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FUND FINANCE FRIDAY

Get Well, Keep Well

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We periodically receive the question about the differences between guaranties, equity commitment letters and keepwell agreements in connection with fund finance credit facilities. Each can be used as a potent form of credit enhancement if specifically tailored to the particulars of a transaction. In this article, we cover not only the differences between each instrument and issues with their enforcement, but also provide concrete examples of recommended provisions to better ensure their effectiveness.

Guaranties

The most common fund finance credit support analyzed in this article, a guaranty is an agreement of secondary liability. The guarantor contractually promises to fulfill the obligations of a principal obligor, such as a borrower, if the obligor defaults on its underlying obligations. The guaranty is made directly in favor of the lender, who could enforce against the guarantor should the borrower fail to repay its loans.

A guaranty can provide utility for numerous scenarios in the fund finance space. Certain limited partners may have tax or regulatory sensitivities to committing capital to an entity that incurs debt for borrowed money. So a sponsor can direct their capital commitments to a feeder fund that does not borrow but instead provides a guaranty of borrowings by a subsidiary fund entity. The guarantor would grant security to the lender in those capital commitments, providing the lender with a source of repayment in an enforcement action. A fund may seek to obtain loans for a portfolio company that are less costly than those available at the portfolio level. The portfolio company will become a “qualified borrower” to take out loans under the credit facility, and the fund will issue a guaranty in favor of the lender that is backstopped by security on the capital commitments of the fund’s limited partners. Less commonly, a guaranty might need to be structured to be given by an affiliated sibling entity rather than a parent, or even by a subsidiary asset-bearing vehicle for the benefit of a fund borrower. In limited circumstances, a sponsor might provide a guaranty for certain aspects of a transaction, such as repayment of borrowings for management fees under default circumstances or a “bad-boy” guaranty against losses incurred by the lender because of material misrepresentations or bad acts by the principals of the fund.

Guaranties are more frequently used in fund finance than equity commitment letters and keepwell agreements because they are better understood by market participants and more robust in their enforcement. They are relatively simple for a fund to implement. If the fund defaults, the lender can seek repayment directly from the guarantor or invoke rights to its collateral. Courts tend to be far more familiar with the requirements and nuances of structuring guaranties, which may bolster their enforceability. And many jurisdictions have entire statutory regimes to govern their application.

To ensure that a guaranty is enforceable, the fund guarantor and the lender should first confirm any limitations in the fund's constituent documents on providing the guaranty. The fund's limited partnership agreement might have a direct constraint on giving guaranties or, more commonly, an indirect restriction on guaranties as part of its overall leverage limitations. Any such limits should be assessed by the contracting parties to confirm compliance under the guaranty agreement.

The guaranty obligations should be supported by a bargained-for benefit to the guarantor. That consideration is easy to quantify when the guarantor is a parent entity that will benefit economically from loans to its subsidiary. If there is a cross-stream guaranty by a sibling fund vehicle or an upstream guaranty provided by a subsidiary for a borrowing parent, that consideration for the guarantor should be carefully assessed. Without valid consideration, the guaranty may not be enforceable and can be subject to fraudulent transfer defenses by other creditors. To circumvent such issues, the guaranty agreement should clearly state that valuable and sufficient consideration has been given.

Generally, a lender will want a guaranty of payment rather than a guaranty of collection. The former permits a lender to proceed directly against the guarantor without first seeking repayment from the borrower, even if the borrower is solvent and able to pay. The latter would require a lender to exhaust all of its remedies against the borrower, including foreclosing on any collateral, which can be a time-consuming and costly process, before the lender can enforce against the guarantor. A guaranty of payment is the default form of guaranty under New York law unless the parties otherwise agree in writing, but it is best practice to have the guaranty agreement (even if governed by New York law) explicitly state that it is a guaranty of payment and not of collection. To avoid the guaranty becoming void because of challenges to the enforceability of the underlying loan agreement, the guaranty should also state that it is absolute and unconditional, and the guarantor waives all legal and equitable defenses to enforcement, to the fullest extent permitted by law.

Equity Commitment Letters

An equity commitment letter is an agreement by a parent entity to contribute capital in the form of equity to a subsidiary. When the subsidiary requires finances to meet its payment obligations, the subsidiary can require the parent to contribute capital to it on demand in exchange for additional equity of the subsidiary. In a fund finance transaction, a routine application is where a creditworthy parent company issues an equity commitment letter to a fund borrower vehicle. An equity commitment letter may also be utilized by a feeder or blocker fund in favor of a subsidiary holding company borrower. The equity commitment letter demonstrates to the lender that the borrower has sufficient resources to meet its repayment obligations under the credit facility.

The equity commitment letter is a useful tool in place of other credit support where the parent company cannot have a customary capital commitment or is unwilling to assume a direct indebtedness or guaranty obligation. It may be used for tax structuring purposes by having tax-resistant limited partners commit capital to a blocker entity that will not incur indebtedness or liability under a guaranty. If a fund is looking to support a portfolio company borrower but has reached the maximum level of debt or guaranty obligations it may provide under its partnership agreement, the fund can issue an equity commitment letter as credit enhancement for the loans to the subsidiary.

Unlike a guaranty that is issued directly in favor of a lender, an equity commitment letter is an agreement by the parent that only directly runs in favor of the subsidiary. The lender must either be made an express third-party beneficiary under the equity commitment letter or be granted the subsidiary's rights against the parent as collateral for the loan. In either case, in a default scenario, the equity commitment letter is meant to enable the lender to cause the parent to contribute the necessary capital to the subsidiary to cure the default. A guaranty agreement, on the other hand, would permit the lender to directly seek repayment from the guarantor parent if the borrower subsidiary defaults.

Equity commitment letters are used much less commonly in fund finance than guaranties and so are not as well understood in our market. There is also relatively little case law on their enforceability, making courts less accustomed to ascertaining their validity or handling their denouement. Still, as a contractual arrangement, an equity commitment letter is an enforceable obligation that binds the parent to its agreements under the terms of the letter. In the event that the subsidiary borrower is unable to fulfill its repayment obligations under the credit agreement, the lender would look to compel the parent to supply sufficient capital to the subsidiary to remedy the default.

As such, a lender should seek to include provisions in the equity commitment letter that provide the requisite protections. The parent might covenant to reserve sufficient capital to meet its funding obligations during the term of the letter. The letter should include a waiver of setoff, counterclaim and defense by the parent in contributing capital. This can forestall the parent from raising defenses that the letter cannot be enforced by the subsidiary and thus removing all benefits to the lender. Ideally, it would also expressly give a right to the borrower or the lender, as a third-party beneficiary or as collateral assignee of the subsidiary's rights under the letter, to claim either damages or specific performance against the parent. That would permit the lender to seek monetary damages if a court holds that specific performance is an inappropriate remedy under the circumstances. Because the lender is not a party to the equity commitment letter, the letter should only be amendable with prior lender consent. The parent and subsidiary must also not be able to terminate the letter without prior consent of the lender, unless the parent's unfunded capital support obligations continue after termination for any liabilities of the subsidiary to the lender that were incurred prior to termination. The provisions that are ultimately agreed by the parties will be negotiated based on the specific needs and preferences for a particular transaction.

Keepwell Agreements

A keepwell agreement is typically an undertaking by a parent to preserve a subsidiary's financial condition. The parent promises support for its subsidiary to pay and discharge its obligations under a specified obligation as they become due. Where the subsidiary would not otherwise have the credit wherewithal to enter into a particular transaction, the parent provides the keepwell support to permit the subsidiary to execute the trade. The degree of credit enrichment that is delivered by a keepwell agreement is derived from the extent of the specific obligations to which the parent agrees.

A keepwell agreement is another form of credit support that may be employed in fund finance transactions. A keepwell can be used by a sponsor to show that it will safeguard the economic strength of a fund, or by a parent investor entity to monitor and protect the financial health of a special purposes vehicle limited partner. But a keepwell agreement's provisions generally do not rise to the level of offering a formal guaranty that a lender will be repaid. Also, unlike an equity commitment letter that requires a funding of capital in exchange for equity, a keepwell usually will contain only general statements of support rather than a direct mechanism through which a parent contributes capital.

The keepwell agreement will be enforceable as a contractual obligation of the parent, up to the amount of support the parent undertakes to provide in the agreement. This distinguishes a keepwell from a comfort or support letter, which can offer assurances to a lender via affirmation of the relationship between the parent and the subsidiary, but is merely a statement of intent rather than a binding contract. If the keepwell agreement is not made in favor of the lender, then as with an equity commitment letter, the lender should seek to be an express third-party beneficiary or collateral assignee of the rights of the subsidiary under the keepwell. This will enable the lender to enforce the keepwell agreement against the parent if ever needed.

To enhance the credit protection of a keepwell agreement, the parent can agree to fund capital to the subsidiary when necessary for the subsidiary to pay and discharge its obligations. The parent should covenant not to take action that would interfere with the subsidiary complying with its repayment requirements or that would leave the subsidiary with insufficient capital to do so. It is helpful to specify that the subsidiary or lender may claim either damages or specific performance. The keepwell agreement should also not be amendable or terminable without prior consent of the lender, like with an equity commitment letter. To protect against the keepwell being deemed to not be an enforceable contract, the parties should avoid any statement that it is not a binding obligation of the parent.

Final Thoughts

As seen above, guaranties, equity commitment letters and keepwell agreements can be utilized effectively in a variety of fund finance transactions. When drafted and used properly, each can provide an enforceable means of delivering a financial benefit to a parent, needed access to liquidity for a subsidiary and appropriate credit enhancement for a lender.