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Fund Finance Friday

Diligence Considerations for Fund Executive Facilities

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In a previous *Fund Finance Friday* **article**, we discussed the due diligence scope and content for GP facilities where security is taken over the GP profit share. As mentioned in that article, we are increasingly seeing facilities being made available to management and executives of a fund for the purpose of the executives funding their commitment as LPs of co-invest vehicles. This raises very different considerations to subscription facilities and also a different set of considerations to facilities relying on the GP profit share.

As with GP facilities, executive facilities may be structured as a direct lend by the bank to the individuals, or a back-to-back arrangement may be established where the bank lends to a fund vehicle or SPV that, in turn, lends to management (or, in the case of a GP facility, the GP) under a proceeds loan. Where lending is transacted through an SPV, the security will usually be established in a "cascade" – each executive will grant security in favour of the SPV in support of its obligations as borrower under the proceeds loan, and the SPV then grants security over its rights under that security to the bank (or its security agent). As these structures involve lending to individuals, it is important to bear in mind consumer credit limitations and regulations, as described **here**.

The security for these structures will vary depending on the size of the facility and the financial strength of the fund and its management. The "core" asset securing such a facility are the distributions payable to the executives in their capacity as LPs of the co-invest fund, but in certain cases, this may be coupled with asset security (generally cash or "cash equivalent" collateral) or even all or a portion of the GP profit share.

The structure will typically require a mandatory payment by the individual borrowers on receipt of their distributions (either net of tax or not) and involve the GP agreeing that it will pay the amount of such distributions to a secured account of the SPV borrower or directly to the banks on behalf of the individual borrowers. The distributions subject to security and any mandatory prepayment regime may or may not include carry.

Where the security extends beyond LP distributions, the assets that comprise the extended security package will need to be the subject of appropriate due diligence.

In this article, we focus on the due diligence (other than legal consumer credit considerations) with respect to the executives and their right to receive distributions in their capacity as LPs of the co-invest vehicle.

Key considerations:

1. Ownership of LP interest and co-invest structure

   As with a subscription line facility, it is important to verify the LP interest of the executive in the co-invest fund. This interest may be held directly by the individual or through an investment vehicle or trust.

   Where the latter is the case, the constitutional documents of the vehicle or trust will also need to be reviewed to ensure that entity is able to borrow (if it will be the borrower on behalf of the executive) and grant security (as ideally the security would be granted by that entity (given it is the LP with the entitlement to the distribution)).

   Where the borrower is the executive and not its investment vehicle, then consideration should be given to whether the investment vehicle should guarantee the performance of the borrower and whether security is needed over the borrower's interest in the investment vehicle (though this may not be available where the investment vehicle holds more than just the relevant LP interests or where it is established for the benefit of a family).

   It is also important to understand how the co-invest fund interacts with the main fund, whether it invests alongside the main fund (in which case there will likely be a co-invest agreement that will include provisions relevant to the points below) or through the main fund (with the co-invest fund effectively a feeder to the main fund).

2. Side letter considerations

   Where there are side letters in place between management and the co-invest fund or GP, then these will need to be reviewed as part of the due diligence. Side letters are less common in the context of management and executives (some funds have a policy of not permitting them), and so they tend to be less of a focus than on subscription or GP facilities.

   A side letter review of the main fund documents will also be needed to ensure that there is nothing in those letters that restricts the main fund from making distributions to the co-invest fund (over and above any limitations that may be in the main fund LPA).

3. Frequency and timing of LP distributions to executives

   The timing of LP distributions to the executives will be a function of two things (leaving aside anything that may arise in the side letters): (1) the main fund LPA will set out the timing for distributions by the main fund to the co-invest fund (or, if the co-invest fund receives payment under the co-invest agreement, then this will more likely be documented in the co-invest agreement) and (2) the co-invest LPA will set out the timing for the payment of distributions to its LPs. Lenders will need to understand how both tiers of distributions operate.

   The making of distributions by the main fund will likely be subject to the usual GP discretions and abilities to hold back amounts for expected liabilities or investments. Similar provisions may also be found in the co-invest LPA, and thought should be given as to whether the facility agreement needs to regulate the ability of the GP to exercise these discretions, particularly after default or enforcement. Where the co-invest fund receives amounts under a co-invest agreement rather than as a distribution from the main fund, then the mechanisms for payment (or holding back payment) in the co-invest agreement will also need to be analysed.

4. Impact of ceasing employment

   Careful review of the co-invest LPA or co-invest agreement is also important with respect to the consequences to the executive of leaving its employment with the fund, either as a "good leaver" or "bad leaver," as this may result in a reduction or forfeiture of the executive's entitlement to distributions.

   Depending on the "leaver" provisions, consideration should be given to the ramifications under the facility should the executive leave the fund – for example, if the executive retains its LP interest and entitlement to distributions through the "good leaver" provisions, then perhaps it is appropriate to limit the ability to draw further (assuming that the executive is relieved, either by transfer or otherwise, of its obligation to fund future capital calls on departure) but not to require mandatory prepayment of existing loans, which can continue to be serviced by the distributions paid in respect of its pre-departure LP interests.

   Where "bad leaver" provisions result in forfeiture or forced transfer of the LP interests, then this has the potential to undermine the security, and thought will need to be given as to whether there is a solution to this either through the LPA provisions or under the terms of the finance documents. This may be less of an issue where the security package comprises assets in addition to the right to distributions (such as the GP profit share or cash collateral) or where the performance of the individual borrowers is guaranteed by a substantive fund entity such as the GP (which would not be unusual).

   The co-invest LPA or co-invest agreement will also deal with treatment of LP interests on death or incapacity, often allowing these to pass to family or family trusts. There are a number of ways to address this (such as acceleration or conditioning any consent to a transfer in these circumstances to a grant of security by the new holder).

5. Removal of GP/Manager and consequence on co-invest entitlement to distributions

   Where the co-invest fund receives distributions under the main fund LPA, that LPA may also place restrictions on distributions to the co-invest fund upon removal of the GP/Manager (which would, in turn, result in the co-invest fund not having profits to distribute to its executive LPs), particularly where the removal of the GP/Manager is for "cause." Removal for cause will likely also mean a significant reduction in any outstanding GP profit share that is owed to the GP/Manager and so, to the extent that this also forms part of the security support (or the GP is a guarantor of the facility), it has the potential to be something of a double-whammy.

6. Impact of executive being a "defaulting" LP

As with third-party LPs and the main fund LPA, the co-invest LPA will likely deal with the scenario of an executive being a defaulting LP. These consequences may well be similar to those for the third-party LPs in the main fund, though they may be tempered somewhat by the executive also being an employee.

7. Restrictions on taking security

Last, but perhaps foremost, the transfer provisions in the co-invest LPA should be reviewed to ensure that the creation of security over the right to receive distributions (which, depending on the jurisdictions involved, may be a pledge or could constitute an assignment) is not prohibited by the LPA. If security is granted over the LP interest itself (and not just the contractual entitlement to distributions) then this will also need to be checked against the transfer and assignment provisions.

In addition to the structuring considerations set out at the start of this article and the key considerations above (which relate primarily to the right of the executive to receive distributions and the ability to create security over that right), due diligence will also need to encompass:

- the ability of any fund entity that is providing a guarantee or security to do so;
- title and the ability to create security over any other assets that comprise the security; and
- any intermediate entities that sit between the co-invest vehicle and the main fund (which may themselves be fund entities with their own LPAs).

The list above is in no way definitive, as there is no "one-size-fits-all" approach to executive and management facilities. The fund structure, location of executives, applicable consumer credit legislation, proposed guarantee and security structure, and circumstances in which distributions can be reduced or suspended will always vary. Thorough due diligence of the executive co-invest structure is an essential "front-loaded" aspect of any such financing, as the outcome of the due diligence will dictate many of the commercial covenants, drawstops, mandatory prepayment and events of default.