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The Future of Fund Finance: Integrating Artificial Intelligence

Corinne Musa

Akin Gump Strauss Hauer & Feld LLP

Investment managers frequently rely on leverage as an essential part of their fund investment strategy. Whether using a subscription facility as a bridge to call capital from investors or relying on a NAV credit facility for follow-on investments in a mature fund, fund-level debt financing has become an essential part of the capital structure of any modern private investment fund. Similarly, investment managers themselves may borrow at the management company level or founders may borrow individually or at the general-partner level for various reasons, like "keeping the lights on" or to fund the required general partner commitment (so-called skin in the game). Even though the variety of fund finance products has evolved over the years, the fundamental thesis for their utility has not changed, and the once creative solutions developed to solve complicated issues are largely settled.

For this reason, the area of fund finance is ripe for the application of artificial intelligence and machine learning tools. This article will discuss (1) the development of private investment funds and customary fund finance products; (2) an overview of artificial intelligence (AI) and machine learning (ML) as it relates to legal and financial products; (3) the current legal framework for AI; and (4) the potential areas for implementing AI across the spectrum of fund finance products.

Investment Fund Basics and Liquidity Options

In general, an investment fund is a legal entity by which a group of passive investors contribute capital to the entity for the purposes of making investments. An investment fund is frequently structured as a limited partnership, where passive investors are "limited partners" in the limited partnership, with control residing with a single general partner (also referred to as the sponsor). The general partner is effectively the investment management firm that sponsors and runs the fund by deciding what investments the fund entity will purchase, when to buy and sell the investments and when to distribute capital back to the investors. Ultimately, both the passive investors and the sponsor have aligned incentives given the framework that has developed for compensating the manager and general partner and returning capital to the investors.

There are many variations on fund structures and types, and the analysis of all of them is beyond the scope of this article. That said, it is helpful to level set on the basics to understand which financial products are useful for which type of fund. To start, there are closed-end funds in which the fund achieves a certain specific size (based on the commitment amounts from the investors), and once the fund has held its final closing, there will be no ability for new investors to participate in the fund other than through secondary transactions (i.e., buying a fund interest from an existing limited partner). This type of fund can span strategies—from traditional private equity buyout to credit to real estate or infrastructure.

The second main type of fund for purposes of this article is open-ended funds. These entities allow unlimited investors, so there is no set commitment amount for the fund. If an investor has the money and desire to invest in the fund, the "open-ended" structure would allow for a new subscription at certain regular intervals. An example of this type of fund in the public context is most mutual funds. Generally, mutual funds allow retail individuals (i.e., not "accredited investors" subject to specific qualification requirements in the private funds context) to participate through any brokerage platform and purchase shares up front. Another type of fund is a hedge fund. Hedge funds are private funds in which investors put their cash in up front to buy shares in the fund, and then investors can exit, or redeem, their shares at certain intervals (i.e., quarterly or annually—subject to various limitations).

The primary source of financing for a fund is the investors. The investors provide the equity commitments or contributions through one form of documentation or another so that they have an indirect interest in the underlying investments of the fund. The focus of financial products for this article is the debt financing that a fund uses in lieu of or in addition to the equity component.

One of the most common tools in the toolkit of fund finance for private funds is a subscription credit facility. With respect to any fund that requires investors to *commit* to fund a portion of equity at some future time (but not, at the time of subscribing to the fund, *actually* fund such commitment), the subscription credit facility (aka "subline" or "capital call credit facility") has developed as a product that acts as a bridge loan between the time of drawing to execute on a particular deal and the receipt of capital contributions from investors. The benefits of this product are so customary and aligned from both the manager and investor perspective that it is unusual for a closed-end fund that draws capital from investors over time *not* to have a subscription line in place, unless the investor commitments have all been drawn or it is instead at the harvest stage for its investments. Subscription credit facilities allow funds to borrow without calling capital, creating benefits for the sponsor from a timing, default risk and rate of return perspective. Additionally, sublines are a low-risk product from a lender perspective if the lender is comfortable with the credit quality of the investors. In a subline, the lender is looking to the investor capital contributions as the ultimate source of repayment for the facility.

Another more recently developed fund finance product is the net asset value credit facility (or NAV facility). Like any asset-based loan for a regular operating company, a NAV facility looks to the value of the assets (i.e., the actual investments) owned by the fund borrower as the ultimate source of repayment for the loan. There are various structures to allow for a NAV facility, but in all cases the investments themselves are meant to be the credit support for the loan, and the cash flows and distributions that flow "up the chain" in a complex structure chart back to the fund and ultimately to the investors are what the NAV lender has decided to lend against. These NAV loans can often fund the initial acquisition (for example, in a portfolio of loan positions or a portfolio of secondaries fund interests) or simply be used as a bridge loan to a more desirable exit of the investment (e.g., at a time when the M&A market or an IPO would provide a better ultimate return). In theory, a NAV lender is hoping to get some equity-like returns without full equity risk, and an investor gets the benefit of not having to part with additional cash for the investment, while getting the benefit of some additional time for the investment to "ripen."

It is important to understand that the type of fund and the financial product that each fund may use will differ. The below chart (while not comprehensive on all fund structures) lays out some of the basic distinctions.

Type of Fund	General Leverage Options	Comments
Closed-End Private Fund	Subscription facility (early stage); potentially NAV facility or hybrid credit facility later in fund life	Usually there are some form of commitments or subscriptions that a lender could lend against for a subscription or capital call facility. A NAV or hybrid facility later in fund life depends in part on the exit options for the investments at the expected time of harvesting investments.
Open-End Mutual Fund	No subscription facility; potentially some form of NAV facility	Investors put capital in up front, so there are no commitments to lend against. Leverage on existing investments may help increase returns.
Hedge Fund	No subscription facility; potentially NAV facility	Usually no subscriptions; however, fund may try to leverage any illiquid positions with side documentation to replicate subscription facility mechanics.

The last fund finance product for purposes of this article is the management company credit facility. The fund manager frequently establishes a credit facility backed by assets of the manager, most typically the management fee streams received from one or more investment funds. Because the manager is much more like a regular operating company than the fund itself, with employees and operating expenses, the management company facility is effectively a working capital facility. The nuance is that the credit support for any borrowing is a steady stream of cash expected to be paid by the fund investors, so the lender looks to the fund documents (and fund investors) to understand the amount and the timing of any payments.

The Rise of Artificial Intelligence

AI and ML have become mainstream topics in the last few years. While the concepts themselves are not new, their application in the world of financial products and legal services has increased exponentially recently. With the advent of OpenAI's ubiquitous ChatGPT, the ability to input a prompt like "Write me an essay about… " and get a semi-intelligible first draft is the stuff of both dreams (for any kid who has put off an assigned homework essay until the last minute) and nightmares (as in, there go our brains).

So what is AI and how is it currently being deployed in the realm of financial products and legal services? Generally, artificial intelligence refers to the means (i.e., learning and reasoning) that a computer program or other machine uses to interpret actual data to create an output. The data that AI and ML rely on may be good data or bad data, but does, in one form or another, exist somewhere. One expert, Robert Otani, refers to AI as "embedded intelligence," meaning the "intelligent" response is based on real actual data (whether good or bad) and is thus embedded in the data (i.e., nothing about it is "artificial"). Another researcher, Ethan Mollick, refers to AI as "co-intelligence" (in his book of the same name), emphasizing how AI can simultaneously feel like an alien life form creating unique responses based on its large language model (LLM) data sets and a helpful assistant, merely aiding in the creativity of the person proposing a unique prompt.

Many aspects of financial and legal services lend themselves to AI, particularly where there is any repetitive task for which there is a sufficient data set of precedent documents to work with and learn from. For many years, litigation attorneys have been utilizing AI tools in the discovery process, by "training" the discovery program du jour to search for terms and patterns, in an effort to cull through the millions of documents, emails and other primary sources that might provide a "smoking gun" in a contentious litigation. Perhaps more recently on the transactional front, corporate attorneys at some law firms have been using AI to assist with creating legal opinions and other forms to use in connection with deal closings. And with public data sets of material transaction documents filed on the SEC's EDGAR, incredibly powerful tools have sprung up (e.g., noetica.ai) that compare deal terms to the market in ways that were unthinkable just a dozen years ago. Octus (formerly Reorg) provides financial and legal analysis of bankruptcy, restructuring and other credit matters and has an AI chatbot that can quickly summarize and analyze complicated debt exchange transactions.

Legal Patchwork of AI

The legal framework of AI is murky at best, as AI companies cope with copyright and other intellectual property issues that arise from usage of training data. Questions abound regarding the ethical and philosophical implications of various AI uses, as well as practical concerns about attributing work products generated by AI. Former President Biden's executive order on AI detailed eight guiding principles and priorities meant to ensure the safe and secure development of AI. The current Trump administration recently revoked that order, intending to "remove barriers" to the development of American AI with an action plan that, at this time, remains to be seen. Although there is no current comprehensive legislation or regulation in place, there *are* existing laws that give some guidance on how to work with AI.

In New York, the rules of professional conduct govern ethical behavior for lawyers and at least some of the questions raised by AI can be answered by considering those rules and related guidance around them. For instance, sharing client information with a closed-universe, in-house AI tool might be permissible in some situations, while broadly sharing client information with the free version of ChatGPT would not. The legal landscape around privacy and cybersecurity is relevant and applicable to AI tools as well because "[d]ifferent jurisdictions may have strict requirements for processing and transmitting personal data," as noted in Akin's recent fund finance article on cybersecurity. Those laws apply whether sensitive data is being fed into a new ML tool or sent via email and should be considered in connection with any information sharing to an AI tool.

Application of AI to Fund Finance

Implementing AI and ML for various tasks in fund finance is an obvious next step in the fund finance practice. Reviewing UCC filings and preparing legal opinions and other closing documents are areas where AI tools could be implemented to compare UCC filing numbers, flag discrepancies, and prepare the more tedious paperwork for any secured credit facility closing. This clear use case could apply to any of the fund finance products discussed above. Management fee facilities, NAV facilities and sublines are usually secured credit facilities with the associated heavy volume of closing paperwork. Tools that streamline preparing signature pages and closing sets exist, but these could be extended to many of the junior-level legal tasks in the process of negotiating a typical fund financing.

In terms of more difficult analytical items, like analyzing compliance with the U.S. Investment Company Act, determining a borrower and guarantor structure based on a complex structure chart, advising on risks relating to borrowing base determinations, and providing input in document negotiations, it is now realistic to envision a world where legal, finance and compliance professionals can feed these items into an AI counterpart and obtain guidance against a backdrop of deals. Being able to immediately compare credit facilities to market terms or generate an issues list on a couple hundred-page credit agreement would have the potential to significantly reduce time and expense for fund finance transactions. This already exists to some degree (e.g., Octus, Noetica), but is far from broadly adopted in the fund finance context, in part, because the deals are private so there is a limited dataset with which to train LLMs.

Firms with the largest sets of private precedents will be the ones that stand out if they can both (1) leverage that data set with AI and ML; and (2) use it to train real life humans. The first part is important because the reality is that a good lawyer in fund finance (or, arguably, any area of law) is usually just an average lawyer who has a significant number of repetitions under their belt. The second part is essential for clients to feel confident with the end result, knowing that they've had the benefit of both AI "co-intelligence" and the sanity check from a person who can assure them that they are getting market terms and a sound deal.

In the coming years, it will be important for finance, legal and compliance professionals to proactively embrace AI tools to better position their respective clients and customers in negotiations on market terms. Market participants from asset managers to law firms may develop (or continue to develop) internal AI tools to ensure that terms are consistent across deals and to get a handle on trends and deviations from any then-current internal or external mandates. Finally, as fund managers, investors and lenders in the fund finance space consider their service providers, they should ask questions both about the capabilities of any AI tools that may be used in negotiations on their behalf, and the expected use of their data going forward.

Corinne C. Musa is a partner at Akin. Corinne's practice focuses on borrowers and alternative lenders in all aspects of fund financing transactions, with a specific focus on subscription credit facilities, net asset value (NAV) and hybrid credit facilities. She also regularly represents clients on management fee and GP lines of credit and other financings throughout an investment fund's structure.

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