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Growth in Fund Finance Market Leads to Increased Financing Options: Focus on Co-Investment Credit Facilities

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The fund finance market has continued to grow at a fast pace in recent years. Increased demand by fund sponsors for fund-related financings has led to a large influx of new lenders. In trying to maintain or gain market share, these lenders are turning to product differentiation to attract clients. In addition to subscription and net asset value (NAV) credit facilities, lenders are increasingly promoting ancillary fund-related credit facilities such as management company credit facilities used for working capital, general partner credit facilities used to meet a general partner's capital commitments and co-investment credit facilities used to facilitate fund investments by the principals and employees of a fund's sponsor, management company or general partner. This article will focus on co-investment credit facilities and is the first in a series of articles on trends in fund finance.

Of the ancillary facilities mentioned above, co-investment credit facilities (also referred to as employee loan programs) have become particularly popular. Where a fund sponsor (the term "sponsor" being used to collectively refer to the sponsor and affiliated entities) offers its principals and employees the opportunity to invest in its funds (directly or as part of the general partner's capital commitment), the sponsor may desire the ability to offer financing to these investors for a portion of their capital contributions. It is often more attractive to the sponsor to arrange for a third party lender to make loans to the sponsor's principals and employees rather than making such loans directly itself. Co-investment credit facilities may be viewed as a perk that is being offered by other sponsors and hence a competitive advantage in attracting and retaining talent. More importantly, they help promote larger investment (or "skin in the game") by the sponsor and its affiliates that is being required by limited partners. From a lender's perspective, co-investment credit facilities provide a means to strengthen the lender's relationship with the fund sponsor and its management, potentially develop ties to high net worth individuals and add an additional revenue source.

Co-investment credit facilities are typically arranged and coordinated by the sponsor, with the sponsor paying the associated set-up costs. While we have seen programs where the loans are initially made to a sponsor vehicle and subsequently loaned to the individual borrowers (who would in turn become guarantors under the facility), the more common approach provides for the lender to make the loans directly to the individuals pursuant to a revolving credit facility. In these cases, the lender will diligence the creditworthiness of the individuals and require specific covenants in the loan documents, such as a minimum net worth test. The loans are usually secured by the individual borrower's interest in the fund or general partner entity and in the distributions received in respect of such interest, together with a pledge of the account into which the distributions are made. However, in some cases, these loans may be unsecured with credit support provided by the sponsor.

The principal negotiated terms of co-investment credit facilities include the advance rate (which is typically around 50% to 75% of the required capital contribution), the required prepayment from distributions (usually in excess of 50%, with exceptions for tax distributions), cross-defaults to other indebtedness and the remedies available to the lender in case of a default by the borrower. With respect to borrower defaults, where the sponsor has not provided credit support for the loan, the sponsor may agree to repurchase the borrower's interest or, in some circumstances, sell the interest to a third party, applying the proceeds to the outstanding loan obligations. Where the lender has the right to foreclose and transfer the interest to a third party (in particular when the third party transferee is not yet known), there are potential implications with respect to covenants provided to limited partners of the underlying fund as well as other compliance issues. The terms vary among co-investment credit facilities and are usually specifically tailored to each situation.

Other issues to consider when arranging a co-investment credit facility include whether any consents are required under the fund's limited partnership agreement, the interaction with the fund's other credit facilities (if applicable), potential disclosure requirements, conflicts of interest, as well as tax, ERISA and accounting implications. Cross-jurisdictional credit facilities require particular attention.

Sponsors should also be aware of the administrative obligations involved with co-investment programs. The amount of work required will vary depending on the structure of the program and the requirements of the lender, and usually include reporting with respect to capital calls, distributions and fund-related changes, as well as notice requirements with respect to the individual borrowers relating to death, termination and transfers of interests.

Proskauer's market leading fund finance practice has experience in all areas of fund financing, including subscription credit facilities, NAV and hybrid credit facilities, warehouse credit facilities, management company and general partner credit facilities, and co-investment credit facilities. Working together with the firm's corporate, tax and other practice groups, our fund finance practice is available to help our clients structure and implement such credit facilities to fit their needs. Please contact us with any questions.

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