CADWALADER

FUND FINANCE FRIDAY

Fund Finance Symposium Panel Recap: Governance, Underwriting and Due Diligence

February 17, 2023 | Issue No. 211

By Linda Filardi
Counsel | Fund Finance

The panel on governance, underwriting and due diligence featured seasoned bankers Gino De Bernardo (Comerica), Mike Henry (US Bank) and Guy Simpson (Bridge Bank), experienced lawyers Anthony Pirraglia (Loeb & Loeb) and Joe O'Donnell (Morrison Foerster), and accomplished fund professional Mary Jo Sanderson (Värde Partners). The clear takeaway of this session was that strong relationships with sponsors, advance preparation, thorough and extensive due diligence on investors, the limited partnership agreement and side letters, and clear and comprehensive term sheets have proven to be best practices in deal execution of a lending facility to a private equity fund.

All agreed that starting the due diligence process early provides advantages: understanding and rating all the investors and conducting proper due diligence of those investors is the best way to stave off surprises. While the current geopolitical environment created new challenges for funds because the sanctioned persons list had been relatively static for a long time, funds had the tools to quickly identify and remove from the borrowing bases the large increase in sanctioned persons bought on by the Ukrainian crisis. In most cases, the interests of the funds were aligned with lenders. More importantly, this underscored to lenders why it is important for the limited partnership agreement to be clear on issues such as sanctioned investors. In addition, strong agent banks that stayed on top of those emerging and critical issues were important to the syndicate lenders.

The panelists commented that funds are looking to put in lines of credit earlier than those lines were expected to be utilized, and that both the funds and experienced lenders have a good sense of the kind of diligence that will be required. Indeed, the lenders want to be part of the initial process and can often bring expertise to the fund when evaluating strategies and investors. One banker commented that their bank was developing its own database of investors and ratings for those investors. Others continue to use third-party services but noted that those services may contain flawed features. For example, investors who had been removed from the fund because of fraud or sanctions in some cases continued to be included in the database.

Experienced bankers review the limited partnership agreement up front to know what is involved and whether the document contains the protections that lenders require − lenders are looking for a bankable agreement and they review side letters and craft a borrowing base that will be available for review. If there is a material deviation from what the fund is expecting, the advance preparation work enables the parties to flush that out well in advance of the expected closing. Reviewing the fund’s organizational documents and structure is key. Advance preparation was the dominant theme − no one wants to get a call deep into the negotiation process that there is an unexpected issue with the borrowing base. Side letters present increasing complicated issues that have driven up legal costs, citing complicated most-favored nation clauses, attorney general’s views on enforceability, investment policy exceptions with politically sensitive industries and even the application of money derived from seized goods. If there is a bad side letter, that may affect all the other investors.

Banks want to understand what is important to the fund in its proposed financing: the focus of the fund, the utilization of the line of credit, and the expected interest rate. The business of providing financing to these funds is, first and foremost, relationship-driven. That means that the bank and the fund will be looking at all of these issues together with their respective fund counsel, and that the lenders have to be transparent about what is acceptable and what is not. Banks favor well-managed GPs where there is a broader institutional relationship across the institution. During times of tighter liquidity, banks will naturally gravitate to transacting with funds that have established their relationships with lenders through several cycles.