as obligor or security provider of any future established entity within the fund group of the current borrowers or guarantors (in particular feeder funds and alternative investment vehicles, given that the establishment of such fund entities could negatively impact the rights of subscription line lenders if not joined to the financing).

Law stated - 31 August 2024

Guarantors – NAV facilities
Are pledged assets typically held at the fund level and pledged directly, or moved to a special purpose vehicle? Is there fund-level recourse in the case of NAV facilities?

It is common to see net asset value (NAV) facilities being made available at the level of an special purpose vehicle (SPV) (held by the fund) holding the underlying investments that lenders agree to lend against.

In such case, NAV lenders may, in addition to a pledge over the equity interests in the SPV, require additional credit support from the fund. Subject to indebtedness limitations affecting the fund and its existing contractual obligations (such as a subscription line financing), a guarantee or equity commitment letter may be required from the fund. In certain scenarios or in the case of hybrid financings, NAV lenders may also require that available commitments form part of the collateral.

Law stated - 31 August 2024

Collateral package – subscription facilities
What is the typical collateral package for subscription facilities?

Subscription line facilities are secured by the available commitments of the fund's investors. The collateral package typically includes: (1) a pledge by the fund over the rights in and to the available capital commitments of the investors, and the claims against the investors in relation to those capital commitments (with the general partner or the relevant management entity that has the power to make capital calls being also a separate party to the pledge agreement); and (2) a pledge by the fund over the bank account(s) to which investors are required to fund their capital contributions.

Law stated - 31 August 2024

Collateral package – NAV facilities
What underlying assets most commonly secure NAV facilities?

Depending on the investment strategy of the fund, the underlying assets that most commonly secure NAV facilities are debt investments, participations in other investment funds (for funds of funds, and secondary funds), private equity investments and real estate investments.

Law stated - 31 August 2024

Pledge structure – subscription facilities
Which parties are typically required to pledge capital-call collateral and how are the pledges structured?

Each fund in a fund group having investor undrawn commitments is usually required to pledge its undrawn commitments and collection accounts in favour of the lenders (or a security agent).

If an investor facing vehicle (typically a feeder fund) is unable to grant direct pledges for tax or regulatory reasons and due to restrictions included in its limited partnership agreement, a cascading security structure will need to be set up. In such case, the feeder fund grants security interests over its investors' undrawn commitments and its collection bank accounts, in each case in favour of its master fund to secure its own capital contributions obligations regarding the master fund. In turn, the master fund grants a security interest over its investors' undrawn commitments (including the undrawn commitments of the feeder), in favour of the subscription line lender (or security agent) in order to secure its own obligations under the subscription line facility. In an enforcement scenario, lenders will be able to enforce the pledge granted by the master fund and exercise all accessory rights attached to the pledged claims or commitments, including the pledges granted by the feeder fund in favour of the master fund to secure such pledged claims. When structuring a cascading pledge, it is important to ensure that the claims of the feeder fund regarding the master fund (documented pursuant to a subscription or commitment agreement) will at all times be at least equal to the available investors' commitments at feeder fund level.

Law stated - 31 August 2024

Pledge structure – NAV facilities
If assets are held in a special purpose vehicle (SPV), are the assets pledged directly by the SPV, or is the pledge achieved indirectly through a pledge of equity interests in the SPV? Are any other pledge structures commonly seen?

The security package is determined on a case-by-case basis depending on (1) the fund's investment strategy and the nature of the underlying investments, (2) the borrowing structure and (3) regulatory and tax considerations.

It is, however, customary to see NAV facilities being made available at the level of an SPV held by the fund, allowing lenders to obtain a pledge by the fund over the equity interests in such SPV (with a pledge by the SPV over its bank accounts). This security structure allows lenders to take control of the SPV and enforce over the SPV's bank accounts, which results in the lenders being the sole beneficiaries of any underlying investments' distributions paid to the SPV.

For secondary funds and funds of funds, an SPV will almost automatically be set up to hold the underlying investments (ie, limited partnership interests in other funds) due to the transfer restrictions generally affecting equity interests issued by investment funds.

For credit funds, it is typical for the fund or SPV borrower to grant an English law debenture or a US law security agreement over the loan portfolio. Transfer and assignment restrictions and pre-consent included in the underlying loan agreements need to be assessed by lenders.

For private equity funds, it is common to see a pledge granted over the holding entity that owns the underlying investment. Lenders will have to determine whether the entry into and the enforcement of such pledge will trigger the application of any change of control provisions at a portfolio company level. If shares in a joint venture holding entity form part of the collateral, shareholders' arrangements of this entity may contain restrictions in relation to the transfer of equity interests, including drag or tag along rights, specific board or committee consent, pre-emptive rights and other transfer restrictions. It should also be assessed whether any transfer of the equity interests could have implications on the regulatory or tax status of the portfolio company.

In addition, it is worth noting that for commercial, existing contractual obligations, tax and regulatory reasons, or due to existing contractual restrictions (notably change of control provisions), NAV facilities can also be unsecured or secured only by a pledge over the bank account into which the borrower receives distributions from underlying investments.

Law stated - 31 August 2024

Perfection and priority – subscription facilities

How are security interests in rights to uncalled capital and bank accounts perfected and how is priority established? Is any notice to investors necessary for perfection or priority and, if so, what are the requirements for such notices? In the case of bank accounts, is a tripartite account control agreement with the account bank, or other notice to or acknowledgement by the account bank, required?

Luxembourg law typically governs the security interests granted by Luxembourg funds over the rights in and to the investors' available capital commitments, and any claims against the investors in relation to such commitments, as well as account banks located in Luxembourg. The relevant security interest is in the form of a financial collateral arrangement governed by the Law of 5 August 2005 on financial collateral arrangements, as amended (the Collateral Law). According to the Collateral Law, security interests over claims against the investors may be created by way of pledges or assignments for security purposes, pledges being the most common Luxembourg law security interests over investors' commitments. Under Luxembourg law, pledges that are not notified to or accepted by the investors are fully recognised and enforceable. However, the debtor of a pledged claim may be validly discharged from its obligation regarding the security provider if it had no knowledge of the pledge in favour of the security taker. It is therefore standard for lenders to require pledges granted by the fund to be notified to the investors, to ensure that the investors will act in accordance with the security taker's instructions and pay their undrawn commitments into the pledged account (or as otherwise instructed by the security taker) if the security interest is enforced. Notices to investors may be served by the pledgor by different means such as registered mail, email or via the investors' portal or an investors' report.

The security interest over Luxembourg bank accounts into which investors are required to fund their contributions may be created by way of a pledge in accordance with the Collateral Law. The pledge agreement must be evidenced in writing and perfected in accordance with Luxembourg law. In practice, as a result of their general terms and conditions or the depositary agreement signed with the fund, Luxembourg account banks have a first-ranking pledge over such accounts. Provided the terms and conditions and depositary agreement do not prohibit pledges over the relevant bank accounts, the pledge will become valid and enforceable against the account bank and third parties once the pledge has been notified to and accepted by the account bank (usually by way of an acknowledgment letter signed by the account bank containing the necessary waiver provisions). It is, therefore, standard for subscription line lenders to require that such acknowledgment be a condition precedent to the first utilisation of the loan.

Law stated - 31 August 2024

Perfection and priority – NAV facilities
How is a security interest in each type of commonly pledged asset perfected, and how is its priority established?

A pledge over the shares in a Luxembourg private limited liability company (SARL) (which is the most common form of Luxembourg holding or portfolio entities) will be perfected once notified to the company whose shares have been pledged, and although not strictly necessary for perfection purposes, it is market practice to register the pledge in the shareholders' register of the pledged SARL. In addition, if less than 100 per cent of the shares (ie, joint venture SARL) are pledged, the enforcement of the pledge requires the prior approval of the shareholders, and therefore, lenders will seek to obtain such shareholders' approval (pre-approving the pledgee as assignee of the pledged shares) as a condition precedent.

A pledge over limited partnership interests issued by a Luxembourg partnership is perfected when notified to, or accepted by, the partnership. Similarly to SARL, it is standard practice to require the registration of the pledge in the partners' register. In addition, in the absence of any rules in the limited partnership agreement providing for stricter transfer/pledge restrictions, the granting of a pledge over limited partnership interest(s) issued by a Luxembourg partnership is subject to the approval of the general partner of such partnership. A pledge granted in breach of the partnership agreement (or, if silent, of the obligation to obtain the consent of the general partner) is null and void.

A pledge over Luxembourg bank accounts is perfected once the account bank has been notified of, and has accepted, the pledge and has waived its general right of pledge and other preferential rights arising under its general terms and conditions or depositary agreement.

A pledge or an assignment for security purposes over receivables is perfected by the mere entry into the pledge or assignment agreement by the parties. Nevertheless, it is usual for lenders to require that a pledge or assignment for security purposes of receivables be notified to, and accepted by, the debtor of the pledged or assigned claims, to waive any defences, right of retention or set-off the debtor may have about the pledged or assigned claims and any applicable transferability restrictions.

According to the Collateral Law, the priority of a Luxembourg pledge is determined by the date on which the pledge became enforceable against third parties.

Law stated - 31 August 2024

Lien searches and filing system

How can a lender assure itself as to the absence of liens, with or without priority to its lien, with respect to each type of collateral? Is a public filing or recordation system available in your jurisdiction to notify third parties of security interests?

Under Luxembourg law, there are no public registrations or other public filing requirements in relation to the execution, performance or enforcement of security interests subject to the Collateral Law. Typically, representations and undertakings are added in the finance documents to certify the absence of existing pledges or liens affecting the relevant pledged assets and to restrict the creation of any future pledge or lien over such pledged assets. In addition, for certain types of assets (such as shares issued by a Luxembourg company and partnership interests issued by a Luxembourg partnership), the absence of existing pledges may be verified by reviewing the shareholders or partners' register of the entity whose shares or partnership interests are to be pledged.

Law stated - 31 August 2024

BORROWING BASE

Capital-call collateral value

How is the typical investor base determined in the case of subscription facilities? What are the typical events during the life of a credit facility that would exclude investors from the borrowing base? What are the common underwriting issues for lenders with respect to investor creditworthiness?

The borrowing base is generally expressed as an agreed advance percentage of uncalled capital commitments of eligible investors (ie, investors satisfying eligibility requirements). The advance rate can be a 'flat' advance rate (ie, same rate across all investors) or investors can be assigned different advance rates. The borrowing base can also be impacted and reduced by other criteria, such as investor concentration limits and exclusion events.

Typical events that could result in an investor being excluded from the list of eligible investors include a certain investor becoming a defaulting investor under the terms of the limited partnership agreement of the fund, an investor exercising defence or excuse rights, the occurrence of an event having a material adverse effect on the investor's ability to fund its commitment, the investor's side letter not permitting the calling of capital contributions from such investor to repay the indebtedness or such investor withdrawing from the fund.

Subscription line lenders may face various underwriting issues when assessing the creditworthiness of investors, in particular the credit history, the liquidity and the regulatory requirements related to the investors and the general market conditions.

Law stated - 31 August 2024

Asset concentration limits
For NAV facilities, are there typically limits on exposure to various types of assets within the collateral pool? How are these limits determined?

It is common to find concentration limits and diversity requirements with respect to the underlying assets constituting the collateral pool to ensure that the net asset value (NAV) loan is not made available against a small number of assets concentrated in a particular region or industry.

Law stated - 31 August 2024

Asset valuation
For NAV facilities, what is the typical process for collateral valuation? What dispute mechanics are available?

The starting point for the valuation of the collateral is usually to follow the valuation method agreed with the fund's investors, and set out in the constitutional documents of the fund. Accordingly, valuations will be undertaken by the sponsor at the frequency agreed with investors under the constitutional documents.

NAV lenders, however, usually benefit from safeguards in the form of dispute rights that provide lenders with the right to challenge the sponsor's valuation and seek an alternative valuation if the lenders do not agree with the valuation provided by the fund.

Law stated - 31 August 2024

FINANCING DOCUMENTATION TERMS

Financial covenants
What are the principal types of financial covenants in the case of NAV facilities? Are any financial covenants typically included in subscription facilities?

The main covenants are the loan to value ratio (LTV) covenants that require the amount of debt drawn under the net asset value (NAV) facilities not to exceed an agreed percentage of the NAV of the fund's underlying investments, whereas in subscription line facilities, the financial covenants focus on the total undrawn capital commitments.

Law stated - 31 August 2024

Other covenants
What other covenants restricting the operation of a fund are commonly included in financing documentation?

Subscription lenders usually limit the possibility for the obligors to incur additional financial indebtedness. Distributions and payment of fees will however only be restricted following the occurrence of a default. Covenants related to the investors' commitments (such as restrictions regarding reduction or cancellation of investors commitments) and the modifications of the limited partnership agreements and other relevant fund documents are also commonly included.

For NAV facilities, covenants with respect to a limitation on the dispositions of the underlying investments of the fund, the indebtedness that the fund may incur and the minimum liquidity that a fund is required to maintain may be required by NAV lenders.

Law stated - 31 August 2024

Repayment – subscription facilities
What is the typical maturity of a subscription facility? How long can individual loans remain outstanding?

Subscription line facilities are short-term loans, and the maturity of any drawn amount is typically no longer than 365 days in order to avoid any leverage considerations at the level of the fund.

According to article 6(4) of the EU Regulation 231/2013 of 19 December 2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision, alternative fund managers can exclude from the calculation of leverage, borrowing arrangements entered into if these are temporary in nature and are fully covered by contractual capital commitments from investors. The concept of 'temporary in nature' is not defined but it is commonly accepted in the Luxembourg market that bridge loans with a maturity below or equal to 365 days would meet the 'temporary in nature' criterion.

Law stated - 31 August 2024

Repayment – NAV facilities
What is the typical maturity of a NAV facility, and what are the typical mandatory prepayment triggers? Are there customary exceptions? Are penalties for voluntary prepayment typical?

NAV facilities are usually structured as term or revolving loan facilities, typically maturing within a period ranging from two to four years. There may be several events that could trigger a mandatory payment, including without limitation, in the case of receipt of proceeds following the sale of an investment, upon the occurrence of a 'change of control' event, if LTV exceeds any pre-agreed threshold or when the pre-agreed concentration limit is no longer met.

Penalties for voluntary prepayment are not common in NAV financings.

Law stated - 31 August 2024

REMEDIES AND ENFORCEMENT

Defaults
What are the commonly included events of default specific to fund financings?

Common events of default include classic 'non-payment' events, the insolvency of or the initiation of insolvency proceedings against an obligor, cross-defaults or cross-accelerations of other financial indebtedness incurred by an obligor under other facilities, the failure by an obligor to comply with certain representations and undertakings listed in the financing documentation, the removal of a managing entity, AIFM or investment adviser, the invalidity or repudiation of certain key obligations under the financing documentation, key person events, the non-compliance by an obligor with its fund documents (including with the investment policy contained thereunder), the failure to comply with its information obligations and, in the case of subscription facilities, the reaching of a certain percentage of defaulting investors in the entities involved in the financing.

Law stated - 31 August 2024

Standstill
What types of standstill provisions are typically available in the case of subscription facilities?

Subscription facilities may contain standstill provisions that apply following the occurrence of certain events of default, notably 'non-payment' events of default. As per these standstill clauses, a fund is first afforded an opportunity to call capital contributions from its investors within a specific timeframe to repay the outstanding indebtedness, before the lenders can exercise their enforcement remedies under the commitment pledge agreement. Lenders are precluded from calling capital contributions within this time frame.

Law stated - 31 August 2024

Enforcement – capital calls
How does a lender enforce its right to call capital from investors in the case of a defaulted subscription facility?

In an enforcement scenario, a lender benefiting from security interests over undrawn capital commitments and collection account(s), created under the regime of the Collateral Law will be able to enforce its rights by, among others:

1. serving a funding notice on the investors, requesting payment into the pledged accounts;

2. requesting direct payment from the investors;
3. appropriating the pledged claims (at a value determined using the valuation method agreed upon by the parties);
4. selling the pledged claims by way of private sale (at arm's-length conditions) or by public sale; or
5. requesting a court to attribute the pledged claims.

It must, however, be noted that that the preferred enforcement approach in respect of capital commitments is to use the remedies under (1) and (2) above.

Law stated - 31 August 2024

Enforcement – NAV facility collateral
What steps must a lender take to foreclose on pledged underlying assets, including in cases where assets are pledged indirectly through a pledge of equity interests in a holding company?

This will depend on the nature of the pledged assets (ie, equity interests, receivables, bank account) and the law governing such pledged assets.

Enforcement of pledges subject to the Collateral Law is quick, cost-efficient and may be done out of court, even in a bankruptcy scenario. The main enforcement remedies in relation to pledges over equity interests issued by a Luxembourg entity are appropriation (pursuant to the valuation method agreed between the parties in the pledge agreements) and private sale on arm's-length conditions.

Law stated - 31 August 2024

Enforcement – bank accounts
What steps are needed for a lender to take control over funds or securities held in pledged accounts?

Following the occurrence of a trigger event agreed by the parties, the lender will be able to block, and take control over, the bank accounts pledged under a Luxembourg law-governed account pledge agreement, by sending a blocking notice to the Luxembourg account bank, without the involvement of courts.

Law stated - 31 August 2024

Bankruptcy and insolvency
How do bankruptcy and insolvency proceedings in respect of a fund affect the ability of a lender to enforce its rights as a secured party over the collateral? Are processes other than court proceedings available to seize pledged assets in enforcement?

Security interests falling within the scope of the Collateral Law are valid and enforceable against third parties, commissioners, receivers, liquidators and other similar officers notwithstanding reorganisation measures, winding-up proceedings or any other similar national or foreign proceedings.

Security interests subject to the Collateral Law may be enforced out of court, even in a bankruptcy scenario.

Law stated - 31 August 2024

LEGAL AND REGULATORY ISSUES

Relevant regulatory and statutory regimes

Are there any regulatory or statutory regimes that raise particular issues for lenders or fund sponsors in fund financings? How are these issues normally addressed?

Luxembourg investment funds qualify in most cases as alternative investment funds within the meaning of the alternative investment fund managers directive (AIFMD), which should not raise particular issues for lenders. Lenders need to ensure that the fund complies with its main obligations under the AIFMD, such as the obligation to appoint a registered or authorised alternative investment fund manager and a Luxembourg depositary.

A Luxembourg investment fund can be established as, or converted into, (1) a risk capital investment company, specialised investment funds or Part II undertakings for collective investment and be subject to the supervision of the Luxembourg supervisory authority for the financial sector (CSSF), or (2) a reserved alternative investment fund (RAIF) that is unregulated. Lenders should ensure that the relevant legal authorisations or registrations have been obtained or made and that the private placement memorandum of the fund (other than for RAIFs) has been approved by the CSSF.

A fund having admitted investors that are subject to the Employee Retirement Income Security Act of 1974 (ERISA) may not be able to grant direct security interests in favour of lenders, and a cascading security structure will have to be put in place.

Law stated - 31 August 2024

Governing law

What is the typical choice of law and choice of jurisdiction in the finance documentation? What conflict-of-laws considerations are typically relevant to fund financings in your jurisdiction?

Subscription line facility agreements and NAV arrangements are typically governed by English law or New York law and submitted to English or New York courts, which are the preferred jurisdictions for fund financing transactions. It should be noted that US lenders generally require available commitments to be pledged under a New York law security document, in addition to a Luxembourg law pledge.

Given that investors are located in different jurisdictions, conflict of law rules must be considered. According to article 14 of Regulation (EC) 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (Rome I Regulation), the law governing a pledged or assigned claim determines its assignability, the relationship between the security taker and the debtor, the conditions under which the pledge or assignment may be invoked against the debtor, and whether the debtor's obligations have been discharged. Because the limited partnership agreement of a Luxembourg fund and its subscription agreements are typically governed by Luxembourg law, Luxembourg law will apply to such matters by the application of the Rome I Regulation. Since the Rome I Regulation provides for a conflict of law rule concerning the enforceability of, and possibility to invoke, a pledge or assignment over claims against the debtor of such claims only and not against third parties generally, it is uncertain whether a pledge over, or assignment of, claims would become enforceable regarding third parties (other than the debtor) if the legal formalities applicable in the debtor's jurisdiction are not duly complied with.

Law stated - 31 August 2024

Document execution

What are the requirements and formalities for the execution of financing documentation? Are there any jurisdiction-specific issues that arise in the fund financing context?

There are no specific requirements and formalities for the execution of Luxembourg law governed fund finance documents. The execution of the finance documents, including security documents, is typically made under private seal and may be done in counterparts. In the recent years, the use of electronic signatures has grown considerably. An electronic signature satisfying the provisions of article 1322-1 of the Luxembourg Civil Code or constituting a 'qualified electronic signature' within the meaning of the Regulation (EU) No. 910/2014 of the European Parliament and of the Council of 23 July 2014 on electronic identification and trust services for electronic transactions in the internal market, has equivalent effect to a handwritten signature, and is, except in certain limited cases, valid for the purpose of the execution of an agreement under private seal. An electronic signature that does not satisfy the above conditions will not be considered as equivalent to a handwritten signature, but it shall not be denied legal effect and admissibility as evidence in legal proceedings.

Law stated - 31 August 2024

UPDATE AND TRENDS

Key trends and developments

What are the most noteworthy recent trends and developments in fund finance in your jurisdiction? What developments are expected in the coming year?

In the current economic slowdown, subscription line financing continues to be an essential tool for Luxembourg fund managers, providing liquidity and flexibility in the earlier stages of a fund's life cycle.

In parallel, net asset value (NAV) financing has gained significant traction as a key source of liquidity, helping fund managers navigate liquidity constraints and drive value creation in later-stage investments. However, the rising popularity of NAV financing has raised concerns among limited partners, who are seeking more transparency around its use. Despite these concerns, we expect the use of NAV financing to continue expanding. Similar to subscription line financing, we anticipate that fund managers and limited partners will soon be aligned on the use of NAV financing.

Additionally, the fund finance market has witnessed the entry of non-traditional lenders, such as private debt funds pursuing direct lending investment strategies. These non-bank lenders are expected to play an increasingly important role, providing new sources of financing in the fund finance market.

Law stated - 31 August 2024