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GUIDE TO

Private Equity Fund Finance



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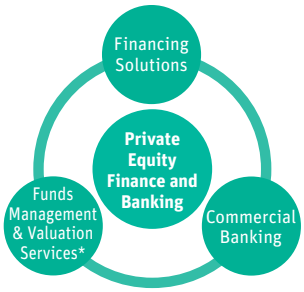
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Introduction

Welcome to the Guide to *Private Equity Fund Finance*, the latest in a series of guides produced by the BVCA designed to act as an introduction to investment strategies and new markets.

Equity bridge facilities are being offered by an increasing number of financial institutions and are playing an important role in a number of UK private equity transactions. Equity bridge facilities provide short-term financing to facilitate an acquisition when funds were not yet accessible to a seller. There are many considerations to be taken into account by private equity practitioners contemplating this form of financing, and it is critical that both they and their advisers have an understanding of the general terms, specific risks and overall process.

This guide is intended to provide an overview of the topic and to review the end-to-end process for establishing a private equity bridge facility. Drawing upon the knowledge of experienced practitioners and advisers, this guide examines key characteristics, considerations and issues relating to executing an equity bridge financing transaction and how best to mitigate risks. It also provides useful technical guidance for fund managers and advisers relating to due diligence, fund documentation and the preparation of a facility agreement.

We would sincerely like to thank our sponsors, Reed Smith and Silicon Valley Bank, for their expertise and assistance in producing this guide.



Tim Hames
Director General
BVCA

Foreword

Equity bridge facilities – also known as capital call or subscription line facilities are facilities which are provided to private equity, real estate or other funds usually secured against the Limited Partner commitments in the fund.

These facilities are different from corporate facilities which are usually provided to operating companies or holding companies owned by the sponsor and which are secured against the assets of the operating group.

The banks' primary recourse on equity bridge facilities is to the Limited Partners who have invested in the fund. In order to ensure that the General Partner or the investment manager, as the case may be, of the fund serves drawdown requests in a timely manner to Limited Partners, the bank is usually given a security assignment and/or power of attorney in order to 'step into the shoes' of the General Partner or the investment manager to make sure drawdowns are made in the event that the General Partner or investment manager fails to do so.

Equity bridge facilities were traditionally put in place in order to provide the fund with the certainty that when the date for an investment arrives, the required funds were available and that there was no risk of a shortfall for any reason. Although this is still one of the principal motivations of a fund for putting in place these types of facilities, such facilities may also serve a number of other purposes. Some of these purposes are briefly described below.

Equity bridge facilities have been made available to funds to allow letters of credit to be issued in favour of a potential seller to guarantee any potential break fee that may be payable by the fund in the event that the fund does not proceed with the purchase of an investment. Equity bridge facilities work well in this situation as the letter of credit does not need to be outstanding for too long.

If the fund proceeds with the purchase then the letter of credit is cancelled. If the fund walks away from the acquisition and therefore is liable to pay the break fee to the seller, the seller can call on the letter of credit against the bank and the bank can be repaid through a drawdown against Limited Partners in the fund. Similarly, letters of credit may also be issued to support the fund's contingencies as a seller (in lieu of escrow arrangements) or to enhance a portfolio company's financing capabilities.

Equity bridge facilities have been provided in order to bridge monies that the seller on an acquisition is entitled to but which are not yet available. For example, there may be a tax credit that has been incurred in relation to a period prior to the acquisition date but which will not be obtained by the relevant tax authorities until post-acquisition. In this instance the bank may be willing to fund the amount of the credit to allow the seller to take receipt on the acquisition date and then look to repayment of the facility when the tax refund comes in. If such a refund is not obtained before the loan repayment date, the bank can force the General Partner or the investment manager to drawdown from the Limited Partners to fund the repayment if relevant.

Increasingly equity bridge facilities and other funds facilities are being put in place for a number of other general purposes. For example, they may be used to effectively provide debt to the fund, to provide lines of credit that do not need to be repaid for longer periods to facilitate the fund's ability to pool its investments, to make follow-on investments, to bridge co-investments and to provide liquidity to managers and General Partners pending receipt of their fees.

Certain institutions in the market have been able to differentiate themselves and obtain new business by extending the repayment terms of such facilities. These financial institutions will have undrawn Limited Partner commitments, in addition to other potential security given by the fund or its subsidiaries (e.g., share charges, assignment of intercompany loans, etc.). If longer term facilities

are provided by these institutions then certain tax (e.g. Unrelated Business Taxable Income) and regulatory issues will need to be considered by the fund before entering into such facilities.

There are certain funds, particularly emerging market funds, which draw down from Limited Partners in a liquid currency such as dollars, euros or sterling, but are required to make investments in illiquid currencies with significant volatilities. An equity bridge allows the fund to proceed with the investment and issue a capital call when the exact funding requirement from its Limited Partners becomes known.

For real estate funds in particular, an equity bridge facility allows the fund to have short term financing until more permanent financing is put in place once the asset has been acquired and repositioned in the acquiring group. Such facilities may also be useful for development finance where the facility is put in place during the development phase on a real estate transaction and as a backstop to construction debt.

For certain active credit funds, fund of funds, venture or growth funds who may need to make investments on a frequent basis, an equity bridge facility allows such funds to 'batch' or 'consolidate' capital calls, so as to avoid drawing down on investors too regularly.

An ever increasing number of banks and other financing institutions are providing these types of facilities as the advantages become more and more apparent. Financial Institutions, are also offering these facilities in order to develop stronger relationships with principals of the funds. Consequently, it may be the private wealth side of financial institutions who may also make these facilities available. This allows such institutions to cross-sell their corporate and investment banking, asset management business, FX capabilities and other services that they offer.

For other institutions a clear policy decision has been made to lend in this area on the basis that such loans provide substantial collateralisation so that the risk of a non-payment default is very low. There is another category of institution that will consider making available such facilities in order to provide financing solutions for bespoke transactions. Such institutions may, in addition to a simple equity bridge facility, provide facilities to the manager, the General Partner, a co-invest vehicle or even to a Limited Partner itself.

Unlike a simple corporate loan transaction, an understanding of fund structures and the variations that exist, and bespoke credit underwriting is essential. The interaction between the various fund documentation of the Limited Partnership Agreement, Investment Management Agreement and Co-investment Agreements are crucial, as is a thorough and deep understanding of the status and powers of the General Partner, investment manager, Limited Partners and any co-investment or sponsor vehicle. This is a very specialist area of debt finance with a small group of banks and law firms who have a thorough knowledge and appreciation of the risks, issues and solutions associated with it.

The purpose of this guide is to set out the key considerations when carrying out an equity bridge financing transaction, to highlight some of the most significant issues and to provide our view on how to remove or mitigate risks that may exist on a financing of this nature. We also set out some of the key considerations on the funds side and the concerns a fund will need to deal with when taking out such a credit line.



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Fund and financing structure

The starting point from the lender and their lawyer's perspective is to understand the fund's structure in detail.

Very often the lender's lawyers will need to carry out a high level review of the fund structure even before heads of terms are finalised. This is because the structure can influence the basic terms of the financing, including:

- Which entity will borrow the debt;
- Whether any guarantees will be required from the fund or other entities and if so will there need to be any limitations on such guarantees;
- The maturity of the facility and the repayment terms;
- The timing for the limited partners to fund their commitments following receipt from the general partner or the investment manager, as the case may be, of a draw down request;
- Whether a security assignment or other form of security can be granted in favour of the bank.

An English law established fund is often set up as a Limited Partnership under the Limited Partnership Act 1907 (see diagram on page 8). Limited Partnerships have two types of partner, a General Partner and Limited Partners. The principal constitutional document of a fund will be the Limited Partnership Agreement and under this document the Limited Partners will commit to invest funds into the partnership when drawdowns are made on them.

The General Partner will usually have primary responsibility for the day-to-day running of the fund and to issue drawdown requests to Limited Partners. Often a fund will have a parallel fund structure under which certain investors will invest in one fund, say fund A, and certain investors will invest in the other fund, say fund B. There may be tax and other reasons why it may be preferable to set up the fund structure with parallel funds. Often the parallel funds will invest jointly into an investment pro rata to the total Limited Partner commitments in each of the funds.

If the bank is lending to more than one fund then a number of questions will need to be answered with respect to the financing structure. The banks starting position may be that all of the funds should be fully jointly and severally liable as guarantors for all of the borrowings of each of the different funds. The funds, however, may have co-investment arrangements in place that make it difficult for each fund to give unlimited cross-guarantees of this nature. It may be that the lender will insist on sub-limits on the tranches provided to each fund to ensure that if the guarantees are limited it will never be out of pocket. Sometimes the lender may require a direct agreement from each of the funds to the lender stating that each fund will make whole any defaults by any of the funds via the issuance of drawdown notices to its Limited Partners for the shortfall.

There are some fund structures where there is a co-investment vehicle or sponsor entity that co-invests simultaneously into investments (see diagram on page 8). Some financial institutions will be willing to provide equity bridge facilities against these co-investment/sponsor commitments as well. The fund documentation and structure needs to be reviewed very carefully by both the banks' and funds' lawyers to ensure that such financing is permitted and that effective security can be granted over

"If the lender is lending to more than one fund then a number of questions will need to be answered with respect to the financing structure"

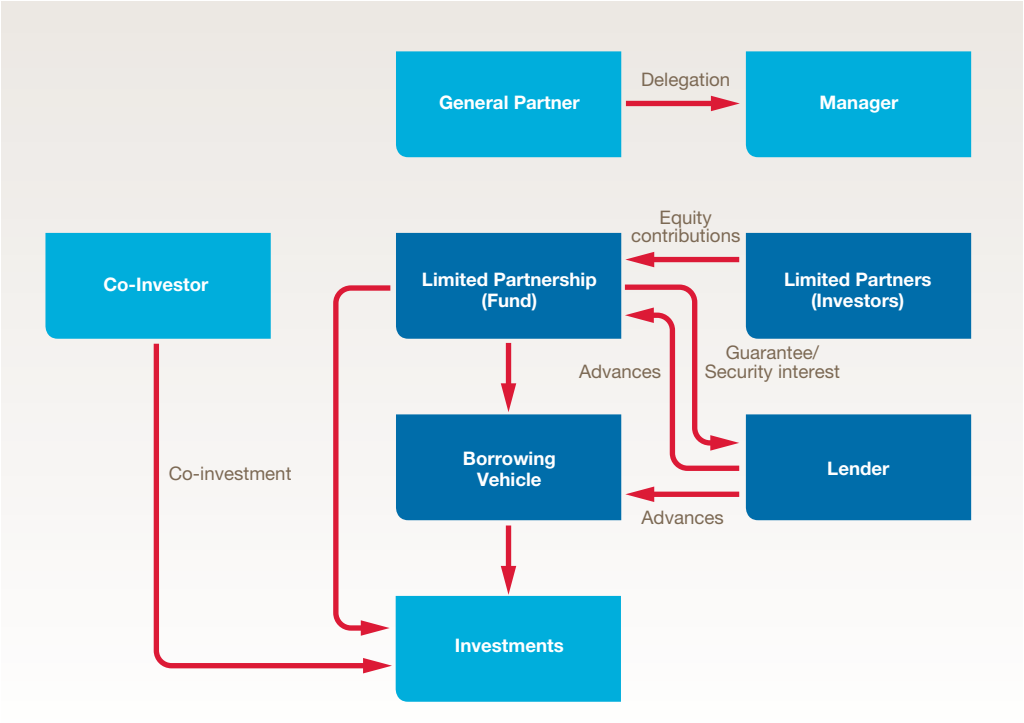
these co-invest/sponsor commitments as well as over the limited partner commitments.

Some financial institutions prefer to set up 'umbrella' facilities pursuant to which there will be one facility agreement and schedules of terms appended for each financing by one or more funds. The interaction between different funds, their respective Limited Partnership Agreement and the ability of each fund to finance the shortfall of another fund needs to be looked at carefully.

Sometimes the fund or the lender may require that the debt is borrowed by a special purpose vehicle (SPV) or an entity other than the fund itself. In this instance the lender will need to obtain a guarantee from the fund for the borrower's indebtedness. The fund itself may have restrictions on borrowing directly or may prefer for tax or other reasons that the debt is provided to an SPV that it controls.

It is sometimes the case that the General Partner has delegated to the investment manager its rights under the Limited Partnership Agreement to drawdown from the Limited Partners. This delegation may be set out in the Investment Management Agreement, a separate delegation instrument or elsewhere. If this is the case then it is very important for the lender to ensure that it has the necessary controls over the investment manager and has an security assignment of this 'delegated' right to drawdown from Limited Partners, together with any other ancillary rights it may have had delegated to it. The investment manager is often a financial services regulated entity (FCA regulated if it carries out activity in the UK) and so it is important for the bank that this entity continues to perform its general investment functions, as well as being able to drawdown funds from Limited Partners if it has been delegated this right.

Example of a fund and financing structure



Limited Partnership Agreement, fund documentation and underwriting

A relatively detailed legal due diligence and specialised underwriting and structuring exercise will need to be carried out by the lender and its lawyers on the fund and the documents that it has entered into prior to any equity bridge facility being made available.

Typically this due diligence will focus on:

- The Limited Partnership Agreement (LPA) relating to the fund (and, in particular, the General Partner's powers under the LPA);
- Side-letters and subscription agreements;
- The Investment Management Agreement;
- Co-investment and feeder fund arrangements;
- The identity of the borrower (if it is not the fund itself) and the identity and financial standing of the Limited Partners;
- The constitutional documents of the General Partner and investment manager.

With regard to the LPA, the lender's lawyers should focus, in particular, on a number of items highlighted below.

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 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 (unless there are certain provisions allowing the General Partner to continue to draw down from Limited Partners for follow-on investments or to pay expenses of the partnership).

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 an investment manager and if so full diligence needs to be carried out on the delegation terms and the powers of the investments manager (See the chapter entitled 'Security', on page 20)

Drawdown and enforcement powers

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 the chapter entitled 'Security', on page 20). 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;
- Enforce certain penalties against defaulting Limited Partners.

"The core of the lender's security package is security over the General Partner's rights against the Limited Partners"

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 the chapter 'Facility Agreement', and the section onthresholds on page 14, below). Typically, the LPA will allow a Limited Partner to be excused from making its LP commitment in certain circumstances, (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 drawdown 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 commitment can be transferred or cancelled as these raise similar issues to those raised by excuse rights. In the case of a transfer, however, the lender's main concern will be to ensure that the financial standing and commitment of the Limited Partners remains largely the same or of similar quality 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 key factor on which the lender will have based its decision to lend.

Restrictions on distributions to Limited Partners and subordination

The market practice in the UK may make it 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 to the payments owed to the lender. 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 takes priority over the Limited Partners' rights to be repaid their funded LP commitment.



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 and other liabilities of the fund have been repaid in full.

Removal of General Partner

The lender's lawyers should identify the circumstances in which the General Partner can be removed or can incur liability under the LPA. Furthermore, it is important to understand the mechanism and timing for replacing the General Partner and if under the law of the funds establishment a general partner needs to be replaced within a certain amount of time.

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, for example to:

- Be excused from funding amounts set out in drawdown notices issue for certain investments;
- Be subject to lower or different penalties; and
- 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 co-investor's co-investment obligations, security over a General Partner's or investment manager'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 or investment manager to draw down these co-investment monies.

Feeder fund arrangements

The fund may have one or more feeder funds as Limited Partners of it. If this is the case full due diligence on the feeder fund entities and then Limited Partners of the feeder fund will be required. The lenders may want to take security at the feeder fund level including over the General Partners of the feeder fund's right to drawdown commitments from the Limited Partners in the feeder fund.

The borrower and the 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 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. Some lenders 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 may be drafted in such a way that the lender is only really lending against certain 'Rated' or 'Qualified' Limited Partners that the lender is comfortable with respect to their identity and credit worthiness.

"It is important to understand the mechanism and timing for replacing the General Partner"

Underwriting of equity bridge facilities

The essential elements from the standpoint of most lenders' underwriting criterion will be the Limited Partners and the reputation and track record of the General Partner of the fund. The lenders will look to analyse the Limited Partners base, across the following criterion:

- **Strength of the Limited Partners** The lenders will generally analyse the Limited Partners in the context of their size (assets under management) and allocation to the private equity asset class. Most lenders are very sensitive to the percentage of commitments from family offices or high net worth individuals, preferring the institutional Limited Partners, such as pension funds, endowments, sovereign funds, etc. over individual investors. Some large institutionalised family offices, with long track records in private equity investing, may be viewed like any other institutional investor. The key concerns in relation to the non-institutional investor base stem from their commitment to the asset class and their financial capacity to meet their obligations to the fund on a timely and ongoing basis. The lenders may address this situation by allowing lower advance rates against the remaining callable capital or shorter repayment terms and by structuring the credit to allow for a larger or longer Limited Partner default buckets.
- **Commitment to fund** The lenders' analysis also takes into account the size of individual Limited Partner commitments as a percentage of overall fund size. Significant concentrations or oversized commitments can raise red flags, including the inability of other Limited Partners to absorb defaults or to significantly influence the fund or the other investors. The lender may also remedy this by allowing a lower advance rate or a lower credit facility amount. The lenders also like to see a high percentage of repeating Limited Partners in follow-on funds, raised by established private equity firms.
- **Commitment to industry** As part of the Limited Partner analysis, the lenders will like to get comfortable with the investors' commitment to the private equity industry, including their overall allocation to the private equity asset class, the length of time they have been investing in the space and their overall investment mandate within the asset class.
- **Performance** Lenders like to see consistent and timely performance by the Limited Partners and will review historical capital calls to identify delays or defaults.

Life stage of the fund

It is important for the lenders to have a full understanding of the status of the fund in its life-cycle from the standpoint of the underwriting and structuring of the credit facility.

- **Deployed capital** Lenders would usually like to see a certain percentage of capital having been called and invested by a given fund. This is particularly important for first-time funds or unproven investment strategies by seasoned managers. Deployed capital reflects both the Limited Partners' 'skin in the game' and their buy-in on the investment thesis. In the case of funds with less-established investors, the lenders may like to see a higher percentage of deployed capital.

  If the fund is still fundraising, it is important for the lenders to have full understanding of the viability of the fund, nature of the investor base, fundraising track record and current status and any restrictions that may be imposed by the limited partners, both under the Limited Partnership Agreements or the side-letters. At this stage in the fund's life cycle, the lender may look to structure the facility with tranched availability (subject to funds raised) or place other restrictions on the availability. The lender may also look towards other enhancements to the credit facility, such as guarantees.
- **Remaining callable capital** As part of the underwriting of the credit facility, the lenders will review the level of remaining callable capital relative to the commitment amount of the credit facility. It is also important to understand the fund strategy in terms of the expected capital deployment of the fund. The lenders also need to have a complete insight into whether the fund has or may have any other obligations, including guarantees that it may be providing on behalf of its portfolio company or companies.

  As part of the structuring of such credit facilities, the lenders' might include Net Asset Value (NAV)-related covenants, particularly, if the fund is in the later stages of its life-cycle or has significant portfolio concentrations.

- **Recallable capital** If the lender is viewing recallable capital to be part of the borrowing base or the advance rate calculation, it will be pertinent for it to understand how the recallable capital is calculated and if there may be any restrictions on the fund to actually recall capital from the Limited Partners, under the Limited Partnership Agreement.

Fund performance

- **Fund and firm metrics** Most lenders review the fund and the firm's performance metrics in a manner similar to that of a typical Limited Partner. Some of the key metrics that the lenders will look at are DPI (distributions to paid-in multiple or the realisation multiple), RVPI (residual value by paid-in capital), TVPI (total value to paid-in multiple or the investment multiple), IRR (internal rate of return) and the rate of deployment of the fund. These metrics are generally viewed against its competitors who have a similar profile and investment strategy, using third-party benchmark reports.

  As part of the analysis of the fund the lender will look to understand the future and outlook of the fund, including their ability to raise future funds. An inability to raise new funds or smaller new funds may reduce the management fees and thereby impact the firm's ability to manage the existing fund(s).

- **Portfolio** It is important for the lenders to assess the underlying investments in the fund's portfolio, as part of the underwriting and structuring. The lender should ensure that it understands the valuation criterion of the fund manager when it evaluates the NAV versus the cost and may wish to spend some time understanding the granularity of the portfolio, including concentrations and any significant changes in the valuations, such as write-offs.

- **Investment strategy** An in-depth understanding of the investment strategy of the fund is critical for both the underwriting and the structuring of the credit. Different investment strategies – venture capital, credit, buyouts, fund of funds, secondaries, infrastructure, real estate, etc. – have unique needs and benefits from using these credit facilities. The investment strategy of the fund manager would have an impact on the expected and actual usage of the credit facility and the level of potential obligations of the fund. Certain fund strategies may have a need to use guarantees for the underlying investments.

- **General Partners** The General Partners are the key part of the investment team of the fund and are responsible for raising capital, making and managing the investments, with the eventual goal of returning profits to the Limited Partners. As part of the underwriting and structuring of the credit facilities, the lenders should assess the overall health of the General Partners and their alignment to the fund, including: 'single' General Partner risk; size and source of the General Partner commitment (equity interest) to ensure so-called 'skin in the game', alignment of interests; the ability to honour their commitments to the fund; and the overall dynamics and health of the partnership. In the case of a less than ideal situation the lenders have the ability to add additional structural elements, such as tranched availability and incremental financial covenants, such as minimum NAV covenants.

"It is important for the lenders to assess the underlying investments in the fund's portfolio"



Facility agreement

Conditions to utilisation

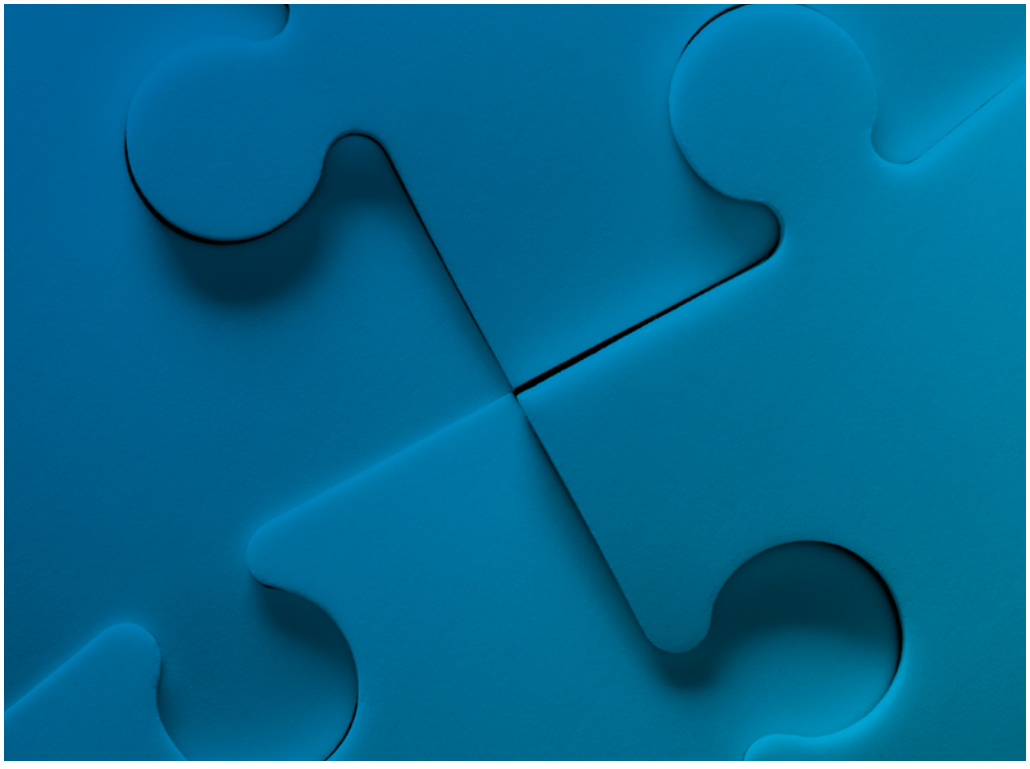
As with a typical corporate facility based on the Loan Market Association (LMA) standard documentation, a capital call or subscription line facility will contain a number of items that will need to be delivered to the lender before the lender is committed to lend. These will include items such as board resolutions, officer certificates and other documents, commonly referred to as 'initial conditions precedent'. There will also be a condition to the lenders obligation to lend that no event of default exists under the facility agreement and that certain representations that the fund gives in the facility agreement are true. For example that no suspension period - as defined in the relevant Limited Partnership Agreement (LPA) - has been triggered or that the relevant ratio of undrawn Limited Partner commitments to financial indebtedness of the fund is being complied with. Another additional condition is that the facility agreement may require there to be a minimum number of capital calls per year as a way for the lenders to ensure continuing performance of the Limited Partners.

Repayment

Typically the facility agreement will require the borrower to issue drawdown notices to the limited partners within a sufficient period of time to ensure the limited partners fund their commitment before the relevant repayment date. Traditionally for facilities of this nature, the repayment provisions in the facility agreement have required the utilisation to be repaid by the borrower within 30 to 90 days of the date on which it was made. However, a number of financial institutions are now prepared to extend repayment dates beyond these sorts of time frames.

Thresholds

A key feature of an equity bridge facility is the concept of thresholds, which relate to the LP commitments. Notwithstanding that the borrower's lawyers will seek to resist the inclusion of these thresholds in the facility agreement, the lender's lawyers will want to include events of default and undertakings relating to these thresholds in the facility agreement.



- **Withdrawal/cancellation threshold** This relates to the maximum proportion of the total undrawn LP commitments (less the undrawn LP commitments of excluded partners) which have been held by withdrawing Limited Partners or Limited Partners who have had their interests in the fund cancelled. A withdrawing partner is a Limited Partner which is going to withdraw from the fund and has notified the General Partner of its intention to withdraw.
- **Insolvency threshold** This relates to 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)** This relates to 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.

  If any of the thresholds above are exceeded, the undrawn LP commitments available to the fund (and therefore to the lender if it enforces its security) may fall below an acceptable level and the lender may be inadequately secured. The lender's lawyers will seek to ensure that breach of these thresholds will be an event of default under the facility agreement.
- **Transfer threshold** This relates to the maximum proportion of the total undrawn LP commitments which can be transferred to an entity other than an associate (which is usually defined in the LPA as an entity that is affiliated to an existing Limited Partner of the fund) after the fund has entered into the facility agreement. Certain lenders may consent to transfers of undrawn LP commitments to new Limited Partners or transfers to affiliates of existing Limited Partners provided such commitments are excluded from the borrowing base for the purposes of the minimum outstanding commitments covenant.

  The lender's lawyers will review the LPA and other fund documents 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)** This relates to 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.

  There are often side-letters entered into between individual Limited Partners and the fund containing provisions that excuse that Limited Partner, in certain circumstances, from complying with a drawdown notice sent by the General Partner. Excuse rights may relate to investments that could give rise to adverse consequences (e.g., under the US Employee Retirement Income Security Act 1974) or excuse Limited Partners from their commitments in relation to the fund's investment in certain industries (e.g., gambling, alcohol). 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** This relates to 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 or liabilities 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.

"The lender needs to know that the extent of excused rights remains at acceptable levels"

Guarantees

The lender will seek to obtain guarantees from each Limited Partnership in respect of the borrowings of any other Limited Partnerships in the fund. This is also the case where the borrower is not the fund itself but a special purpose vehicle (SPV) subsidiary company or any other company within the fund's group and the lender will require a guarantee of the borrower's obligations from the fund. Guarantees will also be required when the lender is lending to more than one parallel fund on the same transaction. The lender's lawyers will need to review the fund documents to ensure that the fund can give the guarantee and that recourse under it is not limited. For example there may be a cap on the value of the guarantees which may be given under the partnership agreement.

For some banks it may be preferable to lend to an SPV or other vehicle with a guarantee from the fund rather than lending directly to the fund.

Representations

An equity bridge facility agreement will contain the standard representations that are found in an LMA facility agreement. These will be given by the fund, the General Partner and, if relevant, the manager depending on the lending structure and the LPA. The usual representations include those relating to status, binding obligations, non-conflict with other obligations and power and authority. In addition, a number of representations will be included that are specific to equity bridge facilities. These include inter alia representations confirming that:

- **Excused partners** The undrawn LP commitments of the excused partners do not exceed the excused partner threshold.
- **The fund** The fund documents permit the General Partner (or if relevant, the manager) to validly deliver drawdown notices to the Limited Partners in order that the proceeds may be used to repay loans made or to cash-collateralise letters of credit issued by the lender.
- **No other material agreements** There are no other material agreements that 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 such as the partnership agreement, side-letters, standard subscription agreements and investment management agreement).
- **No other creditors** There are no other creditors of the borrower or guarantors



other than (i) the Limited Partners in accordance with the terms of the partnership agreement; (ii) the General Partner or manager in respect of their entitlement to fees payable under the LPA or the management agreement; (iii) their professional advisers or administrative service advisers which are required for the purposes of corporate maintenance and the provision of necessary services to the fund and; (iv) the legal advisers of the fund or the lender advising on the negotiation and preparation of the finance documents. The lender may also restrict borrowings at the SPV subsidiary company level as a way of ensuring that any financial returns which can contribute towards repayment of the bridge facility are not eroded by any other creditor that may be in place.

- **No restrictions on assignment or security** None of the fund documents contain any provision that prohibits or restricts the granting of security or assignment by way of security of the rights of the General Partner (or if relevant, the manager).

Information undertakings

The equity bridge facility agreement will contain standard LMA style information undertakings, together with additional information undertakings that are specific to equity bridge facilities. Typically these additional information undertakings require that:

- **Financial information** The lender in the same way as the Limited Partners, is provided with annual and quarterly financial information on the fund, including details of the undrawn LP commitments and the LP commitments that have already been funded together with equivalent information to that provided to the Limited Partners.
- **Statement of investments or valuation schedules** The lender, in the same way as the Limited Partners, is provided on a periodic basis with a statement of the investments in which the fund has an interest, details of the investments purchased, sold and otherwise disposed of during the relevant period and the cost and value of each investment.
- **Excused, withdrawing or defaulting partner** The lender is provided with details of any Limited Partner which becomes an excused partner, a withdrawing partner or a defaulting partner.
- **Notification to Limited Partners** Depending on the jurisdiction of the fund and the type of security given, the General Partner (or if relevant, the manager) will usually notify each Limited Partner that the facility agreement has been entered and that there has been a security assignment of the rights of the General Partner (or if relevant the manager) to draw down commitments from the Limited Partners. Ideally for the lender the notification should also mention that on an event of default, the lender may exercise the rights of the General Partner (or if relevant, the manager) to draw down commitments from the Limited Partners, together with any enforcement rights that the General partner may have.
- **Transfers** The lender is provided with details of any transfer by a Limited Partner of its interest in the fund or any subscriptions by a new Limited Partner in the fund.

General undertakings

The lender under an equity bridge facility will require specific undertakings relating to the value of the security and the structure of the fund. Typically, these will include undertakings (some of which may be found in an LMA facility agreement) that:

- **Negative pledge** Neither the fund nor the General Partner will create or permit to subsist any security over any fund investment, any undrawn LP commitments, any rights of the General Partner (or if relevant, the manager) under the fund documents or any other asset owned

"The lender under an equity bridge facility will require specific undertakings relating to the value of the security and the structure of the fund"

directly by the fund. Usually the negative pledge clause would not restrict the fund's portfolio companies from granting security to third-party creditors to secure debt at the operating company level.

- **Distributions** Depending on the commercial agreement between the parties, there may be restrictions on distributions to the Limited Partners or the General Partner (other than certain limited exceptions) while there are outstanding utilisations or, at least, that no distributions may be made if (i) an event of default under the facility agreement is continuing or (ii) if such distribution would be likely to result in the fund being unable to meet its payment obligations under the finance documents.
- **Transfers** No transfers of undrawn LP commitments may take place that change the composition of the Limited Partners without the lender's prior consent if such transfer would cause a breach of the transfer threshold for the fund. This clause may sometimes be heavily negotiated if it is important for the funds to allow transfers to occur within the Limited Partner group. Notwithstanding this, as previously referred to in the section 'Thresholds' above, banks may be willing to provide some flexibility by allowing transfers of undrawn LP commitments to unapproved Limited Partners provided those LP commitments that are transferred are actually carved out of the borrowing base. A lot will depend on the existing structure of the Limited Partner group on the date the financing is put in place. For example there may be an anchor investor that is a Limited Partner of the fund and if it were to transfer its investments in the fund that would cause an immediate breach of the threshold level. The fund may argue that a change in the composite of the Limited Partners is beyond its control - or limited to the controls it has in the LPA - and so the bank should not restrict transfers to an extent greater than already provided for in the agreement. The lender, however, will normally have a different view on this.
- **Minimum outstanding commitments** The undrawn LP commitments must be at least a certain percentage of all liabilities of the borrower under the facility agreement. In our experience the percentage of undrawn LP commitments to liabilities is typically between 200% and 300% but it may be higher or lower depending on the terms of the financing and the lender involved. This ensures that the lender has adequate collateral if it needs to enforce its security. It is also normal to exclude from this test the commitments of excused, withdrawing or insolvent Limited Partners and the commitments of a Limited Partner which have been transferred to another Limited Partner who has not been approved by the lender. This ratio may also be calculated in some instances by reference to a select group of "Rated" or "Qualified" investors.
- **Defaulting Limited Partners or excused Limited Partners** If a Limited Partner fails to pay any amount requested under a drawdown notice due to it being unwilling or excused from doing so under the partnership agreement, the General Partner will be required in the facility agreement to pursue all remedies available to it against that Limited Partner within a prescribed time. This is unlike in the LPA where there is usually no strict requirement but only a general discretion on the part of the General Partner to take enforcement action against limited partners) and will require each of the other Limited Partners to contribute a pro rata share of the defaulting or excused Limited Partner's contribution to make up any shortfall.
- **Collateral accounts** The General Partner (or if relevant, the manager) undertakes to pay all proceeds received pursuant to the serving of drawdown notices and which are to be used in repayment of the facility directly into an account over which the lender has security generally. Depending on what has been commercially agreed, the fund, the General Partner (and, if relevant, the manager) may be prohibited from withdrawing any amounts from such account until all outstanding loans and liabilities owed to the lender have been repaid or discharged in full. The lender's preference is usually to have the bank account into which the Limited Partner commitments are paid with the same bank. However, where a fund has a long-standing relationship with another bank for its operational banking, the fund may

insist that Limited Partner commitments continue to be paid into this account and the lender will then need to take a third-party bank account charge over the account. The lender will need to make sure that the third-party bank does not have set-off rights or any other encumbrance over the bank account which could restrict the lenders recourse to the monies in the event of an enforcement. Typically, as a condition precedent to the financing, the lender would require notices to be sent out to the third-party bank notifying it of the security granted over the account and requesting that set-off and other rights over the account be waived by the third-party bank. The fund should be free to make withdrawals out of the charged account prior to an event of default.

- **Fund documents** The facility agreement will require no amendments are made to the fund documents after the date of the facility agreement. The fund may insist that this undertaking be restricted to material amendments to the fund documents.
- **Drawdown notices** The facility agreement may require the General Partner (or if relevant, the manager) to serve such drawdown notices under the fund documents within a certain period of time.

Events of default

An equity bridge facility will contain the usual events of default found in an LMA facility agreement. These include events of default such as non-payment, non-compliance with undertakings, misrepresentation, cross-default, insolvency and no material adverse change. There are additionally a number of events of default which will be included that are specific to equity bridge facilities. These include events of default relating to:

- **Thresholds** Certain thresholds (discussed above) may be events of default.
- **Fund events** There will be an event of default following the resignation or removal of the General partner of the fund (or if relevant, the manager or the corporate general partner of the fund), the termination of the fund documents, the dissolution of the fund or the fund ceasing to be a limited partnership, the assignment by the general partner (or if relevant, the manager or corporate general partner) of any of its rights or obligations under the fund documents.
- **Payment default under the partnership agreement** There will be an event of default if the borrower (i.e., the fund) fails to receive more than a certain percentage of its LP commitments before the date upon which those amounts are due under the fund documents, or the General Partner (or if relevant, the manager or affiliate of either of them) fails to fund any portion of its LP commitment before the deadline stipulated in the fund documents.
- **Manager authorisation** There will be an event of default where the relevant authorisation granted to the manger (assuming there is a manager) is withdrawn.
- **General Partner** There will be an event of default where the General Partner ceases to be licensed where the General Partner is legally required to hold such licence.
- **Change of key person** There will be an event of default where there is a change of a key person connected to the fund.

The occurrence of an event of default will give the lender, in addition to the right to accelerate the loan, the right to demand that the General Partner issues drawdown notices to the Limited Partners requiring drawdown of unpaid LP commitments in cash for an amount at least equal to all outstanding utilisations, accrued interest and all other amounts outstanding.

If the lender has been granted a security assignment or power of attorney by the General Partner over the General Partner's rights to drawdown from limited partners, then, following an event of default, the lender can also issue the drawdown notices to the limited partners directly on behalf of the General Partner.

"The occurrence of an event of default will give the lender, in addition to the right to accelerate the loan, the right to demand that the General Partner issues drawdown notices"

Security

Security assignment and power of attorney

The lender will usually take security in the form of an assignment granted by the General Partner over its rights (or if relevant, the manager's rights) to issue and deliver drawdown notices to the Limited Partners and the co-investment vehicles (if they are part of the financing) and to exercise relevant penalties such as the forfeiture of the Limited Partners' rights under the fund documents. A power of attorney may also be granted by the General Partner (and if relevant, the manager) authorising the lender to issue and deliver drawdown notices to the Limited Partners and the co-investment vehicles. It is, however, preferable for a lender to take an assignment of the General Partner's (or if relevant, the manager's) rights, rather than 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 if relevant, the manager's) rights and obtain priority, even though such assignment breaches a negative pledge provisions of the facility agreement.

Bank account security

The lender may also take security in the form of an assignment or charge over the account into which the Limited Partners' LP commitments are paid. Under the facility agreement all proceeds received pursuant to the serving of drawdown notices to the Limited Partners and which are to be used in repayment of the bridge loans will usually be required to be deposited directly into a collateral account. The fund or manager will be prohibited from withdrawing any amounts from the collateral account until there is an event of default.

Points to consider when taking security

The lender's lawyers will 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 if relevant, the manager's) rights against them in respect of undrawn LP commitments. In some instances, the General Partner will be reluctant to notify the Limited Partners of the assignment possibly because it has concerns that notification will give rise to unnecessary questions from the Limited Partners or that notifying the Limited Partners of the assignment could be administratively burdensome. This can be dealt with by requiring the General Partner to notify the existence of the security that the lender has taken over the LP commitments in the fund's quarterly report or in the General Partner's next scheduled communication with the Limited Partners. This avoids a separate and specific notification being sent by the General Partner to Limited Partners informing such Limited Partners about the existence of the security.
- Seek legal advice from local counsel where the security is governed by foreign law on the issues referred to 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 if relevant, the manager's) rights in relation to these obligations will also need to be taken.

Alternative facilities

Other fund related facilities

- **Portfolio company credit** Some lenders may have the ability to enable funds to use the equity bridge facilities, usually under a sub-limit structure, to allow for borrowings at the portfolio company level. The actual need may be driven by several reasons, for example the portfolio company does not qualify for or would have a more expensive standalone financing or needs temporary financing before being able to refinance or sell the company. Portfolio company level sub-limits can serve as timely and effective bridges to a more permanent financing and can offer a significant competitive advantage during the investment process. It is critical for the fund-level lenders to ensure that the credit is underwritten to the fund and to have a clear understanding of strategy of the fund as it relates to the portfolio company or companies. As part of the structuring, the lenders would usually require a certain level of minimum equity contribution and may charge a premium to the equity bridge facility.
- **Standby letter of credits** In a manner similar to the sub-limits allowing for portfolio company level debt, lenders may allow for funds to be able to issue standby letters of credit for different reasons, including, support for a portfolio company and back-stops to certain obligations that a fund may have in relation to bids, financial commitments, etc. As in the case of the portfolio company level debt sub-limits, the standby letters of credit are underwritten to the fund and it is important to have a full understanding on the potential usage of these sub-limits and their impact on the equity bridge facility.

Management company and General Partner related facilities

- **General Partner (Employee Investment Programme) commitment lines** A select group of banks may look to finance a portion of the commitment of the General Partners to the fund. This type of a financing may also be applicable to a broader Employee Investment Programme that some of the private equity firms have in place. In most cases, as part of the underwriting, the banks may require support from the manager. The underwriting and structuring of these credit facilities requires the lenders to have a detailed understanding of both the fund, as well as the manager.
- **Management company line** Management company lines of credit can be viewed as working capital revolvers for managers to effectively bridge between expenses and the periodic incoming management fees. As part of the underwriting considerations the lenders may cover the following criterion: intended usage of the facility; the manager structure(s) and the underlying agreements; the source of fees (number of funds; any waivers, offsets or deferrals that may impact the level of fees); the expense structure of the firm; and future fundraising ability, etc. The lenders will also evaluate the underlying funds, including: life stage of the fund(s) and the remaining callable capital; Limited Partners; and the fund performance. In order to appropriately structure the credit facility, the lenders may also consider the following: clean-up requirements; a security interest in all assets of the managers; covenants in relation to the management fees; minimum debt service coverage requirements; and fund-level investor performance.

"Portfolio company level sub-limits can serve as timely and effective bridges to a more permanent financing"

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