Law360

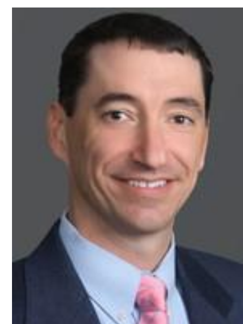
Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Partner Loan Programs And Why They Are Becoming Popular

Law360, New York (April 6, 2017, 1:32 PM EDT) -- As the fund finance market continues to mature, fund-related product offerings are expanding both in number and in customization, attracting a broader array of private equity and real estate funds and credit providers, and increasing the range of the financing products available to funds and their sponsors beyond the traditional subscription credit facility product.[1] We have seen growing interest among participants in the fund finance market in partner or employee loan programs, often also referred to as a shareholder or sponsor loan program or a co-investment line of credit, depending on the nature and structure of the facility (a “co-investment facility”).

Kristin M. Rylko

Laura K. Rosiecki


Zachary K. Barnett

At the most fundamental level, a co-investment facility is a line of credit extended by a bank or other financial institution (a “lender”) to an individual member, principal or key employee of a fund’s general partner, affiliated management company or sponsor (collectively, a “participant”), the proceeds of which are used by the borrower to make direct or indirect investments in funds managed by their firms or the general partner or management company affiliated with such funds. Co-investment facilities are frequently established on a platform basis, permitting multiple participants to partake in the benefits of a credit line while streamlining the documentation process. In some cases, a co-investment facility is structured with the fund’s general partner, sponsor-affiliated “special limited partner” or management company (collectively, a “sponsor vehicle”) as the borrower, with individual employees and principals acting as guarantors of the facility based upon a predetermined maximum allocation of the overall facility amount. While there are a number of similarities between a co-investment facility extended to a general partner or management company and what is commonly known as a management fee credit facility,[2] this article will focus primarily on facilities extended to or for the benefit of individuals affiliated with a fund as part of a broader loan program.

When security is taken, the basic collateral package for a co-investment facility

typically consists of a pledge by the participant of its limited partnership interest in the fund or the relevant sponsor vehicle, including the right to receive distributions from the underlying fund or sponsor vehicle, as applicable. In the case of a sponsor vehicle borrower, the collateral, when required, is often comprised of a pledge of any limited partnership interest the sponsor vehicle holds in the fund, the sponsor vehicle's right to receive distributions from the fund, any management or other fees payable to such sponsor vehicle under the fund's limited partnership agreement (the "partnership agreement"), and potentially any right to receive carried interest payments, as applicable. In either structure, the security package usually also includes a pledge over the deposit account into which fund distributions and other relevant payments are made (a "collateral account"). A control agreement among the borrower, the lender and the depository bank would be needed to perfect the lender's security over the collateral account. In some cases, a co-investment facility is secured only by the collateral account into which fund partnership interest distributions or other payments are required to be made, without a security interest being granted in any partnership interest or other contractual rights held by the borrower. We have also seen co-investment facilities completed on an unsecured basis. In such a situation, additional credit support in the form of guarantees from the sponsor vehicle or individual principal or employee participants, as applicable, may be delivered. A negative pledge over each participant's or sponsor vehicle's partnership interest in the fund or other relevant assets is frequently required in unsecured facilities to give the lender comfort that other creditors will not have a competing secured priority interest over such assets.

In addition, the lender may also require a pledge of a common restricted cash account into which co-investment facility loan proceeds are funded with respect to all individual participant borrowers participating in a loan program (a "common restricted account"). It is customary for such a restricted account to be established nominally in the name of the fund or relevant sponsor vehicle, and gives the lender additional comfort that loan proceeds will be deployed directly by the participant or fund to make investments. Use of a common restricted account also may aid in the administration of a loan program by the sponsor and fund; the fund may withdraw loan proceeds from a single account instead of having to aggregate individual wires from the borrowers to make an investment (similarly, this minimizes the number of wires and advances the lender must send out for a borrowing, which are usually coordinated across participants in the program).

Background and Context

The utility of co-investment facilities in a number of areas makes them increasingly popular. First, a co-investment facility may enhance the ability of participants to invest alongside other investors in a fund, either directly or through a sponsor vehicle, by potentially increasing the amount of capital a participant may commit to a fund (or sponsor vehicle). While for any given employee of a fund or affiliated vehicle the decision to invest in an employer's fund may be discretionary and viewed as an employment benefit, after the economic downturn, sponsors have faced growing pressure by their outside investors to make larger investments in the funds they manage. By leveraging the expected distributions from equity interests held in a fund or other sponsor vehicle, a co-investment facility may permit a sponsor and its affiliated professionals to increase the total amount of capital committed to the fund, thereby helping to satisfy calls from investors that a sponsor have more "skin in the game." This in turn further strengthens

the alignment of the interests between the third-party investors and the fund's principals. Given the positive effect a co-investment facility can have on aligning the interests of the investors and fund management and the recent traction this product has gained in the fund finance market, we suspect that most fund managers would find a co-investment facility beneficial on one or more levels.

Second, a co-investment facility may facilitate the funding by participants of their capital contributions upon a capital demand notice by the general partner of the fund (or the relevant sponsor vehicle) by minimizing or eliminating the need and time for such investors to gather personal funds to honor such a capital call. As mentioned above, the cash proceeds of the loan(s) under a co-investment facility are typically deposited into a segregated common restricted account held by the relevant sponsor vehicle or fund, thus avoiding the need for individual participant borrowers to transfer loan proceeds from their own account to the fund or sponsor vehicle. This permits the fund or applicable sponsor vehicle to more expeditiously deploy capital and avoid having to monitor separate wires from individual affiliated Investors, while also providing additional certainty that a capital call will be satisfied.

Finally, from the perspective of a lender, advancing a co-investment facility may allow a lender to deepen its relationship with a sponsor and better position itself to meet other financing needs of the fund and its affiliated entities. A better understanding of the sponsor's structure and business may in turn lead to opportunities for a co-investment facility lender to provide other financing services, such as portfolio-company-level financings, after-care facilities as the fund approaches and surpasses its investment period, and potentially private wealth management services for the sponsor's principals and employees. A lender willing to provide a co-investment facility to a sponsor may have a competitive advantage in winning subscription facility business over other lenders that are not able to provide liquidity at the top of the fund's capital structure. These ancillary benefits are, of course, in addition to the fees and interest income a lender would earn in providing a co-investment facility.

Structure and Loan Documentation

Co-investment facilities can be structured as term loans or revolving lines of credit and, consistently in our experience, carry an interest rate higher than prevailing rates for a traditional subscription facility. Such facilities may be extended to the participants themselves or to a management company or other sponsor-affiliated vehicle through which the participants will invest. The maximum available amount of a co-investment facility is principally based on a credit assessment of each participant and the quality of the collateral, if required.

The basic loan documentation for a secured co-investment facility will often include the following:

(a) a loan agreement that contains all of the terms of the loan, borrowing mechanics, conditions precedent, representations, warranties and covenants, events of default and miscellaneous provisions typically found in a commercial loan agreement;

(b) a promissory note;

(c) a pledge or security agreement pursuant to which an individual participant borrower assigns its rights with respect to its limited partnership interest in the fund or relevant sponsor vehicle (or in the case of a sponsor vehicle borrower, any limited partnership interest the sponsor vehicle holds in the fund and potential rights to receive management fees and carried interest payments);

(d) a pledge over the collateral account into which distributions and other payments on account of the assets described in clause (c) are to be paid;

(e) a pledge over the common restricted account, if relevant to the particular borrowing structure being employed;

(f) guarantees from individual employees or principals if the borrower is a sponsor vehicle (or in the case of participant borrower(s), a guarantee from the relevant sponsor vehicle);

(g) account control agreement(s) over the collateral account and any common restricted account to perfect the lender's security interest therein and permit the lender to block withdrawals from such account(s);

(h) Uniform Commercial Code financing statements filed in respect of Article 9 collateral against the applicable debtors; and

(i) other customary deliverables, such as an officer's certificate certifying as to the relevant organizational documents, resolutions and incumbency signatures, opinion letters and other diligence deliverables, as appropriate.

In underwriting and advancing a co-investment facility, a lender may also require a more robust document package including one or more of the following: (1) personal financial statements from the participants detailing such individual's financial condition, copies of bank and brokerage statements and tax returns (which materials may be required to be delivered on an ongoing periodic basis); (2) a letter agreement executed by the participant and the fund or management company certifying as to the individual borrower's employment data; and (3) if required under the partnership agreement of the fund or other relevant formation documentation of the sponsor vehicle, a consent to the pledge by the participant (or sponsor vehicle) of its rights with respect to its partnership interest in the fund or other sponsor vehicle from the general partner or other relevant entity, and potentially a consent from other investors in the fund if required by the partnership agreement.

In addition to the loan and other documentation described above, as additional credit support, lenders may require one or more guarantees in connection with a co-investment facility. Where individual participants are the borrowers, the lender may require a guarantee by the management company or other sponsor-affiliated entity of all outstanding amounts under the co-investment facility. Where a sponsor vehicle is the borrower, the lender will often require the individual principals to guarantee up to a predetermined specified percentage of the obligations of the sponsor vehicle under the co-investment facility. In addition, a co-investment facility lender may require that a minimum balance (typically

determined as a percentage of the outstanding loans) be maintained in the collateral account or common restricted account to cover a portion of the outstanding loan balance. Some lenders require that draws on the co-investment facility be used to fund only a specified percentage of the participant's or sponsor vehicle's capital contributions as a way of promoting the borrower's "skin in the game" and ensuring that the borrower's investment is not fully leveraged.

Other key terms that may be included in co-investment facilities are minimum net asset value tests with respect to the relevant fund or sponsor vehicle or financial covenants specifying that the net asset value not decrease by a specified percentage year over year. In situations where the lender is primarily looking to distributions from the fund or sponsor vehicle as a source of repayment, the co-investment facility may include a mandatory prepayment provision, whereby a specified percentage (often between 50 percent and 100 percent) of the proceeds of all distributions, payments and fees paid to the borrower (net of any applicable taxes) must be applied to repay the loan. Co-investment facilities usually include cross-defaults to other material debt of the individual borrowers and often to any subscription credit facility to which any related fund may be a party. Ultimately, the structure and terms of a co-investment facility will be bespoke and contingent upon the fund's structure, underlying formation documentation, financing needs, and the credit quality of the relevant debtors.

Diligence Matters

As with most fund finance products, a lender must carefully review the partnership agreement and other constituent documents to understand how and when payments or distributions with respect to any proposed collateral or loan repayment sources are made, and to assess any attendant risks related to such collateral or sources of payment. The fund's constituent documents should also be reviewed for any limitations on the right of the participant or sponsor vehicle, as applicable, to pledge its limited partnership interest in a fund or right to receive management fees or other payments if such assets are intended collateral.

For example, it is not unusual for a partnership agreement to prohibit a limited partner from pledging its interest in the fund to a lender without first obtaining consent from a specified percentage of investors and/or the general partner. Such a restriction would be relevant if the lender expects to take a security interest in such assets. As noted above, however, we have seen co-investment facilities completed without limited partnership interests as collateral, with credit support instead being provided in the form of any of a guarantee, pledge of collateral account and/or common restricted account, negative pledge over partnership interest rights or minimum balance requirements, for example. In addition, to the extent the fund has entered into a subscription credit facility or other debt obligations, consideration should be given to whether any pledge or other restriction contemplated by the co-investment facility could run afoul of covenants in such other debt instruments. Finally, as with most credit products, a lender will want to assess the general economic and investment environment relevant to the fund's business to stress-test the basic underwriting assumptions used in structuring and pricing a co-investment facility.

Conclusion

As the traditional subscription facility market becomes ever more competitive, lenders that can offer a sponsor additional value-add financing products at different levels of the capital structure may be better able to differentiate themselves in an increasingly crowded market. Co-investment facilities may provide an opportunity for a lender to expand its lending relationship with a sponsor while enabling a sponsor and its principals to have more "skin in the game." With ample legal and credit due diligence and careful structuring, lenders may be able to arrange a co-investment facility to provide additional liquidity at the top of the fund's capital structure in a way benefiting both the lender and the fund.

—By Kristin M. Rylko, Laura K. Rosiecki, Zachary K. Barnett and Mark C. Dempsey, Mayer Brown LLP

Kristin Rylko is a Chicago-based partner and Laura Rosiecki is a New York-based counsel in Mayer Brown's banking and finance practice.

Zachary Barnett is a finance partner in Mayer Brown's Chicago office. He is also the co-head of the firm's global lending practice and the global head of the firm's fund finance practice.

Mark Dempsey, based in Chicago, is a counsel in the firm's banking and finance and fund formation and investment management practices.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] A subscription credit facility, also known as a capital call facility, is a loan made by a bank or other credit institution to a private equity fund, for which the collateral package is the unfunded commitments of the limited partners in the fund (the "investors") to make capital contributions when called by the fund's general partner (as opposed to the underlying investment assets of the fund). For an in-depth analysis of certain alternative fund financing products, please see Mayer Brown's Fund Finance Market Legal Updates "Structuring a Subscription Credit Facility for Open-Ended Funds," "Separate Accounts vs. Commingled Funds: Similarities and Differences in the Context of Credit Facilities," and "Net Asset Value Credit Facilities."

[2] Please see Mayer Brown's article "Management Fee Credit Facilities" available at https://www.mayerbrown.com/Management-Fee-Credit-Facilities-Winter-2014/ for further discussion and analysis of the management fee facility product and key issues when lending against management fee payment streams.

All Content © 2003-2017, Portfolio Media, Inc.