Lending to Private Equity Funds

by Vince Paparo, Joseph Choi and Susan Aufiero

The private equity market has experienced an influx of investors of all types, including large institutions, employee benefit plans, tax-exempt organizations and individuals. As a result, private equity funds have increased dramatically over the past several years. In 2005, the industry experienced a record inflow estimated at $86 billion, compared with $52 billion in 2004, according to National Venture Capital Association. This growth has also created financing needs and opportunities. Lenders willing to provide aggressive financing to support the capital investments of private equity funds has boosted lending levels across the board and, in particular, to funds commonly referred to as “institutional buyers”[1]. This article focuses on some of the legal and structural considerations lenders are likely to encounter when providing such financing. It also highlights certain legal issues addressed in recent litigation.

The purpose and structure

Private equity funds typically seek debt financing in order to increase liquidity for their investment activities and general working-capital purposes. By providing ready cash, third-party financing allows the fund to avoid missed opportunities due to unavoidable delays caused by capital call-notice provisions (contained in all partnership agreements). Financing is generally provided in the form of a revolving line of credit facility, the principal amount of which corresponds directly to the unpaid amount of capital commitments of the investors. In addition, a secured lender may limit borrowing further by conditioning advances on a borrowing base supported by the capital commitments of only those investors that meet certain eligibility/credit requirements, i.e., qualified investors.

As a general matter, financing is usually obtained after the initial subscription period is closed. Private equity funds generally have a fixed ramp-up period between six months to one year, which begins with the admission of its initial investors and closes to new investors thereafter. Lenders provide upfront financing during such period to only certain funds in order to permit a fund to commence making its investments before being fully subscribed. Such funds or their affiliates will have existing relationships with a lender where the lender may be willing to provide financing in order to permit the fund to attract and admit new investors.

(Continued on page 16)

In structuring the financing for a private equity fund, consideration should be given to (i) the number of investors and their capital commitments, (ii) the types of investments the fund will pursue and (iii) the total amount of capital commitments/investors the fund plans or is able to obtain. Lenders willing to provide upfront financing to a fund will typically also review the fund's or its affiliates' historical operations. Nonetheless, the lender will generally limit such financing to a percentage of the capital commitments of the investors in place, but may include a mechanism for the fund to increase the maximum principal amount of the financing based upon the admission of additional creditworthy investors. The fund will then have reached its maximum size and the parties will enter into a permanent facility in order to finalize the financing structure and terms thereof.

Unsecured versus secured
Prior to the issuance of the loan commitment, the lender will review the various components of the fund and its investors in order to determine, among other things, the terms and conditions upon which it and/or a syndicate of lenders would proceed with the financing.

Unsecured: Unsecured financing is generally available to a fund that (i) is deemed creditworthy by virtue of its past performance and its investors, (ii) is managed by a fund manager whose reputation with the lender is favorable and (iii) together with its affiliates, has an existing long-term relationship with the lender. The unsecured lender will therefore rely upon the enforceability of the partnership agreement and the fund manager's right therein to call the capital commitments of the fund's investors in order to repay the loan either upon maturity or an event of default. Since the lender typically only obtains an undertaking from the fund manager, the unsecured lender is well advised to carefully monitor the unpaid capital commitments versus the lender's outstanding loans and the continuing creditworthiness of the investors. In addition, the fund's performance should be monitored as well, since performance by the fund directly correlates with an investor's willingness to fund his capital commitments, notwithstanding its potential default under the partnership agreement.

The pricing for unsecured facilities will typically be higher than secured facilities due to the greater risk, more liberal credit standards and the lender's increased administrative expenses. Higher interest rates are naturally found where less risk or recourse liability has been imposed on the investors.[2] Because the fund endures less scrutiny, the creditworthiness and type of investors also affect the pricing. Finally, higher pricing is sought by the lender due to the expenses associated with additional risks of nonpayment by the investors. The unsecured lender may also be required to seek equitable remedies against investors directly with whom no privity exists, but are the ultimate source of repayment.

Secured: Secured financing for private equity funds is primarily secured by the fund manager's pledge of its right to call capital from the investors. Directly obligating the investors to acknowledge its obligations to repay such financing strengthens the lender's ability to enforce payment of each investor's capital commitments. Therefore, the secured lender will typically require additional documentation between itself and each investor in order to create and maintain a contractual relationship, thereby creating a paper trail to memorialize each investor's obligations to repay the financing through capital calls directly to the lender. Since lenders look primarily to the unpaid capital commitments of investors as the source for repayment, a lender will generally establish parameters as to eligible investors and undertake due diligence particular to such investor. The secured lender will then generally limit the maximum amount of the facility based upon the creditworthiness of not only the fund, but on those investors which have provided such documentation. In such case, the secured lender imposes an eligibility requirement tied to the investors that will limit the availability under the facility based upon the investors which meet such requirements. Although this may initially appear to be an administrative quagmire, lenders should take comfort that pursuing such a secured lending structure reduces administrative difficulties with a large number of investors and their respective counsel in the future and when pursuing remedies. Typically, lenders that provide secured financing to private equity funds will encounter the same investors or affiliates of such investor in a number of funds, as these types of larger investors often seek a number of funds in which to invest. As the lender encounters these investors through various financings, the negotiation of documentation is eliminated, and the transaction costs will reduce. In any event, the lender will likely benefit from such

efforts in a default situation, notwithstanding the costs and difficulty of initially negotiating and documenting a secured facility.

Security interest consideration

The collateral for a secured facility generally consists of pledges by (I) the fund manager of its right to call the capital commitments of the investors, and (ii) the fund and its manager of the fund's deposit account (into which all investors are required to fund their capital commitments). In both cases, the lender will require the fund and its manager to execute a security agreement perfecting the lender's security interest in the collateral with rights arising upon an event of default, in addition to certain other rights that the lender may require. The right to call capital commitments would qualify as a payment intangible or general intangible in which a security interest is perfected upon the filing of a financing statement pursuant to revised Article 9 of the Uniform Commercial Code (UCC Article 9)[3] . Perfection of the security interest in the deposit account will typically require the filing of a financing statement, unless the lender is a bank and such deposit account is held within such bank. Accordingly, the lender and its counsel should review the requirements of perfecting its security interest in such deposit account under UCC Article 9[4] . Furthermore, lenders should ensure that the obligations of the fund manager extend to successors and assigns to discourage investors from seeking to replace the bound fund manager in an attempt to avoid liability to the lenders.

In order to enhance the lender's right to enforce payment of the capital commitments, documentation between each eligible investor and the lender should be strongly considered as a supplement to the subscription agreement, partnership agreement or other agreement that the investor would execute upon entering into the fund. Security documentation may be sought, providing for either the capital commitments of the investors to be concentrated in a deposit account controlled by the lender[5] , and/or a lien against the investor's interest in the fund[6] . Such documentation from each eligible investor will generally be in the form of an agreement whereby the investor (i) acknowledges the credit facility, (ii) confirms its unconditional requirement to fund the capital commitment, (iii) acknowledges the lender's security interest and rights with respect to such capital commitment, and (iv) agrees to fund its capital commitments into a specific pledged deposit account in the name of the fund.

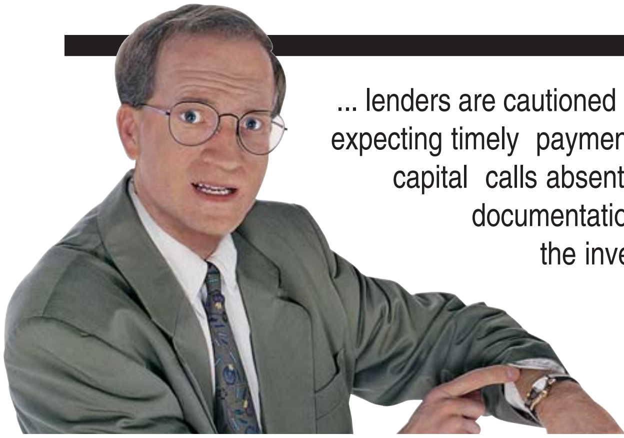
As discussed below, the potential for investors to contest liability would suggest that the above documentation is essential. Enforcement issues may occur with certain investors who use various methods to resist payment and/or performance of their capital commitment. Lenders should be aware of investors that are subject to government regulations which restrict their investment activities, e.g., employee benefit plans, tax-exempt organizations and other foreign entities. Such regulations may render worthless the fund manager's, and therefore the lender's, right to enforce payment of those investors' capital commitments. The permitted activities of the fund must be reviewed carefully and the appropriate safeguards incorporated into the underlying loan documents when obligating (directly or indirectly) certain regulated investors. Furthermore, lenders should ensure that the investors' obligations extend to their respective successors and assigns, as well as distinct future investors in the fund, to discourage recalcitrant activity of investors attempting to avoid liability to the lenders.

Case study: How not to do it!

A certain private equity fund (ABC Fund) manager executed an unsecured revolving credit agreement with a lender evidencing a $100 million loan. Although not directly obligated on the credit agreement, the investors were expected by the lender and the fund manager to cure a payment default and, if necessary, repay the obligations with their capital commitments.

The investors of ABC Fund consisted of over 50 individuals and businesses, each of whom executed a subscription agreement. Under the subscription agreements, each investor agreed to be bound by the Third Amended and Restated Limited Partnership Agreement of ABC Funds (the Partnership Agreement). The Partnership

(Continued on page 20)



... lenders are cautioned about expecting timely payment from capital calls absent direct documentation with the investors.

Agreement (in part) provided for initial capital contributions of the investors' capital commitments, and additional capital contributions to ABC Fund when the fund manager so specified in written notices or drawdown notices to the extent of the investors' capital commitments. The Partnership Agreement, however, proscribed any obligation of the investors directly to creditors[7] .

The investors were advised by the fund manager of loan negotiations with prospective lenders and that capital contributions of the investors would be available to repay the loan followed by the extension of the subject loan. When the loan was closed, the fund manager delivered an "undertaking" as a condition precedent to closing. Pursuant to the undertaking, the fund manager promised to issue drawdown notices to the investors, if necessary, to cure a

Vincenzo Paparo is a partner in the Corporate Department and co-chair of the Finance Group of Proskauer Rose LLP, New York, NY.

payment default (up to the unfunded balance of the investors' commitments). At the time of the closing, the investors did not participate in the negotiation of the loan nor were they parties to the underlying credit agreement or any ancillary documents.

After ABC Fund defaulted on the credit agreement, the lender demanded that the fund manager issue a capital call on the investors (pursuant to the undertaking). The investors refused to satisfy the capital call. Instead, before its due date, the investors executed written consents

Joseph Choi is an associate in the Finance Group of Proskauer Rose, LLP, New York, NY.

removing the fund manager that delivered the drawdown notices for the capital call and appointing a successor fund manager. The investors further amended the partnership agreement in several other significant ways to attempt to evade liability for the obligations. Following further actions to nullify future capital calls, ABC Fund filed for bankruptcy protection. As you would anticipate, the lender found itself not only holding a significant unsecured claim against ABC Fund's bankruptcy estate, but also on weak footing to pursue the solvent investors who were not directly obligated on the loan.

Conclusion

As evidenced by the case study, lenders are cautioned about expecting timely payment from capital calls absent direct documentation with the investors. Credit review of

Susan Aufiero is an associate in the Finance Group of Proskauer Rose, LLP, New York, NY.

the private equity funds and their investors even beyond origination of the credit facilities is a step toward maximizing returns for lenders in these lending opportunities. Security documentation with the investors is, however, also strongly recommended for lenders to pursue, especially from the larger creditworthy investors or where the fund lacks solid investing history. In light of the heavy investing activity in the marketplace, lenders are encouraged to pursue these financing opportunities with an eye toward the previously-described safeguards. ▲

Endnotes

[1] "Creating Liquidity for Call Center Owners", *Technology Marketing Corporation, Customer Interaction Solutions*, Gale Group, Inc. (January 1, 2001), in discussing "Staged Liquidity Transactions" where a private equity fund is brought in to infuse equity and obtain financing to alleviate burdens on entrepreneurs and existing shareholders. The Sept. 11 terrorist attacks also contributed to the growth of these funds by exacerbating a squeeze on public equity capital markets. "Private Capital for Oil, Gas Investments Remains Abundant While Public Markets Sag", *Oil & Gas Journal*, PennWell Publishing Company (December 3, 2001).

[2] "Tax Shelter Syndications—Structuring the Deal", *Real Estate Law and Practice Course Handbook Series*, Practising Law Institute, 270 PLI/Real 407, 418-419 (November 21, 1985).

[3] N.Y. U.C.C. § 9-102 (42), (61); § 9-310.

[4] N.Y. U.C.C. §§ 9-102; 9-109; 9-341; 9-304; 9-104; 9-310; 9-314; 9-312; 9-322; 9-327; 9-607; 9-109; 9-340; 9-332.

[5] N.Y. U.C.C. §9-314.

[6] A lien against the partnership interest is attached by filing of a financing statement or, if certificated, taking possession of the certificate by the lender. *See* N.Y. U.C.C. §9-310; §9-313(a).

[7] "The provisions of this Agreement (including this Article III) are intended solely to benefit the Partners and, to the fullest extent permitted by applicable law, shall not be construed as conferring any benefit upon any creditor of the Partnership (and no such creditor shall be a third party beneficiary of this Agreement), and no Limited Partner shall have any duty or obligation to any creditor of the Partnership to make any Capital Contributions or to cause the General Partner to make a call for Capital Contributions."