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Lessons from the Great Recession

Private Equity Firms as Borrowers and Providers of Credit Support

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Introduction
Welcome, this is the second installment in our “Food For Thought” series of discussions on current issues in the credit markets. The initial gathering one month ago covered the effects of the Great Recession and the so-called Credit Crisis on important provisions of loan documentation. Today’s program has a very different focus. We will speak about private equity funds, how they participate in leveraged transactions, how they borrow for their own purposes and how they access the syndicated loan and bond markets to obtain acquisition finance. Please accept one disclaimer: The views expressed in this presentation are designed, in part, to stimulate discussion and are not necessarily the views of Edwards Angell Palmer & Dodge or its clients.

The four topics discussed in this program are:

1. What does a fund partnership agreement say about debt and guaranties? (Heather Stone)
2. Current developments regarding sponsor make-well agreements. (Stuart Brown)
3. Debt structures when the fund or the general partner is the borrower. (Louis Mercedes)
4. Acquisition financing commitments: what’s new? (George Ticknor)

I. What Does a Fund Partnership Agreement Say about Debt and Guaranties?
(Moderator: Jim Rubens, Panelist: Heather Stone)

Question:
What provisions of a private equity firm’s partnership agreement come into play when the fund is considering borrowing or providing a guaranty?

Answer:
A fund’s partnership agreement likely contains restrictions on borrowing. One set of restrictions may limit the amount of money a fund can borrow. This could take the form of
a hard cap on borrowings, it may take the form of a cumulative cap pegged to the sum of direct borrowing plus guaranties by the fund, or it may limit the amount of a specific type of borrowing – secured versus unsecured borrowings, borrowings from banks versus from “others,” etc. A partnership agreement may also contain restrictions on the term of loans made to a fund. These limitations can be as short as 30 days per borrowing for some funds. A fund’s partnership agreement may also permit borrowings only for specific purposes. A common example of this last type of restriction is a provision that limits borrowings to those necessary to provide a bridge between the issuance of a capital call and when the limited partners must fund their capital contributions.

The second common set of restrictions in fund partnership agreements relates to guaranties. Note that fund partnership agreements typically define a “guaranty” broadly and that these broad definitions pick up much more than a plain vanilla guaranty of bank debt. It would not be unusual for a fund’s partnership agreement to define a “guaranty” as broadly as “guaranteeing or becoming liable for the obligations of another.” The most common restriction on guaranties (as defined by the fund’s partnership agreement) is a cap on the amount of permitted guaranties. Caps on amounts of permitted guaranties vary from partnership agreement to partnership agreement. Like restrictions that cap borrowings, however, they may take the form of a cumulative cap, a separate cap, or a cap on the type of guaranty (for example, guaranties of portfolio company debt may be treated differently than guaranties with respect to other entities).

One other point worth considering with respect to restrictions on borrowing and guaranties in a fund’s partnership agreement is that restrictions are usually not drafted to match how the fund actually does deals. A deal in which a holding company acts as the borrower and a fund acts as a guarantor may not work if the fund’s partnership agreement only permits portfolio company debt, since the holding company itself is not the actual portfolio company.

Question:

Where do these restrictions come from, and what is their purpose?

Answer:

Restrictions and limitations come from the fund’s limited partners. Some restrictions are meant to ensure that the fund stays within its allotted slot in the limited partners’ asset allocation strategy. If the fund has been marketed to the limited partners as a fund intended to make unlevered equity investments in operating companies, limited partners want to make sure that the fund won’t morph into a levered fund. Others are meant to avoid adverse tax consequences to the fund and some or all of the limited partners. For example, some limited partners may have sensitivity to UBTI or UDFI because of their tax-exempt status.

Question:

So, how can a fund work around these restrictions if necessary?
Answer:

With respect to restrictions on borrowing, it helps to try to find the right limited partners and to engage them on the benefits and extent of any borrowing. It obviously helps to make sure that any restrictions or limitations work for all parties ahead of time as well.

For restrictions on guaranties, it is often possible to create a transaction or agreement that doesn’t cause the fund to “become liable for the obligations of another,” such as make-well agreements or equity contribution agreements. Partnership agreements vary and are – by design – vague on what sort of agreements will work in lieu of an outright guaranty. There are no hard and fast rules as to what types of agreements work. Instead, a fund will need to consider what type of agreement to choose out of a spectrum of possibilities. Along the spectrum, we have strong forms of actual guaranties (both unlimited and limited in amount), but also make-well agreements that require a fund to make additional capital contributions to the portfolio company under certain circumstances (including defaults under a loan agreement), or perhaps make payments directly to a lender instead of to a portfolio company. We discuss recent developments in make-well agreements in the next segment of the program.

II. Make-Well Agreements (Moderator: Jim Rubens, Panelist: Stuart Brown)

Question:

Certain funds may provide credit support in leveraged transactions apart from outright guaranties. What form do these credit support mechanisms (a.k.a. make-well agreements) take?

Answer:

Credit support mechanisms by private equity funds take many forms and have various titles. They range from comfort letters, to keep-well agreement and make-well-agreements. As discussed in the first part of this program, funds often the need to take great strides to maintain the tax-exempt nature of returns and gains to avoid UBTI to their limited partners. In most cases, therefore, these make-well agreements read more like commitments to capitalize the portfolio company borrower rather than a guarantee of debt incurred by the portfolio company. Some of these agreements represent deferred investments by the sponsor into the portfolio company, resulting from increased leverage at closing, while others require cash infusions into the company to maintain leverage ratios or borrowing base formula covenants, and other forms require a direct pay down of debt.

From a tax perspective, make-wells that require sponsors to make additional capital contributions to the portfolio company are more likely to be treated as capital commitments than guarantees, whereas agreements that require a direct payment to the lender or payment into a company account controlled by the lender that is then swept by the lender is more
likely to be treated as a guarantee. Note, however, that bankruptcy courts are courts of equity. For obligation purposes, a bankruptcy court will look at a transaction without labels to determine its true nature. A bankruptcy court’s approach differs markedly from the tax analysis that often drives these sort of agreements.

**Question:**

What role do these agreements play in workout discussions or bankruptcy cases?

**Answer:**

In workout discussions or bankruptcy cases, it may help to first determine whether a sponsor intends to double down and try to protect its investment. If there is a make-well then the discussion turns to how to maximize the sponsor’s leverage in discussions with the lender and how to get the most bang for the buck and protection for any follow-on investment.

Make-well agreements are key elements to any distress situation because whether the sponsor, lender and borrower are parties to the same agreement – or the agreement has been collaterally assigned to the lender – these agreements often times are the only contractual link between the lender and the sponsor.

Make-well agreements come into play after the borrower has defaulted under the credit agreement, whether such default is a payment or covenant default. Lenders will be looking to shift the risk of loss to the sponsor, while the sponsor typically is looking to extinguish any additional obligation to support the distressed portfolio company. There is usually a dance between the lender and sponsor about which will support the company going forward by providing additional liquidity or otherwise developing a restructuring plan that involves additional capital in the form of debt and/or equity. These agreements, then, are at the heart of discussions with the lenders, on one hand, that are looking for the first dollars to come from the sponsor under such an agreement, and the sponsor, on the other hand, looking to hold onto its capital as long as possible (to see if the company can turn itself around or if the lender will fund to preserve the value of its collateral). The relative leverage of the lender and sponsor in such discussions depends on the nature of the agreement and the parties’ perceptions of the enforceability of such agreements under the bankruptcy code and under applicable state law.

**Question:**

You mean to say that these agreements may not be enforceable? How can that be?

**Answer:**

The bankruptcy code treats certain contracts differently than others. Specifically, it treats “executory contracts” differently. An “executory contract” is one in which there remains material obligations on both sides of the contract. So, a simple obligation to pay money
under a make-well agreement likely will not be construed to be an executory contract and likely will be enforceable by the parties.

Alternatively, a make-well that contemplates a series of transactions (for example one that requires the sponsor to pay in additional capital in exchange for the issuance of additional securities issued by the company) is more likely to be considered an executory contract. If it is an executory contract then it will be enforceable by the company, but not against the company, subject to exceptions that apply if the contract is construed as a loan, extends debt financing or otherwise extends financial accommodations to the company. Any such agreement may not be assumed by a debtor under the bankruptcy code and, therefore, it may not be enforced against the sponsor. So again, bankruptcy lawyers and judges will review each agreement and determine its true nature to determine whether it will be enforceable in a bankruptcy case.

Question:

Since portfolio companies tend to be under the direction of their sponsors, are there occasions where companies try to prevent a lender from exercising its rights under a make-well?

Answer:

There can be. If a make-well is a direct obligation by the sponsor to the lender, it represents an independent obligation of the sponsor and the debtor portfolio company has no interest. This is known as the “independence principle.” The agreement will be treated similarly to obligations under a letter of credit issued by a bank, for the benefit of its customer/debtor to the order of the ultimate beneficiary, a creditor of the debtor. Letters of credit are issued by a third party apart from the debtor and creditor. Because of the independence principle, the creditor is said to have an independent right to enforce the obligation and the mere substitution of the letter of credit issuer for the creditor upon a draw under the letter of credit is not a violation of the automatic stay in bankruptcy. Plenty of case law exists concerning unsecured obligations with letter of credit enhancements that become secured, fixed, matured, liquidated obligations of the debtor in bankruptcy.

Similarly, make-wells that require direct payments by the sponsor to the lender to pay down debt or to purchase the last-out debt are likely to be construed as independent obligations of the sponsor. Contrast that with a make-well that requires a payment to the company first. In such a circumstance, the proceeds will become property of the company, and then the bankruptcy estate, and the lender will not be able to enforce its claim against the borrower or cause the borrower/debtor to enforce the make-well against the sponsor or recover the proceeds.

Question:

Does the bankruptcy court have the authority to prevent the lender from trying to collect on a make-well?
Answer:

Yes. The bankruptcy code includes a provision that authorizes the bankruptcy court to enter any order in aid of the administration of an estate. Generally that means that the court may order parties to act or enjoin parties from acting.

Courts have the ability to enjoin creditors from suing insiders of the debtor to collect on claims, including guaranty-type claims (i) where one can demonstrate that the pursuit of such a claim will irreparably injure the estate (ii) where the insider has limited means but intends to contribute such means toward the reorganization of the debtor, and (iii) where the balance of equities in favor of a successful reorganization weighs in favor of the debtor.

Many mature funds in fact do have limited resources and many sponsors determine that it is more prudent to honor their obligations under make-wells in the context of a restructuring. This judgment differs from a decision to honor the make-well obligation first, before considering how the restructuring will be structured. In most situations, the sponsor will have but one opportunity to leverage a favorable result and that should be in the context of making the investment under a confirmed plan of reorganization with restructured debt obligations and the obligations under the make-well relieved in exchange for the contribution of such limited resources to the restructuring. In this case, the courts will find that the contribution to be made under the plan will benefit the estate and creditors of the estate, which benefit will outweigh paying the obligation under the make-well into the general coffers of the lender.

III. Deal Structures When the Fund or the General Partner Is the Borrower
(Moderator: Jim Rubens, Panelist: Louis Mercedes)

The previous segment addressed issues relating to private equity funds as sponsors. Before that, we discussed the limitations in a private equity fund’s partnership agreement with respect to the fund’s ability to borrow and provide guarantees. This portion of the program will focus specifically on deal structure when the private equity fund or the general partner entities themselves are the borrowers. There are different ways in which the individual general partners of a fund may borrow for liquidity, but, here we will focus solely on when the general partner doing the borrowing is the entity itself.

Question:

Given that the private equity funds will have a pool of committed capital, why would the private equity fund itself want / need to incur indebtedness?
**Answer:**

A private equity fund will borrow to bridge the time lag between the issuance of a capital call and when the limited partners must fund their capital contributions. So, the loan proceeds are used to fund investments and to pay expenses (including management fees). The bridge loan provides an administrative convenience for the fund.

**Question:**

What type of lending structures have we typically seen when private equity funds are the borrowers?

**Answer:**

_Type of Facility._

Financing is generally provided in the form of a revolving credit facility. Usually the facility has a term of one year, with outstanding loans cleared on a quarterly basis. The facility is typically amended every year to extend the term for an additional year.

_Limits._

Availability under a credit facility is typically dictated by a percentage of uncalled capital commitments since the primary collateral under the facility is likely to be a security interest in the fund’s capital commitments and capital contributions. For example, usually the private equity fund may be able to borrow the lesser of the committed loan amount and 50% of uncalled capital commitments. Requiring the fund to have unfunded capital commitments that are twice the outstanding loan amount is pretty standard. Recently, we have also seen lenders limit borrowing based on the uncalled capital commitments of only those investors that met certain criteria of the lender (i.e., a “qualified investor”), suggesting a trend that lenders are scrutinizing the value of uncalled capital commitments more than in previous years.

Given the short-term nature of these facilities and the fact that the loan amount is a percentage of uncalled capital commitments, a private equity fund typically approaches the loan process with a viewpoint that it should not be an arduous process. The lender, for its part, wants to have as much comfort as possible that committed capital far exceeds the outstanding loan obligation, and that comfort generates paperwork and expense. This provides some tension in the process. From the lender’s perspective, obviously the lender is putting capital at risk and will want to take the necessary steps to minimize such risk. Consider, a lender must address whether the loan will be secured or unsecured? If secured, what type of collateral will it require? What type of restrictions will it impose on the fund? Etc. – and balance these concerns against the desire of private equity borrowers to have as little paperwork as possible.
Collateral.

With respect to collateralization, we’ve seen some unsecured facilities. However, most of the financings that we have seen are secured, typically by a security interest in the partnership’s right to capital commitments and contributions of the limited partners. The general partner undertakes to make a capital call in the event of a default to pay the outstanding loan amount. The lender, during a default, may also have the right to issue a notice to the limited partners that all capital contributions owing to the fund shall be made directly to the lender. This is distinguished from an assignment by the general partner of its right to call capital from the limited partnership, which most Delaware attorneys believe constitutes an improper delegation of managerial responsibility (in the absence of express authorization for such an assignment under the limited partnership agreement).

As part of the collateral package, we also often see lenders take a security interest in the fund’s deposit account, which the lender will require to be kept with the lender. The fund would be required to make all of its deposits into such deposit account. Upon a default, the lender would have the right to pay down the loan obligations with funds from the deposit account.

Recently, as credit markets tightened, we have also seen lenders increasingly requesting pledges of the portfolio company securities of the fund. This can be an issue for the private equity fund, as usually the governing documents for portfolio companies restrict the transfer of securities. Additionally, the private equity fund may want to have the flexibility to pledge such securities to secure the obligations of the portfolio company if required in a credit facility for the portfolio company. The compromise that we have seen here is the “springing pledge.” The bank would require a shelf filing of a pledge agreement for the portfolio company securities. The shelf filing would be activated in the event of a payment default. The pledge agreement would exclude from the collateral any of the portfolio company securities to the extent a pledge of such assets would violate anti-assignment provisions or other restrictions on transfer. We suspect that part of the reason for the additional scrutiny on limited partners and the requirement for additional security was driven by the liquidity concerns of limited partners over the last 2 years and the perceived ability of limited partners to fund their capital commitments.

Covenants.

In addition to reporting requirements and prohibitions on additional indebtedness, we often see negative pledges in respect of the general partner’s and the fund’s rights in respect of capital calls and limited partners’ capital contribution obligations. Lenders often also require a negative pledge in respect of all assets of the fund, subject to certain exceptions (e.g., transfer restrictions in portfolio company governing documents, liens with respect to indebtedness and guarantees permitted under the limited partnership agreement up to a certain threshold).
Question:

What is the structure of a credit facility when a General Partner is the borrower?

Answer:

Type of Facility.

With respect to the general partner entity as the borrower, the structure is usually also a revolver, but we frequently see demand loans as well. The purpose of the borrowing is usually to bridge the general partner’s co-investment obligations pending the receipt of funds from its limited partners. The general partner may also be permitted to use funds for expenses. Usually, these facilities are not for a significant amount of money and the lender looks to the payment of management fees as a source funds for re-payment.

Collateral.

Typically, the loan is collateralized by a security interest in the deposit account of the general partner, which will be required to be kept with the lender. Given the fiduciary duties of a general partner, the management responsibilities and the fact that the general partner’s interest in the fund is typically not assignable without the consent of the LPs, lenders typically do not request pledges of the general partner’s interest in the fund.

Covenants.

Noteworthy covenants are (i) negative pledges in respect of the general partner’s management fees and (ii) cross defaults with the fund line of credit.

IV. Acquisition Financing Commitments: What’s New? (Moderator: Jim Rubens, Panelist: George Ticknor)

The previous topics were about substantive provisions in loan documentation. This next topic is about allocating risks of uncertainty between lenders on the one hand and sponsors and strategic buyers on the other in leveraged buyouts. The litigation among the sponsors and the arrangers in the Clear Channel transaction was a good example of what can happen when the escape clauses of the buyer in a transaction do not align with the escape clauses of the financiers. So, the next topic will explore in the context of a tumultuous period how commitment letters are responding to sellers’ concerns regarding execution risk and buyers’ and lenders’ concerns regarding allocation of financing risk. We have used 9 sets of recent commitment papers in compiling our database, some of which are public and some not, so we are not mentioning names of any of these transactions.
Question:

One traditional source of uncertainty for sellers and equity sponsors is a lack of congruence between acquisition document conditions and financing conditions. How have commitment documents traditionally dealt with this, and what is the trend?

Answer:

Traditionally, lenders have fought hard to retain, and have successfully retained, special financing conditions which were independent of the closing conditions in the acquisition documents. Conditions such as the lender having the right to sign off on the status of regulatory approvals, third-party consents, etc., gave the lenders the right to walk if conditions to the acquisition documents were satisfied but conditions in the financing commitment were not. Lenders often are more risk-adverse than purchasers, and it created the possibility that the purchaser would not have the right to walk from the transaction (assuming there was no financing contingency) but could potentially lose its financing. This is a bad outcome for the purchaser, and ultimately a bad outcome for the seller. In the early stages of the LBO boom, sellers forced deal certainty on buyers and financers by insisting that financing commitments contain no conditions precedent to closing in the definitive loan documentation, except conditions precedent which would permit a buyer to walk from the transaction in the definitive acquisition documentation and certain “Specified Representations” (power and authority, deal authorization, execution, delivery and enforceability of loan documents, solvency, conflicts with charter documents, use of proceeds, margin requirements, perfection of liens, etc.). These provisions were designed to ensure the seller that so long as the conditions to closing under the acquisition agreement were met, the lenders would not have an additional “out” beyond the narrow set of conditions in the merger agreement. These “SunGard” limitations are pertinent only at the time of the acquisition closing. Lenders would benefit from the full panoply of funding conditions and representations and warranties in the context of subsequent borrowings.

Many thought these “SunGard” provisions would become a victim of The Great Recession. As it turns out, virtually all of the major buyout deals in the market over the past 6 months or so contain the “SunGard” limitation on representations and warranties and conditions to closing. As a practical matter, this means that business and legal due diligence are front-end loaded and accomplished substantially, if not entirely, before the commitment letter is signed.

Question:

How about material adverse effect conditions, how have they been affected by The Great Recession?

Answer:

Traditionally, lenders have preserved the right to close based on material adverse conditions affecting the borrower, the acquisition and the financing. Interestingly and consistent with
the “SunGard” limitations on representations and warranties and closing conditions, lenders in large syndicated transactions have relied exclusively on the material adverse effect condition incorporated in the acquisition documents. As a practical matter, this means that matters relating to the financing and the financing markets have to be addressed exclusively through the “flex” provisions. Material adverse effect language in acquisition agreements typically refers to business-specific deterioration of the target. Lenders protect themselves by placing limitations on the ability of buyers to amend or waive conditions in the acquisition documents. For example, waivers of requirements relating to solvency certificates, fairness opinions or changes in purchase price and structure can frequently not be accomplished without the lender’s consent. Occasionally, buyers respond that such changes should be permitted, provided that they do not have a “material adverse effect” on the financing.

Question:

What is a “Market MAC” and how have these provisions changed in the slate of buyouts at the end of 2009 and in 2010?

Answer:

A “Market MAC” condition allows arrangers to refuse to fund a loan commitment if there was a material adverse change in the financing markets. These provisions have traditionally been very common, if not uniform, at all levels of buyout financing commitments from the top end of the market down into the middle zone of the middle market. Interestingly, in the 9 recent deals that we are involved with or have looked at in the middle market, none of them have Market MAC language. Instead, what has developed is elaborate pricing flex provisions. The practical effect of these provisions is that the arranger cannot “escape” its commitment if the market changes, but it can greatly adjust the pricing, yields, fees and structure. Whereas, previous to The Great Recession, it was unusual to see price flex of more than 100 basis points, we are seeing interest price flex in the 2-400 basis point range. The longer the commitment period, the higher the flex. Additional flex can be in the form of enhanced call protection and increased amortization. Also, interest flex is often expressed as a weighted average which would apply to all debt tranches in a facility so that the arrangers can allocate the pricing to the portions of the financing that most need it. In deals which are rated, occasionally interest flex is tied to the level of the rating. The higher the rating, the greater the extent of the interest flex.

Question:

Do these provisions play out differently in broadly syndicated versus club transactions, and where do you think the markets are going?

Answer:

Currently, the top end of the middle market is much more active than the middle and lower ends. There appears to be an imbalance between a large supply of funds prepared to finance
LBO transactions with a relatively small number of deals. Marquee deal sponsors under these circumstances are able to obtain commitments, and even pricing, which seems to roll back the hands of time to 2006. It is not clear at all whether these conditions will prevail further down the middle market in smaller transactions. These small transaction markets have not really come to life yet and our frame of reference is not very broad. Certainly, there is a greatly reduced number of lenders in the middle and lower end of the middle market, and one would suspect that when the deal volume picks up, the existing lenders will have more leverage than lenders at the upper end of the middle market in dictating terms. We have described the commitment negotiation policy as a matter of allocating the risk of uncertainty between seller, buyer and financer. The balance of allocation of uncertainty may well lead to these lenders pushing off more of the risk of uncertainty to borrowers than is the case in the upper end of the middle market. This will not keep equity sponsors from pushing hard on these lenders in the smaller transactions. If and to the extent because of the large supply of funds available to fund large buyouts traditional bank financers move “down market,” perhaps the provisions we have discussed today will as well.