Understanding PE Employee Co-Investment Credit Facilities

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As fund finance facilities, net asset value, or NAV, facilities, and hybrid lines of credit have become commonplace in the market, private equity and real estate firm sponsors continue to seek additional methods to deploy capital as effectively and efficiently as possible.

To accommodate this demand, credit providers are expanding the variety of products offered to their clients in the fund finance industry. Three such products are management lines of credit, general partner, or GP, financing, and employee co-investment facilities.

For purposes of this article, the term sponsor will be used to refer to a member of the investment fund's corporate structure, but the role of the particular entity — be it the management company, the investment fund's ultimate general partner or another affiliate — may vary depending on corporate structure.

Management lines of credit are frequently structured as revolving credit facilities provided to a sponsor's management company. These credit lines provide the management company with working capital to bridge management fee payments that may be payable on only a quarterly (or even more infrequent) basis.

GP financing provides a line of credit to an individual fund's general partner (or equivalent) to assist with the general partner's capital contribution requirements into such fund.

Employee co-investment facilities (also referred to as co-investment lines), or partner loan programs, are lines of credit offered to certain employees of the sponsor to invest in, or alongside, one or more of the sponsor's funds by enabling the employee to utilize loan proceeds to fund capital contributions into the fund. The sponsor (in consultation with the lender) will determine criteria for an employee's eligibility in a co-investment facility.

Eligible employees typically play a significant role in the management, investment strategy or day-to-day operations of the sponsor's investment funds, and may be required to meet a certain level of seniority at the sponsor and/or certain net worth qualifications to be sufficiently creditworthy from a lender's and sponsor's perspective.

In addition to the benefits more fully discussed below, both GP financing and co-investment lines are intended to help a sponsor and the sponsor employees manage liquidity needs.

Benefits of a Co-Investment Line

Co-investment lines offer significant benefits to each party involved. For instance, co-investment lines are negotiated by, and often backed by the credit of, a sponsor, which permits the sponsor to provide its employees access to credit with better pricing and more narrowly tailored collateral packages as compared to what the individuals could procure on their own.

Additionally, these facilities free up a sponsor employee’s personal funds for alternative uses and may prevent the need for the employee to liquidate other assets for purposes of funding capital calls.

For the sponsor, increasing its employees’ participation in a fund can provide several benefits, including:

- It helps satisfy the growing demand from investors that the combined capital commitments of the sponsor and its affiliates or employees meet or exceed a minimum threshold in each fund (which is often included as a minimum capital commitment requirement in the fund’s partnership agreement). Leveraging future distributions allows the sponsor and its employees to meet those demands efficiently.

- Offering the sponsor employees the opportunity to invest in the fund and receive related returns provides an additional employee benefit and can further an employee’s commitment to the sponsor and the long-term success of its funds.

- Utilizing proceeds of the co-investment line to make sponsor employees’ capital contributions eases the sponsor’s administrative burdens by providing more certainty as to the timing of receipt of funds.

In addition to the fees and interest charged on the facility, a lender benefits from providing a co-investment line by gaining greater familiarity with a sponsor and the sponsor employees.

The strengthened relationship gives the lender an advantage when bidding to provide portfolio-level financing, traditional subscription financing and private wealth services. The lender is also generally able to charge higher interest rates for these lines as compared to traditional subscription facilities.

However, as co-investment lines can range anywhere from a couple million dollars to tens of millions of dollars (with many falling below $25 million), the increased rates on their own may not be sufficiently enticing to a lender.

The Catch: Due Diligence

Despite the aforementioned benefits, co-investment lines are not yet commonplace, in large part due to the level of diligence required. Lenders will often require robust personal financial packages from each sponsor employee, both prior to offering the facility and as an ongoing reporting requirement.

For example, each sponsor employee may be asked to deliver personal financial statements (balance sheets and income statements), capital account statements, tax returns, and brokerage, bank and mutual fund statements on a quarterly, or more frequent, basis. This is in addition to driver's licenses or passports with home addresses, relevant trust agreements and any related changes over time.

A sponsor employee may view this diligence as invasive and burdensome to provide, and it requires additional time and underwriting for lenders and their counsel to process.

The burden of underwriting the financial information and completing know-your-customer requirements generally falls to the lender, but counsel will often be tasked with conducting lien searches and reviewing the employees' personal documentation and trust agreements, if applicable, to confirm identity, verify title to assets, and account for the movement of partnership interests or other assets from a natural person in, or out, of such trusts.

Additionally, lenders must also diligence the fund and sponsor, as the partnership interests held by the sponsor employees in the fund and the related distributions paid to the sponsor employees will be a significant piece of the lender's collateral package.

If the fund is unlikely to provide the anticipated returns, a lender would be forced to pursue more burdensome foreclosure procedures against the sponsor employee's personal assets. Lenders will therefore consider the relationship they have with the sponsor, the sponsor's track record in the industry, the quality of the third-party investors in the underlying fund, and overall fund strategy.

In light of these considerations, it is often easier for sponsors to obtain co-investment lines from lenders with whom they already have a relationship. These lenders already have familiarity with the sponsor and are thus more willing to undertake the remaining diligence despite the relatively small facility size.

Structure and Documentation

Having decided to establish a co-investment line, the parties must determine what structure best serves the needs of the sponsor, lender and sponsor employees. In some instances, the sponsor employees will serve as borrowers while the sponsor acts as guarantor.

Alternatively, this structure can be flipped with the sponsor or an employee co-investment vehicle as the named borrower and the sponsor employees as guarantors.

In each case, the sponsor negotiates the credit documentation and offers program participation to certain of its employees who are deemed sufficiently creditworthy by the lender.

As these facilities are often bespoke to each sponsor/lender relationship, they can require a significant amount of time and expense to establish. In contrast to more traditional financing arrangements between a lender and affiliated corporate entities, counsel must document relationships between the lender, sponsor employees, fund, GP and any other applicable sponsor entities, each of which has distinct interests.

By way of example, the sponsor will often want to support the underlying sponsor employees while simultaneously limiting its own obligations and working with the lender to develop reporting and payment mechanics that will simplify administration of the fund.

In addition to negotiating these conflicting perspectives, counsel and lender will often need to develop a customized set of representations, covenants and reporting requirements tailored to each employee's financial position.

Documentation unique to individuals could also involve more onerous execution requirements which counsel must manage, including requiring notarization or a comparable process for persons living abroad, tax diligence based on each country of residence, or variations in name (for example, married names or nicknames).

One counterbalance to these upfront costs is the flexibility to document a single line that may service multiple sponsor employees and multiple funds with limited variation over time.

After completing the necessary diligence and determining an appropriate structure, documentation can be drafted. Counsel should ensure that facilities would include most of the documents and provisions outlined below.

Loan and Security Agreements

First, a loan agreement will cover basic borrowing mechanics, representations, warranties, covenants, events of default and other customary lending provisions.

Borrowing mechanics may vary by facility; for ease of administration the sponsor or the lender may require that the lender automatically fund all or a portion of each capital call issued by a fund by making a loan under the facility, while other facilities may permit each sponsor employee discretion to request loans for some or all of the capital calls made.

Availability under the facility will be tied to the lesser of the lender’s commitment (which typically equals all or a set portion of each sponsor employee’s capital commitment into the fund in the aggregate) and a borrowing base.

The composition of the borrowing base can be customized for each facility but will often be calculated by applying a predetermined advance rate to the lesser of the net asset value of the limited partnership interests in the fund pledged to the lender as collateral and the amount of capital contributions made or to be made to the fund that were funded or reimbursed by loan proceeds.

Additionally, the loan agreement may include (1) a minimum net asset value requirement for the pledged partnership interests or for the fund as a whole, and (2) mandatory prepayment requirements as the fund makes distributions. Determining how to calculate mandatory prepayments is often a key negotiating point in these facilities and may tie into the borrowing mechanics.

One approach that favors the sponsor employees only requires prepayments if a borrowing was made with respect to the investment returning the distribution in question.

For example, if two capital calls are made by the fund, one to make investment A and one for investment B, but the employee only used loan proceeds under the co-investment line to satisfy the capital call for investment B, distributions related to investment A would not trigger a mandatory prepayment.

Another alternative requires a fixed percentage be prepaid, regardless of whether the line was used in connection with the underlying investment. Lenders and sponsors may prefer the latter approach for ease of administration.

The loan agreement may include sponsor- and fund-related requirements, or these can be shifted into a separate master agreement. If a master agreement is utilized, the sponsor and fund’s duties therein apply equally to each sponsor employee’s loan.

Note that even if a sponsor is not providing credit support, lenders will often require the sponsor be party to the facility in some capacity to ensure the fund does not permit the sponsor employee to breach its obligations under the facility and to streamline the flow of information and reporting.

The loan agreement or master agreement will obligate the sponsor to deliver updates on capital calls, investments, distributions, asset valuations, capital account statements and other pertinent information.

Furthermore, the sponsor will agree to provisions as to the operation and existence of the fund, the limited partnership interests, and continuity of investment strategy in order to provide comfort that the collateral will maintain its value. This approach is less burdensome than obtaining the same information from each sponsor employee individually.

In addition to the loan agreement, each sponsor employee will deliver a promissory note — if a borrower — and security agreement. Depending on the structure, the latter document may contain a pledge of such employee’s limited partnership interest in the underlying fund.

This security agreement will govern (1) the lender’s right to foreclose on the limited partnership interest, and (2) the right to collect fund distributions and apply them to repay the obligations under the facility, whether in the ordinary course or following a default.

Note that the fund’s organizational documents may prohibit or restrict a limited partner’s ability to transfer or pledge its interest in the fund, so often the pledge of its partnership interest will require the consent of the fund’s general partner.

Collateral Accounts, Guarantees and Standard Authority Documentation

Several collateral accounts may also be established in connection with a co-investment line. First, a collateral account will be opened to receive fund distributions that will be deposited by the fund directly into such account at the direction of the sponsor employees.

The lenders’ security interest in this collateral account will be created pursuant to an account pledge and perfected under the Uniform Commercial Code by an account control agreement with the depository bank. Depending on the prepayment mechanics, the documentation might contain a sweep mechanism or be a blocked account (or both).

Second, lenders may also require a separate account into which the lender deposits loan proceeds for collection and application by the fund to the capital contributions of the sponsor employees. This account is opened in the name of the fund and similarly pledged to the lender by the fund.

This second type of account may not be required, but consolidating borrowing proceeds into a single account eases the administrative burdens of both the lender and the sponsor, as only a single wire must be sent and subsequently collected. The lender obtains the added benefit of knowing that the proceeds may be applied by the fund directly to satisfy a capital call.

In many instances, a guarantee will be required from either the relevant sponsor entity (if the sponsor employees are the borrowers) or the sponsor employees (if the sponsor serves as borrower). While co-investment lines can be structured without a sponsor’s credit support, lenders frequently look to the sponsor's creditworthiness to backstop the obligations under the facility.

A sponsor guarantee will almost invariably be required in facilities with more junior sponsor employees. As the role of the sponsor, including as guarantor, is an oft-contested structuring point, counsel should ensure that the lender and the sponsor have settled on an approach prior to beginning documentation.

Lastly, the facility will include standard commercial loan deliverables, such as opinions of counsel, organizational documents, resolutions and incumbency certificates from any sponsor entities, as well as trust documentation from sponsor employees, if applicable. Uniform Commercial Code lien searches will be conducted on all parties and financing statements filed for each sponsor employee or sponsor entity, as applicable.

Additional Considerations

In addition to the in-depth financial diligence described above, lenders' counsel must also delve into the fund's organizational and credit facility documentation. As mentioned above, the fund's partnership agreement may prohibit investors — including the sponsor employees — from pledging their partnership interest without consent.

The partnership agreement will outline whether the general partner may grant that consent acting alone or if a broader consensus is required.

Furthermore, sponsors and lenders may clash over the scope of the general partner's consent. Understandably, lenders desire broad consents granting access to all available remedies, including the ability for the lender to become a limited partner in the fund or to transfer the partnership interest if necessary.

A fund's general partner must balance the lender's ability to foreclose upon its collateral against any limitations in the partnership agreement that could prohibit a future transferee (be it the lender or a third party) from owning the partnership interest.

Similarly, lenders and their counsel must scrutinize any subscription facility or other debt of the fund. Although an underlying subscription facility is unlikely to give borrowing credit to the fund based on the unfunded capital commitments of the sponsor employees — as compared to unaffiliated investors — these underlying debt facilities may restrict pledges of the sponsor employee's partnership interest or bank accounts of the fund or limit the payment of distributions in certain circumstances.

As restrictions on distributions are commonplace in subscription financing, lenders of co-investment lines must consider the potential impairment on their ability to be repaid, and, if deemed necessary, seek the approval of the fund's creditors for the co-investment line.

Finally, lenders and sponsors should consider how the facility will operate if at any time a sponsor employee ceases to be an employee of the sponsor. In such a situation, the employee may be required to transfer its partnership interests in the applicable funds or, even if such a transfer is not required, the lender may be unwilling to continue advancing credit once the employee's relationship with the fund has changed.

The lender's counsel should ensure that the loan documentation adequately addresses a change in employment status — or related disposition of the sponsor employee's partnership interests — with mandatory prepayment triggers.

You should also consider whether certain situations, such as a termination of the sponsor employee's employment for cause, should give rise to an event of default that would enable the lender to immediately exercise remedies.

Conclusion

As sponsors look to attract and retain top talent in the industry, co-investment lines can offer the financing needed to make employee investment an attractive benefit, while also meeting investor requirements for additional sponsor participation.

These facilities give lenders greater access to principals and senior employees of a sponsor, thus making the lender a more attractive source for traditional fund finance products.

While the diligence requirements can be daunting, co-investment lines fill a growing demand within the marketplace for additional liquidity and flexibility at the upper levels of a sponsor's corporate structure.

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