

## **Private Equity GP and Employee Co-Investment Credit Facilities, Management Lines of Credit**

Due Diligence, Structuring and Documentation; Role of Sponsor, Administrative Issues

---

THURSDAY, APRIL 14, 2022

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

---

Today's faculty features:

Julia Kohen, Partner, **Simpson Thacher & Bartlett LLP**, New York

James S. Lawlor, Counsel, **Reed Smith**, Philadelphia

---

The audio portion of the conference may be accessed via the telephone or by using your computer's speakers. Please refer to the instructions emailed to registrants for additional information. If you have any questions, please contact **Customer Service at 1-800-926-7926 ext. 1.**

### Sound Quality

If you are listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory, you may listen via the phone: dial **1-877-447-0294** and enter your **Conference ID and PIN** when prompted. Otherwise, please **send us a chat** or e-mail [sound@straffordpub.com](mailto:sound@straffordpub.com) immediately so we can address the problem.

If you dialed in and have any difficulties during the call, press \*0 for assistance.

### Viewing Quality

To maximize your screen, press the 'Full Screen' symbol located on the bottom right of the slides. To exit full screen, press the Esc button.

## *Continuing Education Credits*

FOR LIVE EVENT ONLY

---

In order for us to process your continuing education credit, you must confirm your participation in this webinar by completing and submitting the Attendance Affirmation/Evaluation after the webinar.

A link to the Attendance Affirmation/Evaluation will be in the thank you email that you will receive immediately following the program.

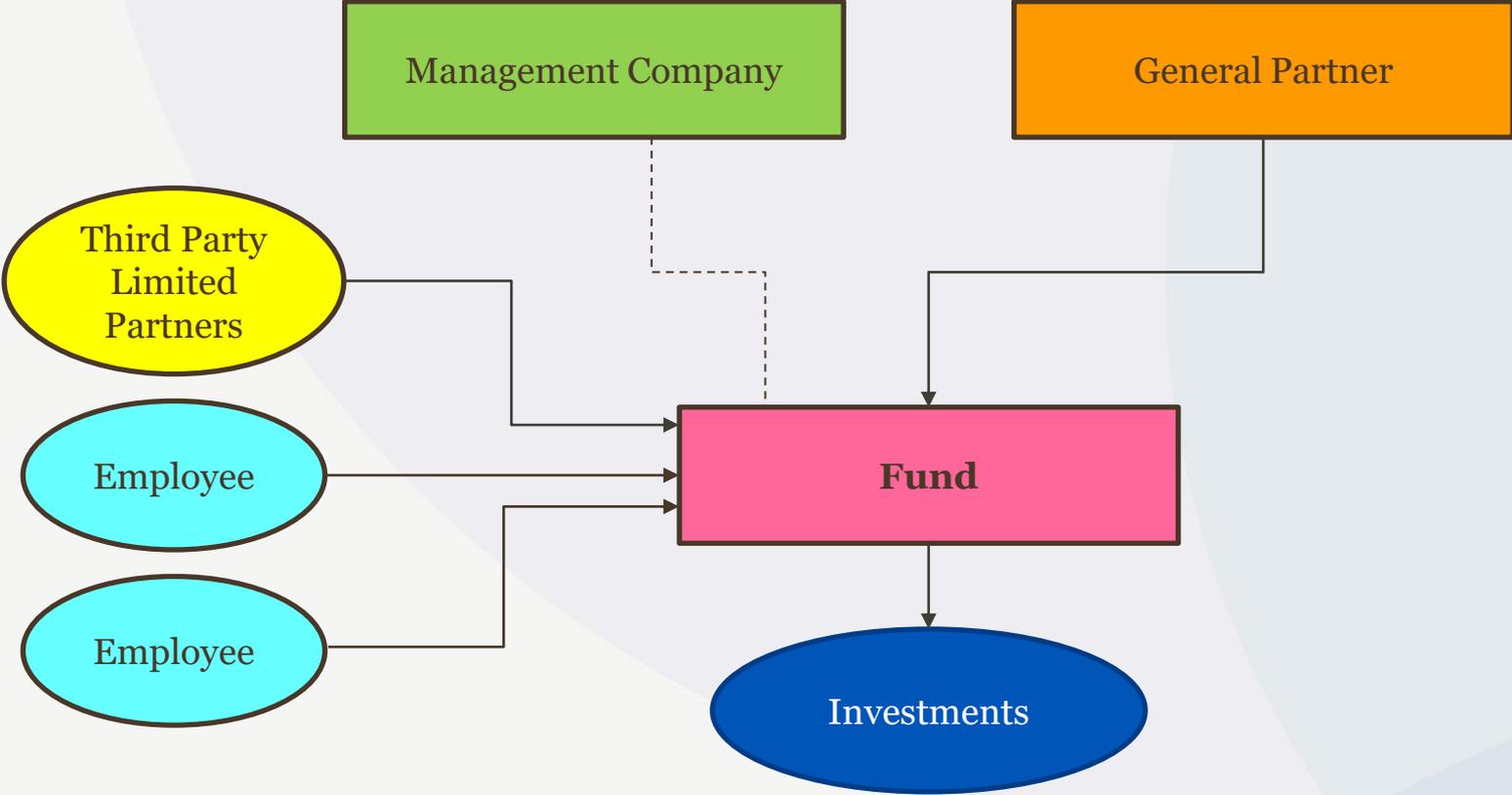
For additional information about continuing education, call us at 1-800-926-7926 ext. 2.

If you have not printed the conference materials for this program, please complete the following steps:

- Click on the link to the PDF of the slides for today's program, which is located to the right of the slides, just above the Q&A box.
- The PDF will open a separate tab/window. Print the slides by clicking on the printer icon.

**Recording our programs is not permitted. However, today's participants can order a recorded version of this event at a special attendee price. Please call Customer Service at 800-926-7926 ext.1 or visit Strafford's website at [www.straffordpub.com](http://www.straffordpub.com).**

# Structure



# Management Lines of Credit, Employee Co-Investment Lines of Credit & GP Facilities

- As private equity fundraising has increased and the subscription facility market has grown, fund sponsors are increasingly interested in obtaining other means of liquidity for their businesses and their investing professionals
- At the same time, lenders are deepening their relationships with fund sponsors and expanding their product offerings to include:
  - **Management Lines of Credit** – working capital facilities for fund managers that are secured by management fees paid to a management company
  - **Employee Co-Investment Lines of Credit** – loans made to employees and investment professionals to finance their investment in funds
  - **General Partner Lines of Credit** – loans made to a general partner for the purpose of financing the general partners' capital contributions to a fund

# Management Lines of Credit

- **Type of Facility:** Working capital facility for fund managers that are secured by management fees paid to a management company
- **Borrower:** Management Company
- **Use of Proceeds:** Liquidity to smooth cash flows and bridge expense obligations in between the quarterly and/or semi-annual payments of the management fee
  - Loan proceeds and letters of credit may be used by the management company for various working capital purposes, including meeting payroll obligations, paying operating and administrative expenses and satisfying lease obligations

# Collateral

Typically secured by a pledge of:

- Bank account into which such fees earned by the manager are deposited
  - To perfect the lender's security interest, the lender and borrower will need to enter into an account control agreement with the bank where the account is maintained in
  - In an enforcement scenario, the lender can exercise exclusive control over the account and access any management fees that are deposited into such account
- Management fees that a fund manager collects pursuant to the limited partnership agreement or other management/advisory agreement entered into with the funds managed by the fund manager
  - Lender's security interest in the right to receive payment of management fees is perfected by filing a UCC-1

# Negotiation Points

- ***Negotiation Point #1:*** Many management agreements contain a standard anti-assignment provision that prohibits the fund manager from assigning or pledging any of its rights under the management agreement
  - UCC contains override provisions that render such anti-assignment provisions unenforceable for the limited purposes of facilitating a financing
  - Therefore, as a technical matter, a fund manager may grant a lien on its *right* to receive management fees without violating such an anti-assignment provision
  - Fund managers should consider whether they are comfortable entering into a financing arrangement that runs counter to the express provisions of the negotiated management agreement
    - If so, fund managers should consider whether sufficient disclosure has been provided to investors

# Negotiation Points

- ***Negotiation Point #2:*** A lender may also request that the underlying funds enter into side letters whereby to acknowledge the pledge of management fees and agree to deposit such fees into the pledged account or, during the continuance of an event of default under the management line, as otherwise directed by the lender
  - If the lender does require such letters, the underlying funds should only agree to pay management fees when due and payable under the management agreement
  - Funds should not covenant to pay such fees into the pledged account or directly to the lender if the management fees have not yet been earned
- ***Negotiation Point #3:*** In some cases, a lender may also request a personal guarantee from one or more of the founding partners or members of the management company
  - If a guarantee is requested, particular attention will need to be paid to the exposure of those individuals and their comfort in providing such credit support
  - Complications may arise if more than one individual is providing the guarantee

# Diligence

As part of its decision to provide a management working capital facility, a lender will also want to:

1. Diligence each management agreement
2. Understand how fees are calculated, when they are paid and the composition of the assets under management
3. Determine whether the facility will only finance (and be collateralized by) fees payable by (a) funds under existing management agreements and/or (b) future funds
4. Identify entities that will directly receive management fees and ensure that each such entity is joined as a borrower or credit party under the management line
5. Consider track-record of the manager and the strategy of funds under management

# Common Covenants

- Intended to provide the lender with comfort as to the creditworthiness of the fund manager and the stream of management fee income, as well as protect against adverse changes to the collateral package
- Common covenants include:
  - Prohibition on amendments to any management agreement that reduce the amount of management fees payable by the funds
  - Limitations on postponing, cancelling, reducing or suspending the payment of management fees (with the understanding that carve-outs may be necessary to allow for exceptions that have already been incorporated into the management agreement)
  - Financial covenants applicable to the fund manager, such as minimum assets under management or a minimum amount of management fees payable in any given year
  - Reporting relating to management fees

# Interplay with Subscription Facilities

- If any of the funds under management are (or may become) borrowers under subscription facilities, the management company and lender will need to be mindful of any subordination provisions in such facilities
- Some subscription facility lenders seek to limit the payment by the funds of management fees during an event of default under the subscription facility if, at such time, there are loan obligations outstanding to subscription facility lenders
- If a fund is required to sign an acknowledgment letter in connection with the management line of credit, consider any necessary exceptions that take into account limitations set forth in the subscription facility
- Fund sponsors should resist subscription facility limitations on the payment of management fees
  - If the parties do agree to any such limits as a commercial matter, those limits will need to be carefully crafted so that, absent extenuating circumstances, management fees can continue to be paid

# Employee Co-investment / Partner Loan Programs

- **Type of Facility:** Loans made directly to employees and investment professionals to finance their investment in funds
- **Borrowers:** Individual employees and investment professionals
- **Use of Proceeds:** Finance borrowers' capital contribution obligations to funds and provide liquidity
- **Role of Fund Sponsor:** Facilities are often arranged and managed by the fund sponsor, which will:
  - Negotiate the form of loan documentation
  - Coordinate borrowing requests that are timed with the calling of capital
  - Provide the lender with periodic reporting as to the fund interests pledged by the participants as well information as to any payments of dividends and distributions in respect of such interests
- **Collateral:** Secured by equity interests acquired by employee borrowers
  - **Note:** Sarbanes Oxley prohibits issuers from arranging credit to any of its directors or executive officers

# Diligence

- A co-investment lender will diligence potential borrowers to determine their creditworthiness to participate in the program, including whether the borrowers satisfy specific underwriting criteria, such as a minimum net worth and credit score
- Potential borrowers will be asked to provide sufficient documentary support to evidence their creditworthiness, which may include the first few pages of their recent tax returns and K-1s
- If the pool of participants is more junior (and, hence, deemed by the lender to be not as creditworthy as more senior partner professionals), the lender may look for credit support from the fund sponsor
- Alternatively, the lender may structure the facility as an on-lending arrangement, whereby the lender loans monies directly to a fund sponsor entity which, in turn, on-lends such monies to the employees to finance a portion of their co-investment interests
- Lenders will want to diligence and understand the underlying investment fund strategy

# Common Covenants

- Borrowers may be permitted to finance (or refinance in the case of previously made capital contributions) 50% to 70% of their required capital contributions
  - Each capital contribution made by a borrower will be funded with a combination of loan proceeds and such borrower's available cash
- Typically, there is also a maintenance test, with a corresponding requirement that a borrower make a mandatory prepayment (and/or post additional collateral) if the maintenance test is breached due to a decline in the value of the collateral securing such borrower's co-investment loans

# Common Covenants

- Borrowers are required to prepay their loans with negotiated percentages of each return of capital and distribution (other than tax-only distributions) that they receive
  - During an event of default, the lender may require that 100% of such amounts received be applied to such borrower's outstanding co-investment loan obligations
- Prepayment requirements are applied on a borrower-by-borrower basis
- A default by one borrower does not result in other borrowers being put into default under their loans

# Administrative Considerations

- Administrative burdens on the lender and the sponsor can be significant, especially in light of the number of employees that may participate in the loan program
- Fund sponsor will need to provide the lender with:
  - Advance notice of each capital call being financed with borrowings
  - Notice of each return of capital for which a mandatory prepayment is required
  - Notice of a borrower's death, disability or termination of employment (which may adversely affect the borrower's ability to repay its loans)
  - Notice of any transfer of fund interests to the borrower's estate planning vehicle (in which case, the vehicle would be expected to be joined as a borrower)
  - Notice of any change in name or address of the borrower (which can affect the lender's security interest and trigger the need to file an amended UCC financing statement)

# Negotiation Points

***Negotiation Point #1:*** Is the sponsor is willing to provide a guarantee or other credit support for the co-investment loans?

- Many sponsors resist providing guarantees of their employees' debts
- Similarly, sponsors are disinclined to enter into on-lending programs, as they would be the direct borrower vis-à-vis the co-investment lender
- Sponsors may agree to a buy-back or re-marketing obligation whereby they either:
  - Purchase a defaulted employee's pledged fund interests or
  - Assist in marketing the defaulted employee's fund interests to other potential qualified buyers, in each case with the proceeds of such sale being applied to repay the defaulting borrower's loan obligations under the co-investment facility

# Negotiation Points

***Negotiation Point #2:*** What percentage of cash dividends and distributions in respect of pledged fund interests is required to be applied as a mandatory prepayment of the co-investment loan?

- Proceeds with respect to a fund interest can be applied to the employee's co-investment loans generally or only to the loan that was used to finance that fund interest
  - Some programs take a borrower-friendly approach and apply the mandatory prepayment requirement on a fund-by-fund, investment-by-investment basis (and look only to the affected percentage of the underlying interest held by that pledged fund)
- However it is administratively more convenient for the fund sponsor to apply proceeds to entire loan
  - This also leads to faster repayment of loans, which eases the burden on the sponsor if it has provided credit support for the employee loans

# Negotiation Points

***Negotiation Point #3:*** Nature of the consent provided by the general partner of the underlying funds

- *Consent to Pledge:* Collateral consists of fund interests, and the general partner of each fund must consent to the pledge by borrowers
- *Condition Consent to Foreclosure:* The general partner is obligated under the limited partnership agreement of each underlying fund not to permit transfers that would violate applicable law or cause a tax, ERISA or other regulatory problem for such fund
  - Lender ability to foreclose may be further complicated if the pledged interest is in an employee securities company
  - Alternatives are for a sponsor to guaranty the loan or agree to a buyback option

# Interplay with Subscription Facilities

Partner loan programs and fund-level subscription facilities can impact each other in two ways:

- (1) If interests in a fund borrower are pledged to secure a partner loan program, the fund's general partner may need to disclose this to the subscription facility lender
  - This may result in the affected partner being excluded from the borrowing base calculation for the subscription facility
  - Even if the pledge, in and of itself, does not result in such an exclusion from the borrowing base, in the event of a transfer of such fund interest in a foreclosure, the partner will be excluded from the borrowing base on account of such transfer
  
- (2) Subscription facilities commonly prohibit fund borrowers from making distributions to partners during certain defaults
  - Co-investment facility lenders should be mindful that any such subordination of payments to partners may adversely affect their ability to be repaid

# GP Lines of Credit

- **Borrower:** General partner or a principal of the fund to invest through the general partner
- **Use of Proceeds:** Financing the general partners' capital contributions to a fund, and therefore provides the principals of the fund liquidity
  - Facility sizes vary, but many funds have a minimum capital commitment requirement for the GP (which is often reflected as a percentage of total capital commitments), which satisfies investor requirements for the fund sponsor to have “skin in the game”
- **Diligence:** Lenders will want to diligence
  - The principals of the fund who are obligated to fund directly or indirectly to the general partner
  - Track-record of the sponsor
  - Strategy of the underlying fund(s)

# Points of Negotiation

- **Collateral:** Lender may require the general partner to grant a lien on its interest in the underlying fund
- ***Negotiation Point #1:*** Most limited partnership agreements prohibit the fund's general partner from "transferring" its general partnership interest
  - A pledge by the general partner of its general partnership interest in the fund could be considered a transfer that might violate the limited partnership agreement
  - Can the LPA be amended to bifurcate the general partner's interest into a general partnership interest (with the associated carried interest) and a limited partnership interest?
    - The general partner would only pledge its limited partnership interest to secure the GP financing

# Interplay with Subscription Facilities

- Most subscription facilities include a negative covenant prohibiting the general partner of the fund borrower from granting a lien on its general partnership interest
- Pledge by the general partner of its limited partnership interest in a fund may result in the general partner being excluded from the borrowing base in the fund's subscription facility
- If the general partner subsequently transfers any portion of its limited partnership interest, such transfer will be subject to any applicable covenants in the subscription facility
- Subscription facility may restrict borrowings by the GP or an event of a default in a subscription facility may include a cross-default to GP debt
- Certain events under the subscription facility – an event of default and/or cash control event – may restrict the fund from making distributions to LPs and the GP and thereby limit the source of repayment for a lender under a GP line

# Considerations across all these financings

- *Verbiage can be misleading* – When discussing financing options with a potential lender, the parties should be specific about which entity or person is borrowing and what collateral or other credit support is available for the borrowing
- *Disclosure* – Has appropriate disclosure been provided to limited partners about the potential financings and their impact on the investors and the funds in which they invest
- *Relationship Lending* – As with subscription facilities, these financing options are all examples of relationship lending

# Considerations across all these financings

- *Potential Conflicts of Interest* – Sponsors should be mindful of potential conflicts of interest if a lender offers all facilities as a package deal
- *Nature of the Collateral* – Fund interests are relatively illiquid, whereas a management line is collateralized by fees that are paid in cash
- *Plan ahead for each of these facilities:*
  - If a management line is contemplated – consider what flexibility to include in the form of management agreement
  - If a partner loan program is contemplated – where will employees invest, can interests be pledged and can the sponsor provide a guarantee or other credit support
  - If a GP line contemplated – consider drafting the LPA to bifurcate the GP and LP interests

# Questions?



**Julia Kohen**  
Partner  
Simpson Thacher & Bartlett LLP  
(212) 455-2375  
jkohen@stblaw.com



**Jim Lawlor**  
Counsel  
Reed Smith  
(215) 851-8113  
jlawlor@reedsmith.com