Forms of Credit Support in Fund Finance

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In the fund finance market, there are a wide array of financing structures that are utilized by private investment funds ("Funds") to improve liquidity and/or obtain leverage and a variety of collateral and credit support packages that lenders rely upon for repayment.[2]

While the fund finance market has unique characteristics when compared to other types of corporate borrowers, the types of credit support used by Funds and lenders have much in common with traditional lending facilities and rely heavily on tried and true lending instruments. This article will examine three types of credit support commonly used in the fund finance market: (i) the unfunded equity capital commitments of limited partners of a Fund ("Capital Commitments"), (ii) a guaranty ("Guaranty") and (iii) an equity commitment letter ("ECL"). Each of these forms of credit support are broadly accepted cornerstones of fund finance that provide a suitable and reliable means by which a Fund can access debt while providing a lender with an enhanced credit profile in any transaction.

Capital Commitments

Perhaps the most well-known type of credit support in the fund finance market is the unfunded Capital Commitments of third-party investors in a Fund. Under a subscription-backed credit facility or a capital call facility ("Subscription Facility"), a Fund and its general partner pledge (a) the rights to the unfunded Capital Commitments of the limited partners, (b) the right of the general partner of the Fund to make a call ("Capital Call") upon the unfunded Capital Commitments of the limited partners after an event of default and to enforce the payment thereof pursuant to the terms of the partnership agreement, and (c) the account into which the limited partners fund capital contributions in response to a Capital Call, in each case in order to secure the obligations of the Fund owing to a lender.[3] Upon a default by the Fund under the Subscription Facility, a lender may enforce the right of the general partner of the Fund to make a Capital Call upon the unfunded Capital Commitments of the limited partners and require the payment of capital contributions pursuant to the terms of the partnership agreement. As contrasted with other types of credit support, such as a Guaranty, the obligation of the limited partners to honor their Capital Commitments and make capital contributions in response to a Capital Call will run directly in favor of the Fund as opposed to the lender.

Capital Commitments, however, do not necessarily need to be pledged as collateral in support of repayment obligations and can be used as credit support in facilities that are not a standard Subscription Facility. For instance, in connection with a Fund level credit facility that is secured by all or a portion of the Fund's underlying investment portfolio, the collateral pledged by the Fund may consist of deposit or

securities accounts or the equity shares held by the Fund in a portfolio company and various rights relating thereto. For these types of facilities, the unfunded Capital Commitments may be viewed by a lender as a potential source of repayment rather than as a direct part of the collateral. To support this view, the loan documents for such a facility may include representations, warranties and covenants related to the amount of unfunded Capital Commitments that must be maintained by the Fund for the duration of the facility, with the expectation that if the underlying assets of the Fund are insufficient to repay the facility, there is another liquid and substantive source of repayment that the Fund may rely upon. This type of credit support may provide the Fund with needed flexibility to avoid placing a lien on the Capital Commitments, which may in fact be prohibited under the terms of the partnership agreement, while allowing a lender to rely on the Fund's access to the Capital Commitments as a potential source of repayment. Using Capital Commitments as credit enhancement may provide a Fund with significant debt opportunities while at the same time bolstering its credit profile in the eyes of a lender.

Guaranties

A second type of credit support commonly used in the fund finance market is a Guaranty. A Guaranty is an agreement by one entity ("Guarantor") in favor of a lender to support the repayment by a principal obligor of its outstanding obligations to such lender in connection with a credit facility. The Guarantor is most commonly a Fund that provides a Guaranty in support of the obligations incurred by one of its subsidiaries or portfolio companies, but a Guaranty may also be provided by a sponsor, a feeder fund or portfolio company, in each case to support repayment by the Fund of its obligations.

Guaranties have wide applications in the fund finance market, and the use of a Guaranty may be preferable in a scenario where a portfolio company incurs debt but does not itself have the ability to call upon the unfunded Capital Commitments of the parent Fund. The Fund may agree to provide a Guaranty in such instance in order to provide the appropriate amount of credit support requested by the lender to support the repayment obligations of the portfolio company. The obligation of the Guarantor to make payments under a Guaranty on behalf of the principal obligor, should it default on its obligations, runs directly in favor of the lender.

There are several types of Guaranties employed in the fund finance market, and they will vary both in scope of the guaranteed obligations and the liability of the Guarantor thereunder. The scope of a "bad-boy" Guaranty, for instance, is typically limited to losses incurred due to certain bad-acts or material misrepresentations made by the general partner of a Fund under a credit facility, but will not be triggered by the Fund's financial ability to make payments to the lender. Payments from the Guarantor under a "bad-boy" Guaranty will only be required if the loss results directly from the bad-act or false misrepresentation specifically covered by the terms of such Guaranty. Whether a Guaranty is a guaranty of payment versus a guaranty of collection is another distinction. A guaranty of payment will typically be an absolute and unconditional Guaranty that permits the lender to seek payment directly from the Guarantor without any obligation to first seek payment from the principal obligor. A guaranty of collection, also known as a conditional guaranty, will require that the lender exhaust its remedies against the principal obligor (including, without limitation, foreclosing on any collateral) prior to seeking payment from the Guarantor. Under New York law, a guaranty of payment

is presumed unless the parties have otherwise explicitly agreed that the Guaranty is a guaranty of collection.[4]

The relationship of the Guarantor to the principal obligor is as important as the substance of the Guaranty itself. Upstream guaranties (i.e., a Guaranty given by a subsidiary of a Fund), cross-stream guaranties (i.e., a Guaranty given by a sister entity or other affiliate of a Fund) or downstream/parent guaranties (i.e., a Guaranty given by a Fund to support a portfolio company) are all potential types of Guaranties that may be employed in the fund finance market. Understanding the nexus between the Guarantor and the principal obligor will allow a lender to assess the validity of a Guaranty and whether the Guarantor has received adequate and fair consideration in exchange for providing the Guaranty. This analysis is fundamental to the enforceability of the Guaranty, is particularly relevant in respect of an upstream or cross-stream Guaranty, and will be necessary to help avoid any fraudulent transfer defenses that other creditors of a Guarantor may invoke if a Guarantor is later deemed insolvent after making a payment under the Guaranty.[5] Experienced legal counsel can assist both Funds and lenders in navigating the specifics of using a Guaranty as credit support.

Equity Commitment Letters

A third commonly used form of credit support in the fund finance market is an ECL. An ECL is an agreement that evidences a commitment to contribute capital or other financial support by one entity (the "ECL Provider") in favor of another entity (the "ECL Recipient") and may be used to demonstrate to a lender that the ECL Recipient has additional resources for the repayment of its obligations under a credit facility.[6] Use of an ECL may be more expedient or efficient in some instances than arranging for other types of credit support and provide a potentially significant credit enhancement. ECLs have broad application in the fund finance market, but the most common scenario for employing an ECL is when a Fund issues an ECL in favor of one of its portfolio companies to support repayment of debt incurred by such portfolio company. A lender may be wary of relying strictly on the performance of a portfolio company for purposes of repayment, and the use of an ECL by a Fund in this instance will provide added comfort to the lender that there are additional sources of repayment available to the portfolio company. There are a variety of applications for an ECL, and the use thereof does not need to be limited to the Fund/portfolio company scenario described here for illustration.

An ECL should be distinguished from other similar arrangements, such as a keepwell agreement, pursuant to which a sponsor may undertake to monitor and safeguard the financial health of a Fund, or a letter of support/comfort letter, the purpose of which is to provide a lender with some assurance that a Fund will be able to meet its obligations to such lender. In the fund finance market, an ECL should be viewed as a commitment by the ECL Provider to contribute capital to the ECL Recipient and stands in contrast to a keepwell agreement or letter of support/comfort letter that are merely statements of intent rather than an actual commitment to undertake financial support. The obligation of the ECL Provider to contribute capital under and pursuant to the terms of the ECL runs in favor of the ECL Recipient, with only the ECL Recipient having the right to enforce the terms of the ECL. A lender, however, may be specifically designated as a third-party beneficiary under the terms of the ECL, and the rights of the ECL Recipient under and pursuant to the ECL can also be collaterally assigned to a lender under a credit facility.

Each ECL is a bespoke instrument that implements the specific level of credit support required and the conditions under which such credit support will be available. For purposes of the fund finance market, an ECL will also likely include, among other things, waivers of defenses, counterclaims and offset rights (including with respect to those rights arising under the US Bankruptcy Code that may pertain to a bankrupt ECL Recipient) in respect of the ECL Provider's obligation to contribute capital to the ECL Recipient and other suretyship-related defenses that may be available to an ECL Provider under applicable law. Experienced legal counsel can assist both Funds and lenders in tailoring an ECL to achieve the necessary level of credit support while ensuring that it is distinguishable from other types of credit support.

Comparing Capital Commitments, Guaranties and ECLs

While Capital Commitments, Guaranties and ECLs can each be used as credit support in the fund finance market, the nuances specific to each type of credit support will dictate the effectiveness of the applicable credit support when applied to a specific lending arrangement.

As noted above, the use of unfunded Capital Commitments as credit support (as opposed to being pledged to the lender as collateral under a Subscription Facility) will run in favor of the Fund. The lender, by placing parameters around maintaining a certain level of unfunded Capital Commitments, is effectively relying on a liquidity test and ensuring that capital will be available to the Fund in order to repay indebtedness owed the lender. The lender will not have the ability, however, to enforce the payment of the unfunded Capital Commitments when used simply as credit support as opposed to collateral. In contrast, a Guaranty is credit support that runs in favor of the lender and allows the lender to seek payment directly from the Guarantor. With direct recourse to the Guarantor under a Guaranty, a lender will effectively have two sources of repayment – the principal obligor and the Guarantor. An ECL will artificially create two sources of repayment (the ECL Recipient and the ECL Provider), but the ECL will only run directly in favor of the ECL Recipient. The use of a collateral assignment of an ECL, however, will permit the lender to enforce the terms of the ECL on behalf of the ECL Recipient.

Conclusion

The use of Capital Commitments, Guaranties and ECLs are all appropriate ways to provide credit enhancement in the fund finance market and can be utilized effectively in numerous situations. Each of these types of credit support, while tailored to the particular characteristics of fund finance, are not novel to fund finance and are widely accepted forms of credit support in lending generally. Despite the prevalent use of these forms of credit support, the effectiveness of the credit enhancement and the strength of the credit support provided thereby must be determined on a case-by-case basis. The strengths and weaknesses of Capital Commitments, Guaranties and ECLs must be determined by analyzing a variety of factors including the proposed credit structure, the supporting documentation and the specific language included therein. Only after a detailed review can any of these forms of credit support be viewed as the preferred solution in a given financing. When used properly and with the assistance of experienced legal counsel, each method of credit support can provide a creative solution that delivers needed access to debt and liquidity for a Fund and appropriate credit support for a risk-averse lender.

Endnotes

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[2] For a detailed update on current trends and developments in the fund finance market, please see Mayer Brown's *Fund Finance Market Review Spring 2018*.

[3] For a more detailed description of the subscription facility market and features of the subscription-backed credit facility product in general, please see our article *"Subscription Credit Facility Market Review" in Fund Finance Market Review, Fall 2016* at www.mayerbrown.com/Fund-Finance-Market-Review---Fall-2016-09-26-2016/

[4] NY Gen Oblig L § 15-701 (2016).

[5] See *Restatement (Third) of the Law of Suretyship and Guaranty § 9.*

[6] Equity commitment letters are often used in more traditional acquisition financings as evidence that the acquisition vehicle has sufficient funds to complete the acquisition but are equally effective in the fund finance market as a commitment to ensure repayment of the indebtedness incurred by a Fund or one of its portfolio companies.

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