Developing Side Letter Issues

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Introduction

A subscription credit facility (a "Facility") is an extension of credit by a bank, financing company, or other credit institution (each, a "Lender") to a private equity fund (the "Fund"). The defining characteristic of such a Facility is the collateral package securing the Fund's repayment of the Lender's extension of credit, which is composed of the unfunded commitments (the "Capital Commitments") of the limited partners to the Fund (the "Investors") to make capital contributions ("Capital Contributions") when called upon by the Fund's general partner, not the underlying investment assets of the Fund itself.

The documents establishing a Facility contain provisions extending credit to the Fund and securing the related rights of the Lender. Additional documentation governs Investors' rights and obligations to the Fund as they relate to the Facility. Specifically, Investors' rights and obligations largely arise under the Fund's limited partnership agreements and Investors' subscription agreements. However, individual Investors also frequently negotiate and enter into a letter agreement with the Fund ("Side Letters"), separate and apart from other Investors, which interprets, supplements, and alters the terms of that Investor's rights, duties, and obligations under the related limited partnership agreement or subscription agreement. Side Letters can and do have a significant impact on Facilities.

Traditionally, Side Letters have been used to address unique economic issues between Funds and their Investors (e.g., family and friends or late-closing investors) and/or issues specific to particular Investors (e.g., governmentally regulated investors). That tradition has matured with the Facility market and, as such, the frequency, sophistication and size of Side Letters have grown dramatically. With that growth, issues arising in Side Letters have continued to develop, each of which holds significance for Funds, Lenders, and Investors. As discussed in greater detail below, Side Letters can impact every aspect of a Facility, including its very existence. Nevertheless, with prior review by experienced legal counsel, nearly every issue discussed in this article arising in Side Letters can be effectively mitigated or resolved.

To that end, we recommend that Funds disclose all Side Letters to their Lenders as part of the Lenders' due diligence review of the Investors' documents while negotiating a Facility. It has been our experience that such a review is most constructive when begun prior to the execution of any Side Letter. During such initial review, Lenders have the opportunity to identify, analyze, and resolve any potential issue with the Fund, a scenario far preferable to renegotiating finalized Side Letters with Investors based upon Lenders' subsequent review and comment.

In this article we discuss a number of developing issues in Side Letters and their potential impact[1] on Funds and their Lenders, including (1) placement agent regulations; (2) investor documents and deliverables; (3) transfers; (4) sovereign immunity; (5) excuses; and (6) overcall and concentration limits.

Placement Agent Regulations

In response to investigations into alleged corrupt practices involving the use of placement agents in connection with public pension funds, retirement systems, and other government fund entities (collectively, "Government Investors"), a growing number of governmental authorities have taken measures to restrict the use of placement agents and curb so-called "pay-to-play" abuses.[2] A number of the resulting rules regulate the investment activities of Government Investors by banning the use of placement agents, registered lobbyists, and other intermediaries (collectively, "Placement Agents") in obtaining investments by Government Investors. A common manifestation of such regulations requires a Fund to represent and warrant to a Government Investor that it did not use a Placement Agent to obtain such Government Investor's investment and that no benefit was paid or promised to the Government Investor's employees, affiliates, or advisors to obtain its investment. While the severity of a breach of Placement Agent regulations varies from jurisdiction to jurisdiction, the strictest form of remedy provides a Government Investor the unilateral right to cease making Capital Contributions to the Fund or to withdraw from the Fund altogether.

Although many Funds may be comfortable making such representations, both Lenders and Funds should be apprehensive of the consequences of potential breaches for several reasons. First, the ability of a Government Investor to unilaterally withdraw from a Fund based on its determination of the Fund's compliance with policy or applicable law is at odds with the underwriting standards applied by Lenders when entering a Facility. Typically, such underwriting decisions are based on an analysis of Investors' creditworthiness without accounting for the consequences of a breached Placement Agent regulation. Second, the failure of an Investor to honor a capital call is virtually always an "exclusion event" under a Facility, which could result in the removal of such Investors from the Facility borrowing base and trigger a mandatory prepayment by the Fund.

We have seen Funds and Lenders take precautions to mitigate the impact of Placement Agent regulations in Government Investors' Side Letters. For instance, in Side Letters allowing an Investor to cease making Capital Contributions if a Placement Agent regulation is breached, Lenders may include language making clear that the termination of an Investor's obligation to fund further Capital Contributions does not apply to liabilities relating to, and Capital Contributions called in respect of, indebtedness of the Fund incurred prior to the Government Investor's withdrawal or cessation of Capital Contributions. In other instances, we have seen Funds make conforming representations and warranties to their Lenders that provide the Lenders with recourse to the Fund in the event that the Fund breaches its Placement Agent-related representations and warranties to its Government Investors. Alternatively, a Lender and Fund may agree that the Lender will advance a lower rate under a Facility against the Capital Commitments of Government Investors subject to Placement Agent regulations in recognition of the additional risk undertaken.

Investor Documents and Deliverables

Because Lenders are not party to a Fund's limited partnership agreement and subscription agreements, Lenders may require Funds to deliver additional documentation from each Investor acknowledging, representing, and covenanting to certain undertakings related to the Facility for the Lenders' benefit. For instance, we are familiar with requests from Lenders to Funds for financial

statements, annual reports, investor letters, and investor opinions, among other documents and deliverables, with respect to the Fund's Investors. Many Investors, however, have used Side Letters to resist such obligations to deliver additional documentation. Such limitations are of consequence to both Lenders and Funds because they can impact a Lender's willingness to extend credit in a Facility based on the Investor's unfunded Capital Commitment. As a result, Funds may find that their anticipated borrowing base and credit availability under a Facility is unexpectedly diminished should such deliverable carve-outs remain in their Side Letters.

While the consequence of a problematic limitation in an Investor's Side Letter on its obligation to deliver investor documents can be drastic, the remedies for such situations are readily attainable. For example, in lieu of actually delivering additional documentation, Funds may incorporate the substance of such items, including the relevant acknowledgements, representations, and covenants, in the Fund's limited partnership agreement. Such streamlining efforts can address both Lenders' desire for additional comfort from Investors and Investors' hesitation at providing additional documentation and deliverables.

Transfers

One of the structural issues addressed in a Fund's formation documents is an Investor's right to transfer its interest in the Fund. In negotiating that issue, competing interests exist. On one hand, Investors prefer that their interest in a Fund be unfettered and fluid in order to facilitate any desirable or necessary transfer. On the other hand, Funds and Lenders prefer consistency among the Fund's Investors and Lenders may be reluctant to extend credit based on the Capital Commitments of a subsequent Investor who is unfamiliar to the Lender. The preferred mechanics of achieving that consistency vary among Lenders. Some Lenders prefer that transfers of an Investor's interest in the Fund be subject to the preapproval of the Fund's general partner. Other Lenders, however, prefer that they themselves retain pre-approval and consent rights. In either case, Lenders may require a prepayment of the transferring Investor's Capital Commitment prior to such transfer.

The impact of an unrestricted transfer of Investors' interests in the Fund, while delayed, can nevertheless be severe. For example, although an Investor may retain its entire interest in a Fund for the majority of the Fund's existence, a transfer of that interest months or years after a Facility is in place can trigger a borrowing base deficiency, requiring the Fund to make sizeable repayments. In light of those lurking consequences, Lenders and Funds are well-served to be mindful of provisions in Side Letters addressing Investors' right to transfer their interests. To prevent the potential negative consequences of a transfer, Investors typically agree in a Side Letter to give their Fund the right to pre-approve any transfer of the Investor's interest in the Fund and, in turn, Funds agree not to unreasonably withhold such approval.

Sovereign Immunity

In addition to Government Investors, sovereign wealth funds and various other instrumentalities of foreign and domestic governments may become Investors in Funds. Such Investors often possess certain sovereign immunity rights that protect them against enforcement proceedings, which in their broadest form, shield the Investor from all liability, including a Lender's attempt to collect Capital Commitments contractually due and payable under a Facility.[3] For that reason, Lenders evaluating the creditworthiness of an Investor's Capital Commitment are well-served to analyze the effect of any applicable sovereign immunity rights.

To the extent that such analysis becomes problematic, Funds can address the potential complications arising from the Investor's sovereign immunity rights in a Side Letter.

An Investor's sovereign immunity rights are commonly addressed in a Side Letter through two mechanics. First, Funds begin by expressly acknowledging that the Investor retains all of the rights inherent in sovereign immunity. Then, however, the Investor agrees to limiting language making clear that the Investor's sovereign immunity rights do not relieve it of its obligations under the relevant partnership agreement, subscription agreement, and other fund documents. The cumulative effect of those maneuvers is to acknowledge both the Investor's sovereign immunity rights and its obligation to make Capital Contributions when called upon by the Fund.

Excuses

To meet their ongoing fundraising desires, Funds are turning to certain non-traditional Investors that may have unique investment constraints. Such non-traditional Investors may bring cultural, religious, and/or jurisdictional investment preferences to a Fund that prevent the Fund from using the Investor's Capital Contributions to fund certain investments. Frequent examples of such preferences include prohibitions on investing in gambling facilities, tobacco or alcohol products, and the like. To balance their desire to expand their sources of capital to non-traditional Investors with such Investors' investment preferences, Funds have often provided "excuse rights" to such Investors.

Excuse rights permit, under certain circumstances, an Investor to elect not to fund a capital call relating to a particular investment that conflicts with the Investor's investment preferences. In such an arrangement, an Investor who is excused from funding a capital call often cannot be relied upon to fund the repayment of an extension of credit under a Facility used by a Fund to acquire an excused investment. The implication for Lenders of such excuse rights is that their collateral under a Facility may be diminished based solely on the investment preferences of an Investor. To mitigate that potential consequence, Funds should clearly designate how a legitimately excused Investor's unfunded Capital Commitment will be treated after such an excuse is made. Such a designation is appropriately made in connection with the documentation of excuse rights in an Investor's Side Letter.

Overcall and Concentration Limits

As the Facility market has expanded into the buyout and private equity industries, Lenders have more frequently encountered overcall and concentration limitations. Overcall limitations constrain the ability of the Fund to call capital from its Investors to cover shortfalls created by other Investors' failure to fund their Capital Commitments when called.[4] Similarly, concentration limitations may restrict the percentage that a single Investor's Capital Commitment and/or Capital Contributions may comprise of a Fund's aggregate Capital Commitments and/or Capital Contributions. For instance, an Investor may require that its Capital Commitment not represent more than 20% of a Fund's aggregate Capital Commitments.

From the Lenders' perspective, overcall and concentration limitations fundamentally conflict with their expectation that Investors in a Facility are jointly and severally obligated to fund capital calls up to each Investor's respective Capital Commitment. The effect of such limitations upon Lenders is clear: they may not be able to rely on the support of the entire pool of Capital Commitments for repayment of any extension of credit under a Facility if the Fund's Investors have successfully negotiated overcall or concentration limitations. Not surprisingly, Lenders generally take a negative view of the credit implications of such limitations.

While overcall and concentration limitations are still relatively rare in Funds' formation documents, they require Lenders to evaluate not just the entire borrowing base of a Facility, but also the Fund and Investors themselves in order to adequately analyze the risk of Investor default. Fortunately, as rare as overcall and concentration limitations are, Investor defaults have been even more infrequent in the Facility market. That said, whenever possible, Funds should narrowly tailor overcall and concentration limitations to carve out Facility-related items, including the obligation to fund capital calls related to indebtedness incurred under a Facility.

Conclusion

This article highlighted certain issues that Lenders and Funds should consider when reviewing and/or negotiating Side Letters in connection with a Facility. For more information about those issues and the various options for effectively resolving them, please contact the authors of this article. ◆

Endnotes

1 We note that each issue discussed in this article should be considered within the context of a most-favored nation provision as discussed in our MFN article on page 18 of this *Winter 2015 Fund Finance Market Review*.

2 For a discussion of certain of these restrictions, see our Legal Update dated October 28, 2010 "California Imposes Lobbyist Registration Requirement and Contingency Compensation Prohibition on Certain Placement Agents," available at http://www.mayerbrown.com/publications/california-imposes-lobbyist-registration-requirement-and-contingency-compensation-prohibition-on-certain-placement-agents-10-28-2010/; see also our Legal Update dated July 29, 2010 "SEC Adopts Advisers Act Pay-to-Play Rule Relating to Government Plans", available at http://www.mayerbrown.com/publications/sec-adopts-advisers-act-pay-to-play-rule-relating-to-government-plans-07-29-2010/; see also our Government Relations Update dated April 28, 2009 "New York State Comptroller Bans Placement Agents, Paid Intermediaries and Lobbyists in Investments with Common Retirement Fund," available at http://www.mayerbrown.com/publications/new-york-state-comptroller-bans-placement-agents-paid-intermediaries-and-lobbyists-in-investments-with-the-common-retirement-fund-04-28-2009/.

3 For a more thorough explanation of the historical basis of sovereign immunity and the related implications for Funds and Lenders in a Facility, see our Legal Update "Sovereign Immunity Analysis in Subscription Credit Facilities" dated November 27, 2012, available at http://www.mayerbrown.com/Sovereign-Immunity-Analysis-in-Subscription-Credit-Facilities-11-15-2012/.

4 A more fulsome examination of the several varieties of overcall limitations and their unique implications on Facilities is beyond the scope of this Legal Update. For further treatment of the subject, see our Legal Update "Subscription Facilities: Analyzing Overcall Limitations Linked to Fund Concentration Limits" dated June 29, 2013, available at http://www.mayerbrown.com/Subscription-Facilities-Analyzing-Overcall-Limitations-Linked-to-Fund-Concentration-Limits-07-29-2013/.