

Fund Finance Friday



Diligence Considerations for GP Facilities

April 24, 2020 | Issue No. 74

Previous *FFF* articles have discussed an increase in demand for GP and co-invest facilities over recent years. In light of current circumstances, some market participants are already predicting an increase in the popularity of these products, with GPs, managers and co-invest participants wanting to ensure they have an available source of liquidity to meet their obligations to provide capital to their funds. Anecdotally, and in line with these predictions, we have seen a healthy uptick in work around existing GPPS facilities (increases, additional borrower accessions) over recent months.

In light of this, it seems timely to build on our previous pieces about GP facilities by discussing some of the key points to bear in mind when considering the due diligence (and structuring) for a GP facility.

GP support facilities rely on GP profit share (or “GPPS”) as the source of funds for repayment of the facility, with security generally being taken over the entitlement of the GP to the GPPS and/or the account into which the GPPS is paid. This gives rise to a very different set of due diligence considerations to a standard subscription facility (although, in some ways, as discussed below, the subscription facility due diligence remains a sub-set of due diligence for a GPPS facility).

Depending on the structure of the fund, entitlement to the GPPS may rest with another fund entity – most likely the manager, if not the GP. Or the GP may have an entitlement to the GPPS under the LPA but may be contractually required to pay on the GPPS to other advisors or managers in the fund for their own account. In these circumstances, the due diligence will need to follow the GPPS through to the ultimate fund party beneficiary. This is discussed further below, but in the interests of keeping the list below digestible, we have assumed for present purposes that the GPPS is payable to (and retained by) the GP.

Increasingly, a GPPS facility may be coupled with a co-invest facility and, in some cases, the GPPS (or a portion of it) may be used as collateral for a co-invest facility. Co-invest facility due diligence is beyond the scope of the considerations below (and will be discussed in a later article). If you would like to discuss co-invest due diligence prior to the publication of that article, then please feel free to contact me or another member of the Cadwalader team.

Key Considerations:

1. Entitlement to GPPS

It is important to understand from the LPA which fund entity has the entitlement to the GPPS. Depending on the fund structure, the GPPS entitlement may sit with the manager rather than the GP (in which case, the manager will participate in the financing in place of or as well as the GP). Particularly in European transactions it shouldn't be assumed that the profit share entitlement is with the GP.

The entity with the entitlement to the GPPS (as mentioned above, we assume for present purposes this is the GP) will be party to the facility either as the borrower or a guarantor (with an SPV as borrower). As the GPPS is the primary, if not only source of funds to repay the facility, the capacity of the GP to borrower (or guarantee) the full amount of the facility under its formation documents is key.

2. Obligations to pay GPPS on to other fund entities

Depending on the structure of the fund, the GP may be required to pay on the GPPS to other fund entities (usually the manager and any advisors). This is increasingly common in Europe where a separate AIFM is required. Depending on the terms of the facility, it will likely be necessary to track the GPPS through to these

entities and ensure that they are granting security over their entitlement to receive the GPPS and the bank account into which it is paid.

For example, if only part of the GPPS is required to be applied in mandatory prepayment of the facility (with the fund being entitled to retain the remaining part of the GPPS to pay costs such as salaries), then on enforcement GPPS amounts already paid could sit with any of the fund entities through which it passes. Practically, the final entity in the GPPS waterfall may well be the entity with employees and costs and consequently contractually entitled to a significant share of the GPPS to allow it to meet these costs. The GPPS is generally paid either quarterly or semi-annually. This means that, at any time, a significant part of the GPPS already paid could be held by an entity other than the GP pending its application to monthly or periodic expenses. Therefore, bringing these entities within the scope of the security package (and ideally having them as guarantors) is important to realising value of past GPPS on enforcement.

The obligation to pay on the GPPS will typically arise in the management or advisory agreements and constitute a percentage of the GPPS (up to 100%) depending on the extent to which the GP has delegated its rights and responsibilities to the manager or other adviser. These documents (and any other instruments of appointment as well as formation documents) will need to be reviewed for the same issues raised in this list with respect to the GP. Ultimately, these documents will be “fund documents” for the purposes of the facility and compliance with their covenants will need to be regulated.

3. Calculation and timing of GPPS

Calculation of the GPPS needs to be modelled by the fund to show that it will support the facility. The due diligence should outline the manner by which the GPPS is calculated, and the lender needs to ensure that this description aligns with the parameters by which the model has been prepared.

The GPPS calculation will vary over the life of a fund, often moving from a percentage of investor commitment to a percentage of unrealised acquisition costs. Payment of the GPPS is generally quarterly or semi-annually.

The GP may be entitled to certain placement or other fees which may either be retained by the GP (in which case these fees should also ideally form part of the GPPS concept for the purposes of the facility) or paid into the fund (in which case set-off should not be required). If the placement or other fees in a period exceed the GPPS, then the due diligence should be clear as to whether the GP is required to pay that amount or can carry forward the set-off into subsequent periods.

Understanding the timing of the payment of GPPS is also important in terms of establishing the repayment profile (albeit via mandatory prepayments rather than scheduled amortisation) and monitoring this post-closing.

4. Reduction, suspension, forfeiture and clawback of GPPS

The LPA may well provide for circumstances in which GPPS is reduced, suspended or forfeited. For example, this may occur with respect to an investor's share of GPPS where that investor's interests are themselves forfeited. Practically, it may also be limited by a key person event to the extent that it leads to an inability to call capital to pay GPPS.

These events will need to be identified and appropriate protections (such as drawstops or mandatory prepayments) included in the facility documentation.

The LPA may also create circumstances in which GPPS can be clawed back. Where this is the case, the management and advisory agreements under which the GPPS is paid on to other fund entities should ideally reflect a similar contractual clawback (to ensure that the money returns to the GP, allowing it to meet its obligations under the LPA so as not to jeopardise later GPPS payments).

5. Removal of the GP and consequence to GPPS

Removal of the GP will, logically, also lead to a termination of the GPPS entitlement of the GP. Often there may be a termination fee payable where removal is without cause and care should be taken to ensure that the termination amount is within the scope of GPPS concept for the purposes of the facility. Care should also be taken to ensure that the scope of the security extends to the rights to receive any termination fee.

It is important to understand the timings and notice requirements for removal of the GP (whether for cause or not) so that suitable notification barriers can be built into the facility agreement.

6. Capital calls to pay GPPS

Capital calls for the purpose of paying GPPS will generally be possible and, therefore, the due diligence applicable to a subscription line facility becomes a subset of the due diligence for a GP facility. Particular attention should be paid to periods during which the right to call capital is curtailed; the LPA may well provide that capital calls for GPPS are not permitted during a suspension period (or only during the initial part of any suspension period) or when the investment period is terminated early.

In addition, LP side letters will often contain provisions which adjust (or prohibit) capital calls to pay GPPS (either by reducing the GPPS percentage rate from that stated in the LPA – which is also relevant to point 3 above – or prescribing times when such calls cannot be made).

7. Ranking of GPPS and impact of insolvency

The ability to pay GPPS under the LPA distributions waterfall needs to be clearly understood so that any pre-agreed contractual subordination with respect to GPPS is understood.

The position under the LPA will not necessarily be applicable on insolvency of the fund and so local law advice should be obtained as to the ranking of the GP's entitlement to GPPS relative to the LP's on insolvency. For example, will local law give effect to the ranking set out in the LPA between the various partners?

8. Restrictions on creation of security

The GP may well be restricted from assigning its rights to the GPPS under the LPA. This may be a “by-product” of the general assignments prohibition in the LPA and not purposefully aimed at preventing creation of security over the entitlement to receive the GPPS – but it may, regardless, either limit the effectiveness of the security or mean that the security cannot be granted absent LP consent.

The GP is, however, unlikely to be restricted from creating security over its bank accounts and, as a commercial matter, it may be sufficient that there be a contractual agreement to pay the GPPS into that account (with the security agent having control over any release from the account).

In addition to the points mentioned above, GP facility due diligence will also need to:

- ensure the appointment of the relevant entities under the fund documents or any related management/advisory agreements can be tracked,
- explain the requirements placed on the relevant fund entities to make contributions to the fund (and the consequences of those contributions not being made),
- explain the way the GP (or manager) is structured and if it is itself a fund, then including which entities sign on its behalf and who is responsible for its day-to-day business, and
- ensure there is sufficient capacity and power under the GP (or manager) documents for it to borrow, grant security and give any related guarantee.

The above list is by no means intended to be exhaustive. GPPS is often a bespoke and complicated part of any LPA that is frequently adjusted on a per investor basis through the side letters. However, it serves to demonstrate how intricate these financings can be and that, in the end, the success of the financing will depend on the depth of the due diligence and its effective application in the facility drafting.