Equity bridge financing and side letters, the hidden enemies

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The recourse to equity bridge financing at the fund level has a long tradition that is currently developing even more in the present context of low interest rates. These lines of credit are used to allow the limitation on the numbers of capital calls and reduce the administrative burden associated with it, combined with a better responsiveness for closing transactions. The managers also appreciate it as performance booster thanks to the leverage effect.

Since the adoption of the Alternative Investment Fund Managers Directive (AIFMD), as long as such lines of credit are granted for a temporary period, usually set for a maximum of 365 days, and are secured by the undrawn commitments of the investors (and not the assets of the fund), they are not accounted as leverage.

It is then common to see in the constitutive documents of funds (limited partnership agreement and offering memorandum), that the fund may have recourse to equity bridge financing and grant security over the undrawn commitments of the investors.

However, it has to be remembered that aside from the constitutive documents of the fund, the entering into side letters with investors also has a long tradition that has not been reduced at all despite the AIFMD's requirements to bring transparency on the rights given to certain investors. The recourse of side letters remains vivid and becomes even more intensive as the regulatory and tax framework gets more complex. The tax and regulatory frameworks applicable to funds and professional investors, such as pension funds or insurance companies, require a number of clarifications, confirmations and reporting obligations to enable certain investors to make a commitment to the fund.

In this context, it is common to find in side letters provisions limiting potential requests from a third-party lender to the investors. For instance, the investors would not want to be involved in the due diligence exercise of the banks and they typically request an undertaking from the fund that they will not have to disclose any other documents or information than what is already disclosed at the time of their subscription to the fund or that is not otherwise publicly available. They may request the following, in addition to limiting the security to be granted on their undrawn commitment: a cap on the amount to be borrowed compared to the total commitments, their involvement at the time of the implementation of the security, the formalities to be complied with if drawdown notices are issued by third-party lender, a guarantee that the proceeds of the capital calls will always be credited to the bank account of the fund, to mention a few examples.

Other clauses of side letters may have unclear consequences on the recourse that the third-party lender may have against the investors. Nowadays, the investors list in their side letter the sector of activities that are prohibited. While these sectors would generally not be the targeted sector of the fund, new investment criteria, such as sustainability risks or undertakings in terms of environmental, social and governance objectives (ESG) could allow investors to be exempted from participate in any particular investment of the fund that would be in breach of their internal policy in respect of ESG.

Generally, investors benefiting from excuse rights are not part of the borrowing base and their undrawn commitments attributable to the excused investment diminish in the corresponding proportion to the amount of the line of credit. In the context of ESG requirements for which the fund industry is still in its preliminary approach, the uncertainty is quite important.

These types of clauses are not without consequences when negotiating the line of credit with banks that would take place after closing with the investors. Should the manager envisage such financing, the negotiation of the side letters should be quite specific on that matter.

The exponential effect of most favored nation clauses

One issue is to identify an investor that has requested certain protection against third-party lender financing; another is the multiplication effect of most favored nation clauses (MFNCs).

Indeed, the specific arrangement agreed to by a fund and an investor could potentially go beyond these two parties through the effect of the MFNCs. Typically, the MFNCs ensure that the investor will be able to benefit from the rights granted to other investors in the fund, through their own side letter. At each closing, or at the time of the final closing, the investor benefiting from MFNCs could ask the fund to be provided with the side letters entered into by other investors (or a summary thereof, for confidentiality purposes) and then elect to benefit from some of the provisions. As a result, a clause in a side letter that restricts the possibility of granting the undrawn commitments as a security to the third-party lender is likely to be elected by the other investors.

If the investor base backing the repayment of the equity bridge financing would be reduced, the availability of external financing for the fund will shrink and the cost thereof will increase, as the risk appetite of the lenders for unsecured loans becomes minimal.

The lesson to be learnt here, is that negotiating a line of credit at the fund level has to be kept in mind while onboarding investors in the fund during the closings occurring before the external financing of the fund.