Private equity funds

Equity bridge facilities

Leon Stephenson and **Christopher Akinrele** of **Reed Smith LLP** outline the key characteristics of equity bridge facilities that are provided to private equity funds and the main issues that the lender's lawyers need to review in the fund documents.

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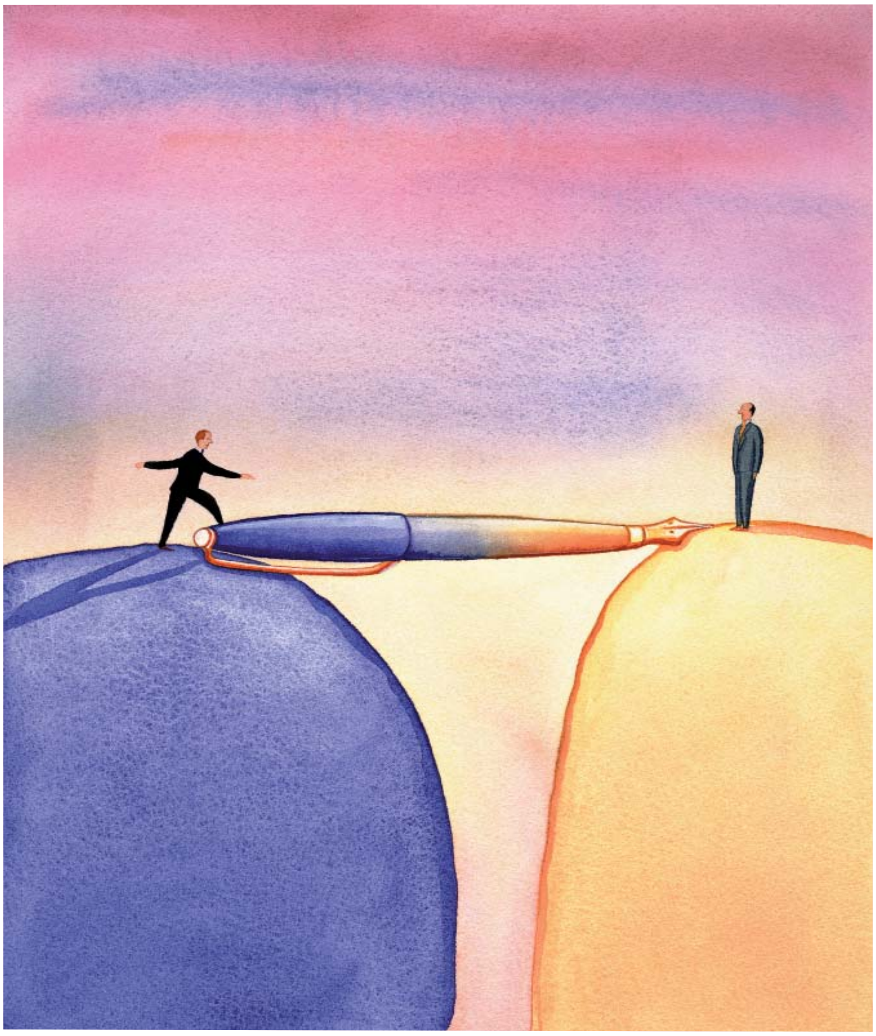

Equity bridge facilities (or capital call facilities, as they are sometimes referred to) that are provided to private equity funds (funds) and secured by the fund's limited partners' commitments to make capital contributions (LP commitments) are a very specific type of product, but are becoming increasingly popular in the UK loan market. A growing number of banks and financial institutions are now providing these facilities and a market position on some of the issues highlighted in this article is being reached. The form of documentation is also becoming more standardised and established.

This article considers:

- The importance of understanding the fund's structure (often a limited partnership) and the key issues to consider when conducting due diligence on the fund.

- The specific provisions (such as representations, undertakings and events of default) that are included in facility agreements (or loan agreements) for providing equity bridge facilities to funds.

- The security that a lender will take over the general partner's rights to draw down the limited partners' capital contributions to the fund.

WHAT IS AN EQUITY BRIDGE FACILITY?

An equity bridge facility provided to a fund is a short-term form of finance. It is used to bridge the portion of investments made by a fund that are eventually to be financed from capital contributions that the investors in a fund are required to make. The facility might be less than the total cost of the invest-

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ments, as a portion may be financed by longer-term debt. An equity bridge facility can be either a revolving credit or term facility. It will usually be a loan facility but a letter of credit facility may also be provided.

Assuming that a loan facility is made available, the lender will advance monies to the fund on or just before the date that the fund is required to make an investment. Generally, the advances made by the lender under the equity bridge facility will be reimbursed by the fund's limited partners when they make their required capital contributions to the fund (assuming that it has been set up as a limited partnership). This form of bridge financing gives a fund the certainty that the portion of the purchase price of an investment to be funded from the limited partners' capital contributions is available when the purchase price for that investment has to be paid. Effectively, the risk of the limited partners failing to make monies available is shifted from the fund to the lender.

An equity bridge facility will usually be made available for a short period (for example, 12 to 24 months) to fund investments permitted under the limited partnership agreement (LPA) governing the fund.

Usually, the fund's obligations under the facility agreement will be supported by security in the form of an assignment of the general partner's rights in relation to each limited partner's LP commitment, coupled with a power of attorney. Security will also normally be granted in favour of the lender over the bank account into which the limited partners pay their LP commitments (*see "Guarantee and security" below*).

Timeline

The following is a timeline showing the typical process of putting in place an equity bridge facility to a private equity fund:

Heads of terms and intended structure agreed. Minimal due diligence by lender's lawyers to establish proposed structure of facility.

↓

Due diligence on fund by lender's lawyers is carried out.

↓

Due diligence on fund ends and due diligence report delivered to lender.

↓

Facility agreement prepared and negotiated.

↓

Security documents and other conditions precedent prepared and negotiated.

↓

Facility agreement signed.

↓

Security documents signed.

↓

Completion and drawdown.

THE FUND'S STRUCTURE

The starting point, from the lender's lawyers' perspective, is to understand the fund's structure. Often, the lender's lawyers need to review and comment on the basic fund structure even before heads of terms for the financing are signed (*see box "Timeline"*). This is because the structure can influence the basic terms of the financing which will be made available by the lender, such as:

- Which entity will borrow the debt.
- Whether any guarantees will be required.
- The repayment periods.
- The extent of the security package.
- The timing, following the utilisation of the equity bridge facility, for the general partner to send drawdown notices to the limited partners requesting that they fund all or part of their LP commitments.

A fund is often set up as a limited partnership registered under the Limited Partnerships Act 1907 (*see box "Typical fund structure using a limited partnership"*). Limited partnerships have two types of partner:

- A general partner (and, in some circumstances, more than one general partner).

- Limited partners.

An English limited partnership has no separate legal personality and contracts with a third party through its general partner. The general partner's capacity to contract depends on the nature of its own legal personality.

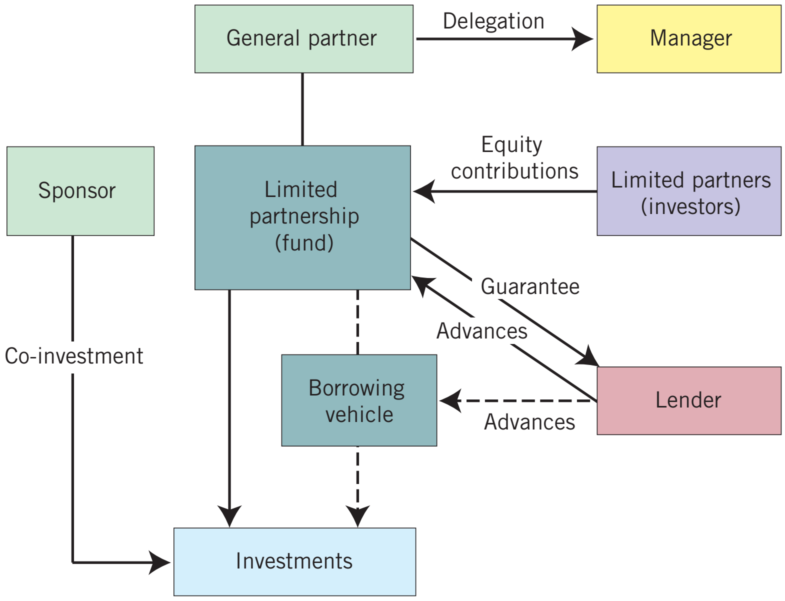
Under the LPA governing the fund, the limited partners will be committed to invest capital in the fund (that is, their LP commitment) to finance investments identified, typically, by the general partner or, alternatively, the manager or an adviser appointed for that purpose. The general partner is responsible for dealing with the fund on a day-to-day basis (or will have delegated all or some of its powers and rights to a manager).

The general partner or manager, as the case may be, is responsible for sending out drawdown notices to the limited partners to request the LP commitments. There may also be a sponsor which co-invests alongside the fund in investments that have been identified.

In terms of funds flow, first the lender will lend either to the fund directly or to a separate borrowing vehicle. If the borrower is not the fund but a separate borrowing vehicle, the lender will, typically, require a guarantee from the fund to support the obligations of the borrowing vehicle (*see "Guarantee and security" below*). The advance made by the lender is used by the fund to make an investment. The general partner, or manager, then draws down LP commitments from the limited partners and monies from the sponsor, if there is one, to repay the lender.

Typical fund structure using a limited partnership

The diagram shows a typical private equity fund structure using a limited partnership. Although many fund structures have added complexities (for example, feeder funds, parallel funds and different co-investment arrangements), the diagram illustrates the basic funds flow for a typical equity bridge facility.



DUE DILIGENCE

A relatively high-level legal due diligence exercise will be carried out by the lender and its lawyers on the fund and the documents that it has entered into. Typically, this due diligence will focus on:

- The LPA relating to the fund (and, in particular, the general partner's powers under the LPA).

- Side letters and subscription agreements.

- The management agreement.

- Co-investment arrangements.

- The identity of the borrower (if it is not the fund itself) and the identity and financial standing of the limited partners.

LPA

With regard to the LPA, the lender's lawyers should focus, in particular, on the following:

Term and commitment period. The lender's lawyers should review the LPA to find out the term of the fund (that is, the length of time for which it has been established) and the commitment period during which the limited partners are obliged to make available their LP commitments to the fund. Understandably, the lender will be keen to ensure that both the term of the fund and the commitment period are as long as possible and, in any event, extend well beyond the final repayment date of the facility.

General partner's powers. The lender's lawyers should review the general partner's powers under the LPA. Such powers may have been delegated to a manager but, for the purposes of this article, it is assumed that the general partner retains such powers (unless otherwise specified).

The core of the lender's security package is security over the general partner's rights against the limited partners, through either an assignment by way of security, a power of attorney or a combination of the two (*see "Guarantee and security" below*). Therefore, it is imperative that the LPA provides the general partner and, in turn, the lender, with adequate powers of recourse against the limited partners. As a minimum, the lender will want the general partner to be able to:

- Make calls on undrawn LP commitments (that is, require the limited partners to make a capital contribution to the fund).

- Issue and deliver drawdown notices to the limited partners.

- Require non-defaulting limited partners to make up any shortfall arising as a result of other limited partners not funding their LP commitments.

Permission to enter into finance documents. The LPA should also be checked to ensure that it permits (and/or does not contain any restriction preventing):

- The fund (acting by the general partner) entering into the facility agreement.

- The general partner, on behalf of the fund, granting the security required by the lender.

Limited partners' excuse, cancellation and transfer rights. The lender's lawyers' review of the LPA should also focus on the circumstances in which limited partners can exercise their "excuse rights" (*see "LP commitment thresholds" below*). Typically, the LPA will allow a limited partner to be excused from making its LP commitment in certain circumstances, while those circumstances exist (in which case, such limited partner is commonly referred to as an excused partner). As the lender's main security is over the general partner's ability to draw down funds from the limited partners, it will want to ensure that the circumstances in which a limited partner is excused from complying with a drawdown notice are as narrow as possible.

The lender's lawyers should also check the circumstances in which a limited partner's LP commitment can be transferred or cancelled, as these raise similar issues to those raised by excuse rights. However, in the case of a transfer, the lender's main concern will be to ensure that the financial standing and commitment of the limited partners remains largely the same throughout the life of the facility. This is because the identity of the limited partners goes to the value of the lender's security and is a matter on which the lender will have based its decision to lend.

Restrictions on distributions to limited partners and subordination. The practice in the UK is that it is very difficult for a lender to obtain a consent letter from the limited partners under which they agree that payments to them from the fund will be subordinated. Under such a letter, the limited partners would agree that, if an event of default under the facility agreement is continuing or if there is an insolvency event affecting the fund, the lender's right to ensure that drawdown notices are issued on the limited partners requiring them to fund LP commitments in an amount sufficient to repay outstanding amounts under the facility agreement takes priority over the limited partners' rights to be repaid their funded LP commitments.

Instead, the lender often relies on the waterfall provisions in the LPA (that is, the pre-determined flow of funds and priority of distributions among the parties). Ideally, the LPA should specify that no distributions to the limited partners or other persons can be made until the facility has been repaid in full or, at least, that there can be no distributions if an event of default under the facility agreement is continuing.

Removal of general partner. The lender's lawyers should establish the circumstances in which the general partner can be removed or can incur liability under the LPA. Typically, the LPA will contain provisions that allow the general partner to be removed if it incurs liability to the fund.

Side letters and subscription agreements

The lender's lawyers should review any side letters and subscription agreements to check if they give a particular limited partner additional rights to those given to the limited partners generally in the LPA to:

- Avoid honouring drawdown notices.

- Transfer its partnership interest (in particular, its undrawn LP commitment).

Management agreement

If appointed by the general partner, the manager will carry out management responsibilities and duties that are otherwise imposed on the general partner by the LPA, as if it were the general partner. As a result, where appropriate, the lender will want to ensure that the manager is a party to the facility agreement, and that the manager also gives security in favour of the lender over its rights against the limited partners and sponsor (or other co-investor).

In the same way as for the general partner, the lender should examine carefully the circumstances in which the manager can be removed and replaced.

Co-investment arrangements

The lender's lawyers' review of any co-investment arrangements should focus on how the sponsor's (or other co-investor's) obligation to co-invest arises and the mechanism by which the fund can request and draw in monies from the sponsor (or other co-investor). If the lender is financing against the sponsor's (or co-investor's) co-investment obligations, security over the general partner's rights in relation to these obligations needs to be taken so that the lender can ultimately step into the shoes of the general partner to draw down these co-investment monies.

The borrower and limited partners

As with any form of debt finance, the lender will need to carry out due diligence on the borrower. If a separate borrowing vehicle is used rather than the fund, the lender will need to do due diligence on this vehicle (for example, as to its identity) as well as due diligence on the fund.

Additionally, because the lender's only recourse in economic terms is to the limited partners, it needs to carry out due diligence on the limited partners. Typically, this involves a review of their identities, addresses and the size of their LP commitments, both individually and in relation to the overall size of the fund. The lender may give all or some of the limited partners (for example, the larger investors on which it will be particularly relying in terms of its security) a rating to assist this analysis. These ratings will be used by the lender in its credit assessment of the transaction and effectively "value" those investors which are given such a rating.

THE FACILITY AGREEMENT

A number of key provisions are generally included in facility agreements for providing equity bridge facilities to funds.

Committed or uncommitted facility?

An equity bridge facility to a fund is usually committed, although some lenders also make uncommitted lines available. Often, this decision is influenced by the internal policy of the lender in question, with some institutions preferring to offer an uncommitted facility so as to preserve their balance sheet and to provide more competitive pricing to borrowers. An uncommitted facility may benefit the borrower (whether the fund or a separate borrowing vehicle) as no commitment fee will be payable by it on the undrawn amount of the facility. As an equity bridge facility frequently has a short period for repayment, the facility can often be undrawn for some time, so high commitment fees may be incurred. However, a committed facility obviously gives the borrower greater certainty of funds.

If the facility is uncommitted, the facility agreement may contain a mechanism under which the borrower can submit a pre-notification request to the lender so that the borrower has greater certainty about the facility's availability before committing to an investment. On receipt of the pre-notification request, the lender has to agree whether or not to make the loan (or letter of credit, as appropriate) on the proposed utilisation date. Accordingly, the facility is effectively turned into a committed facility in relation to a proposed utilisation at the pre-notification stage.

Repayment and prepayment

Typically, the facility agreement requires the borrower to issue drawdown notices to the limited partners within ten to 20 days of the facility having been utilised. This is to ensure that the borrower can repay the monies advanced under the facility agreement before the repayment date. Typically, the repayment provisions in the facility agreement require the utilisation to be repaid by the borrower within 30 to 90 days of the date on which it was made.

Often, the LPA contains provisions specifying when a suspension period is triggered; this is normally when certain of the key principals managing the fund (that is, the key individuals involved in the fund who make investment decisions) fail to allocate sufficient time to managing the fund. The occurrence of a suspension period can restrict the general partner's right to draw down LP commitments. This means that the lender's security effectively becomes worthless because the general partner no longer has the right to draw down the LP commitments, which is how the facility will be repaid. Usually, the facility agreement specifies that if a suspension period is triggered under the LPA, the borrower must prepay outstanding utilisations and the facility will automatically be cancelled in full.

Usually, the expiry of the LP commitments also triggers mandatory prepayment and cancellation of the facility in full.

Additionally, the facility agreement usually contains the customary triggers for mandatory prepayment and cancellation, and voluntary prepayment and cancellation found in Loan Market Association (LMA) documentation.

LP commitment thresholds

A key feature of an equity bridge facility provided to a fund is the concept of thresholds, which relate to the LP commitments (*see box "Thresholds"*). The facility agreement will include events of default and other provisions relating to these thresholds.

Representations and warranties

The standard LMA-style representations are given, as appropriate, by the fund, the general partner and, if relevant, the manager. These include those relating to status, power and authority. Additionally, a number of representations will be included that are specific to equity bridge facilities to funds, such as confirmation that:

- The undrawn LP commitments of the excused partners do not exceed the excused partner threshold (*see "LP commitment thresholds" above*).
- The fund documents permit the general partner (or manager) to validly deliver drawdown notices to the limited partners with a view to the proceeds being used to repay loans made or to cash-collateralise letters of credit issued by the lender.
- No other material agreements have been entered into by the limited partners, the sponsor, the fund, the general partner or any other borrowing vehicle (other than as disclosed to the lender).

Thresholds

In an equity bridge facility provided to a private equity fund, there are a number of thresholds or concepts that relate to each limited partner's commitment to make capital contributions (LP commitments). Typically, the following thresholds or concepts are significant to a lender:

Threshold or concept	Meaning	How dealt with in facility agreement
Cancellation threshold	The maximum proportion of the total undrawn LP commitments (less the undrawn LP commitments of excluded partners (*see below*)) which can be transferred to unapproved limited partners or withdrawing partners. (A withdrawing partner is a limited partner which is going to withdraw from the private equity fund (fund) and has notified the general partner of this intention to withdraw. The cancellation threshold prevents circumvention of the transfer threshold referred to below as it covers entities that are currently limited partners but will shortly cease to be so.)	If any of the respective thresholds are exceeded, the undrawn LP commitments available to the fund (and therefore to the lender if it enforces its security) will fall below an acceptable level and the lender will be inadequately secured. Typically, breach of these thresholds will be an event of default under the facility agreement.
Insolvency threshold	The maximum proportion (in terms of their undrawn LP commitments) of limited partners who can be subject to insolvency or analogous proceedings.	
Defaulting limited partner threshold (or defaulting investor threshold)	The maximum proportion (in terms of their undrawn LP commitments) of limited partners who can be in default of their obligation to advance any of their LP commitments under a drawdown notice.	
Transfer threshold	The maximum proportion of the total undrawn LP commitments which can be transferred to an entity other than an associate (as defined (usually) in the limited partnership agreement (LPA)) after the fund has entered into the facility agreement.	The lender or its lawyers will review the LPA and related documents (such as side letters and subscription agreements) and carry out due diligence on the limited partners to evaluate the lender's credit risk in providing the facility. Transfers by the limited partners of their undrawn LP commitments could alter the fund's composition so that it is very different to that on which the lender based its decision to lend. As a result, the facility agreement will usually include an undertaking that each obligor will ensure there are no transfers above the transfer threshold. Failure to comply with this undertaking will be an event of default.
Excused partner threshold (or excused investor threshold)	The maximum proportion (in terms of their undrawn LP commitments) of limited partners who can be excused in whole, or in part, under the LPA or any relevant side letter or subscription agreement from complying with a drawdown notice sent by the general partner.	The LPA usually contains provisions excusing a limited partner, in certain circumstances and while those circumstances exist, from complying with a drawdown notice sent by the general partner. Typically, this will be where previously agreed with the general partner or where that limited partner's participation would breach restrictions based on the US Employee Retirement Income Security Act 1974. The lender needs to know that the extent of excused rights remains at acceptable levels so, usually, the facility agreement will contain a representation that the undrawn LP commitments of the excused partners do not exceed the excused partner threshold and an undertaking that the general partner provide details of any excused partners.
Excluded partners	Any limited partner which is an affiliate of the lender, insolvent or defaulting in some way.	Usually, the facility agreement will stipulate a minimum ratio or percentage of undrawn LP commitments (less the undrawn LP commitments of excluded partners) to total debt outstanding under the facility agreement. Deduction of the undrawn LP commitments of excluded partners ensures that only undrawn LP commitments to which the lender would genuinely have recourse are included when making the calculation.

- There are no creditors of the fund (and borrowing vehicle, if relevant) other than the general partner and manager in respect of their fees and those of their professional advisers or administrative service advisers.

Information undertakings

Similarly, in addition to the standard LMA-style information undertakings, a number of information undertakings will be included that are specific to equity bridge facilities to funds. Typically, the facility agreement requires that:

- The lender is provided with annual and quarterly financial information on the fund, including details of the undrawn LP commitments and the LP commitments that the limited partners have already funded, and equivalent information to that provided to the limited partners.

- On a periodic basis, the lender is provided with a statement of the investments and other property and assets in which the fund has an interest.

- The lender is provided with details of any limited partner which becomes an excused partner or a withdrawing partner (*see "LP commitment thresholds" above*).

- The general partner (or manager) notifies each limited partner that:

  - the facility agreement has been entered into; and

  - the lender may, in certain circumstances, exercise the rights of the general partner (or manager).

General undertakings

The lender will require specific undertakings relating to the value of the security and the structure of the fund. Typically, these will include undertakings that:

- Neither the fund nor the general partner will create or allow to exist any security over any fund investment, any undrawn LP commitments or any other asset owned directly by the fund.

- No distributions to the limited partners or the general partner may be made (other than certain limited exceptions), ideally, until the facility has been repaid in full or, at least, that no distributions may be made if an event of default under the facility agreement is continuing.

- There will be no transfers of undrawn LP commitments that change the composition of the limited partners without the lender's consent or if the amount of undrawn LP commitment transferred does not cause a breach of the transfer threshold for the fund (*see "LP commitment thresholds" above*).

- The undrawn LP commitments must be at least a certain percentage of outstanding debt under the facility agreement (typically, at least 150% to 250%). This ensures that the lender has adequate collateral if it needs to enforce its security.

- If a limited partner fails to pay any amount requested under a drawdown notice, the general partner will pursue all remedies available to it against that limited partner within a prescribed time, and will require each non-defaulting limited partner to contribute a pro rata share of the defaulting partner's contribution to make up any shortfall.

- The general partner must direct the limited partners to pay their LP commitments directly into an account over which the lender has security (*see "Guarantee and security" below*).

Events of default

Typically, an equity bridge facility to a fund contains LMA-style events of default. These include, among others, non-payment by obligors, cross-acceleration affecting an obligor, material adverse change, breach of representation and non-compliance with undertakings.

Additionally, a number of events of default will be included that are specific to equity bridge facilities to funds. These include:

- Events of default relating to the different thresholds. As previously mentioned, these are events of default because if a threshold is exceeded, a key feature of the lender's security package will be undermined (that is, having recourse to sufficient undrawn LP commitments to repay the outstanding debt).

- Removal of the general partner (or manager).

- Breach of the ratio of undrawn LP commitments to the outstanding debt under the facility agreement.

- Termination of the fund.

The occurrence of an event of default will give the lender the right to exercise the general partner's (or manager's) rights against the limited partners, including requiring them to fund their LP commitments.

GUARANTEE AND SECURITY

If the borrower is not the fund but an alternative entity (for example, a subsidiary company or any other company within the fund's group) the lender will, generally, require a guarantee of the borrower's obligations from the fund. If so, the lender's lawyers need to ensure that the fund can give the guarantee and that recourse under it is not limited.

The lender will take security over the rights of the general partner (or manager) to draw down LP commitments from the limited partners. This will take the form of a deed of assignment and/or a power of attorney, in both cases executed by the general partner (and, if relevant, the manager). It is preferable for a lender to take an assignment of the general partner's (or manager's) rights, rather than just a power of attorney, in order to avoid potential priority issues with other creditors. This is because a power of attorney is merely a delegation of authority and a subsequent creditor could still take an assignment of the general partner's (or manager's) rights, although such assignment is likely to breach provisions of the facility agreement. The lender also usually takes security over the account into which the limited partners' LP commitments are paid.

In connection with taking the security, the lender's lawyers need to:

- Review the fund documents to ensure that they do not prohibit:

- assignment of the general partner's right to draw down the limited partners' LP commitments; or

- the lender being granted a power of attorney to act on behalf of the general partner.

- Consider whether notice can be given to the limited partners to perfect an assignment by way of security of the general partner's (or manager's) rights against them in respect of undrawn LP commitments. However, in some instances, the general partner will be reluctant to notify the limited partners of the assignment. This could be because it has concerns that notification will give rise to unnecessary questions from limited partners or that notifying the limited partners of the assignment could be administratively burdensome. One solution is to insert the relevant notification in the fund's quarterly report or in the general partner's next scheduled communication with the limited partners rather than sending out a separate notification relating just to the assignment.

- Take advice from local counsel, if the security will be governed by a foreign law, on the issues referred to in the two bullet points above. For example, under Guernsey law, an assignment by way of security is not created until notice is given; notification is not just a perfection requirement. This means that if notification is not given until the general partner's next scheduled communication with the limited partners, the lender will not be secured for this preliminary period.

If the lender is also financing against a sponsor's (or co-investor's) co-investment obligations, security over the general partner's (or manager's) rights in relation to these obligations will also need to be taken.

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