Proskauer

Private Credit Deep Dives – Sponsor "Guarantees" (Europe)

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As borrowers continue to feel the squeeze caused by inflation and high interest rates, lenders in the European mid-market have seen a marked increase in covenant relief, waiver and amend and extend requests from borrowers on existing private credit loans. In order to bring the lenders to the table to consider these requests, most sponsors rely on the relationship that they have with that lender. In turn, lenders will be mindful of their reputation in the market – few lenders want to be known for enforcing their security and taking the keys to the business at the first sign of trouble. In instances of significant financial underperformance, or where sponsors are unable to dissuade lenders from considering stepping in and enforcing their security, they have another potential option that can sweeten the deal for lenders. It is in this context that sponsors may offer up (or perhaps lenders may even request) some kind of equity support for the business in the form of a "sponsor guarantee" or "equity commitment." At its simplest, this entails a sponsor committing to inject equity into the banking group and/or to repay all or part of the senior debt following the occurrence of certain agreed funding trigger events.

Whilst having a sponsor offer up some form of equity commitment is credit positive – particularly for assisting private credit providers in obtaining investment committee approval for the requested covenant relief/waivers – there is often a disconnect between what sponsors mean by such an offer and what private credit providers interpret it to mean. Mitigating this disconnect at an early stage of negotiations will help streamline the documentation process and avoid any unwanted surprises that require investment committees to reappraise their approval.

This deep dive with Daniel Hendon (Partner) and Andrew Surgey (Associate), lawyers in Proskauer's Private Credit Group in London, will highlight key considerations for private credit providers when negotiating and ultimately documenting these arrangements.

1. **Structure** – The exact nature and scope of the support that these arrangements provide in the European mid-market vary widely, and the factors that influence the final position are equally as variable. Key among them is the question of how

invested the sponsor is in the relevant asset and the extent of the financial support that the sponsor is willing to provide. This may depend on whether they still see continuing value in the equity or if performance has deteriorated to such a degree, they view the business's value breaking in the debt and the equity as being underwater. Another relevant factor may be the stage of fund life cycle the sponsor fund finds itself in (and therefore the remaining uncalled capital commitments available to it). On the "lender friendly" end of the spectrum, we've seen a sponsor provide a "guarantee" in favour of the finance parties for the entirety of the group's senior debt, payable on acceleration (following any event of default), in exchange for the permanent removal of financial maintenance covenants. This arrangement created a direct contractual recourse mechanism between the finance parties and the sponsor itself. At the other "sponsor friendly" end of the spectrum, we've seen sponsors provide a form of soft commitment in favour of the parent entity to the effect that they'll consider using their equity cure rights in the loan agreement if and when the need arises. This arrangement did not create any contractual recourse mechanism between the finance parties and the sponsor. The latter, from a legal standpoint, does little more than acknowledge the equity cure provisions in the loan agreement and offers limited scope for contractually enforcing an injection. More frequently the arrangements land somewhere between these two extremes and finding a suitable landing point often entails lengthy negotiations.

2. **Key considerations** – When considering the nature and scope of the support, it's important to address a number of key questions:
    1. What is the quantum of the support – does it cover the entirety of the outstanding senior debt or is it limited to the amount required to cure specific future covenant breaches (or some other figure)?
    2. What should be the funding trigger events?
    3. If the sponsor is required to fund under the arrangement, will the funds be made available to the group to retain or will they be applied in mandatory prepayment of the facilities, or perhaps a combination of the two?
    4. Is the support going to be a "soft", relationship-based arrangement without any contractual recourse by the finance parties to the sponsor or is it a "harder" commitment/guarantee that establishes an enforceable contractual relationship between the finance parties and the sponsor?
    5. What kind of entity (e.g., a limited partnership, limited liability company or otherwise) is going to be providing the support and what jurisdiction is it incorporated or established in? From what source of cash will it fund any required payment and are there any restrictions on it entering into such an

arrangement?

6. To the extent a fund is providing the commitment/guarantee, should fund level constitutional documents, LPAs, side letters, management agreements, etc. be reviewed to ensure that there are no restrictions/concerns or should the finance parties instead rely on representations and warranties (or even the sponsor's verbal assurances)?

7. Should the sponsor provide evidence reflecting that it has access to cash and/or uncalled capital commitments sufficient to meet its obligations should it be required to fund under the arrangement? And should the sponsor have any ongoing information undertakings regarding having access to such cash and/or uncalled capital commitments?

8. Should the document be designated as a "Finance Document" (meaning breach of its terms causes a default)? This would be particularly relevant if there are information requirements that apply before the guarantee/commitment itself is called (meaning lenders could in theory (and depending on the drafting) accelerate the debt if the sponsor ceases to comply with those requirements).

The answers to these questions are deal specific and will largely depend on the nature of the relationship between the sponsor and the private credit fund, the sponsor's reputation in the market, the asset's past and forecast performance and the private credit fund's appetite to take the keys in a sustained downside scenario.

3. **Funding triggers**– Given that this credit support is typically provided as a consequence of financial underperformance, the instances in which sponsors are willing to fund are often linked to the occurrence of maintenance financial covenant breaches (such as leverage and minimum liquidity covenants), or of consecutive breaches of such covenants and/or certain other agreed major events of default (such as non-payment, non-delivery of financial information, insolvency related, cross-default, etc.). Additional triggers, such as a breach by the sponsor of any material provision of the guarantee/commitment document itself, are sometimes negotiated into the arrangement.
4. **Application and routing of funds** – One of the key points that is negotiated is following the occurrence of an agreed funding trigger, whether the funds should be made available to the group for it to retain, be applied in mandatory prepayment of the facilities or, perhaps, a combination of the two. The answer to this may depend on whether the objective is to reduce leverage or to provide business liquidity. Where funding is made available to the group (be it alone or in

part), the drafting of the arrangement should require (a) that the injection comes through the top of the structure to ensure that there are no structural/subordination or security concerns (i.e., typically via "topco" pursuant to the agreed "New Shareholder Injection" permission in the loan agreement), and (b) that the topco and midco vehicles initially receiving the funding from the sponsor are under a procurement obligation to downstream the funds to the banking group to ensure that the group actually gets the benefit of the funds. Where funding is required to be applied in mandatory prepayment of the facilities, the drafting of the arrangement should ideally require that the funding is paid by the sponsor directly to the agent on behalf of the relevant borrower. This skips a step by not having the funding routed through the banking group and, crucially, avoids a scenario where the banking group may not, after receiving the funds, apply the funds in mandatory prepayment of the facilities. This could, for example, be because an administrator has been appointed or bank accounts have been blocked.

5. **Diligence and reporting requirements** – The rationale for performing diligence on the sponsor is broadly the same that applies in respect of sponsor-backed investee companies – creditors need to know that the sponsor is financially and legally capable of making the commitment that it is offering. The ambit of the diligence exercise will be determined by the kind of entity (e.g., a limited partnership, limited liability company or otherwise) that is going to provide the support, the relationship between the lender and the sponsor and the sponsor's bargaining power in the market. As you might expect, sponsors are generally reluctant to provide their financials and constitutional/fund documents, and larger sponsors may not entertain any of these requests.
    a. In terms of financials and assuming that the vehicle providing the support is a limited liability company, LLC or similar entity, demonstrating that it has access to cash is usually straightforward and is accomplished by the sponsor providing financial statements and/or other easily accessible financial information. However, where the entity providing the support is a limited partnership without legal personality, demonstrating that the entity has access to cash and/or uncalled commitments from LPs can be tricky. It's worth bearing in mind that this kind of entity will likely have other commitments and arrangements in place that will limit the amount of uncalled commitments to which it has access in reality. Indeed, and as with all funds that frequently raise capital to deploy in the private equity market, it's fair to assume that the quantum of uncalled commitments will decline over time as the commitments are deployed for investments. The vehicle may, for example, have (a) committed to contribute cash or equity to an investment or acquisition that has not yet closed, (b) contingent

liabilities pursuant to guarantees or capital calls that have already been entered into/made, (c) defaulting LPs that refuse to fund commitments, or (d) commitments that cannot be applied towards arrangements of this nature. So, whilst requesting evidence of the uncalled commitments is a useful starting place, what these uncalled commitments really mean would require a much more detailed analysis of the sponsor's investment pipeline, existing arrangements, contingent liabilities, etc., which private credit funds appreciate is a diligence exercise that is simply too extensive to undertake.

2. However, including forward-looking disclosure requirements that are carefully drafted can both assuage sponsors (by not requiring them to divulge their complete financials) and at the same time, ensure that credit funds obtain a suitably focused reporting obligation that demonstrates that the sponsor can actually stand behind, and make good on, its financial commitment. Private credit funds can require the sponsor to demonstrate the "unrestricted callable capital" it has access to at a relevant point in time. In essence, "unrestricted callable capital" is the aggregate total of uncalled commitments, less all current and near-term liabilities that would be treated as liabilities in accordance with relevant agreed accounting principles. The scope and frequency of the obligation on the sponsor entity for it to report on its unrestricted callable capital are deal specific. In terms of scope, and absent careful drafting, the reporting obligation may not, in substance, actually achieve what private credit providers are after – understanding how fund vehicles operate is key to this exercise. In terms of frequency, the most common reporting timeframe that we see is on a quarterly basis, whereas some only apply following an event of default under the loan agreement and written request to the sponsor.

3. In terms of the scope of the diligence on the constitutional/fund documents, it's generally a straightforward exercise where the vehicle providing the support is a limited liability company, LLC or similar entity with distinct legal personality. However, similarly to the difficulties with undertaking financial diligence in the context of a limited partnership, where the entity providing the support is a limited partnership, performing standard reviews of the fund documents can end up being an extensive exercise as funds can have a swathe of complex founding documents including LPAs, subscription agreements, management agreements, side letters and GP constitutional documents. Some private credit funds require both a legal opinion from the sponsor's funds counsel on the entity's capacity and authority to enter into the arrangement and for their counsel to review the fund's documents. Other private credit funds may rely on

either the opinion or diligence on the documents alone or some may rely on the sponsor's reputation alone and don't require an opinion or any diligence on the fund's documents. Again, the approach to this is deal specific.

6. **Parties and cross-default**– If the entity providing the support is a limited partnership, ensure that the entity entering into the arrangement has the ability to issue drawdown notices to the fund's LPs. This is typically the GP but the authority to issue drawdown notices can be delegated to other entities, such as managers. Where the authority to issue drawdown notices has been delegated, consider requiring these entities to be a party to the arrangement. To ensure that the document reflecting the sponsor's support dovetails with the finance documents, ensure that: (a) depending on the structure at hand and as mentioned at paragraph 4 above, topco, midco, the parent and the borrower are a party to the arrangement to acknowledge it and to procure that the injection that is made into topco is downstreamed to the banking group, which is then applied by the borrower in accordance with the arrangement; and (b) the agent is a party to the document to acknowledge the arrangement and, in particular, for it to acknowledge that it's designated as a "Finance Document" (assuming this is the agreed position). If the document is not designated as a "Finance Document" and if there are obligations that relate to the sponsor alone (such as information requirements that apply before the guarantee/commitment itself is called), the underlying loan agreement should be amended to cater for a cross-default under the arrangement. Absent this cross-default mechanism, the sponsor breaching the newly designated finance document won't result in an event of default under the loan agreement because a failure to comply with any provision of a finance document typically applies to obligors alone. Including a cross-default will result in an event of default under the loan agreement, pursuant to which the lenders can take enforcement action and it provides the proverbial stick to wield over the sponsor and the group.

In summary, whilst the number of these arrangements that we've seen in the European mid-market have been on the rise in the face of the current market headwinds, how each arrangement is ultimately documented is inherently deal specific. It's difficult to say what's "market" other than private credit providers wanting as firm a commitment as possible and sponsors wanting as soft a commitment as possible. Bridging the gap at an early stage between what private credit funds would like in terms of sponsor support and what a sponsor is willing to provide will, ideally, streamline negotiations and make discussions with investment committees easier. For any related questions on this topic, please reach out to your contact within Proskauer's Private Credit Group.

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