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FUND FINANCE FRIDAY

Equity Commitment Letters – A Refresher

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By Patrick Calves
Partner | Fund Finance

By Brian Foster
Partner | Fund Finance

We have recently seen a notable uptick in the usage of equity commitment letters (ECLs) in fund finance transactions and have been spending an increasing amount of time discussing their merits with our clients' credit teams. So, even though *Fund Finance Friday* has done overviews of various types of credit support in the past (see links at the end of article), we thought it was time for a refresh on ECLs, how they are deployed in fund finance transactions and what lenders should look for when relying on them as credit support.

What Is an ECL

An ECL in the fund finance landscape is typically structured as a commitment by a parent fund to contribute capital in favor of a subsidiary that is an obligor under the relevant financing transaction. Similar in purpose to a guaranty, an ECL is a type of credit support that lenders in fund finance transactions may rely on to add another source for repayment of their loans (*i.e.*, by providing a lender with indirect access to the ECL provider's balance sheet). However, unlike a guaranty where the lenders are a direct beneficiary of the guarantor's obligations, an ECL is an agreement by the parent that only directly runs in favor of the subsidiary obligor as the direct recipient of the parent's commitment. Thus, ECLs are used to bolster the subsidiary obligor's credit and liquidity profile to demonstrate to a lender that it has additional assets available to meet its obligations in connection with the credit facility.

Below are a couple of common examples of use cases for ECLs in fund finance transactions.

1. *Subscription Facilities* – ECLs may be used in single (or concentrated) investor subscription facilities where a parent fund provides support to a thinly capitalized holding vehicle that is an investor in the fund. The purpose of the ECL is to persuade a lender to

underwrite the LP's uncalled capital commitment to the fund notwithstanding that it is thinly capitalized given the availability of the parent's funding commitments under the ECL.

2. *NAV Facilities* – In fund finance, we most frequently see ECLs employed in NAV facilities. An ECL may be provided by a creditworthy parent fund to support a subsidiary holding company that is the borrower under the relevant facility. Where the borrower in such a facility may only hold a relatively concentrated portfolio of investments (*g.*, equity interests in a small number of portfolio companies), the ECL in this context may be necessary to reduce the risk profile of the facility either to (a) entice a lender to enter into the facility in the first place or (b) allow the borrower to obtain financing at a more attractive interest rate than would typically otherwise be available for a NAV facility underwritten against such a concentrated portfolio.

Why Use an ECL

ECLs serve as useful tools where a parent fund is unwilling to assume a primary obligation in respect of a particular transaction (*i.e.*, unwilling to assume a direct debt or guaranty obligation). We see this particularly with funds in jurisdictions where the incurrence of a financing at the fund level may result in adverse tax consequences for the fund (and/or its investors) and where the fund has reached its borrowing/guarantee limits in its fund documentation. Nonetheless, with proper structuring and documentation, an ECL can both address the fund's particular legal/tax/indebtedness requirements and provide additional recourse for a lender relying on the ECL for credit support.

Factors to Consider When Structuring an ECL

There are a number of considerations that lenders should be mindful of when negotiating ECLs in order to make sure that (i) the obligations of the ECL provider are clearly defined, (ii) the lender is able to monitor the ECL provider's credit profile and (iii) the lender is able to exercise remedies directly against the ECL provider in a default scenario.

Defining the Commitment. ECLs should be carefully drafted to quantify the amount of the ECL provider's funding commitment. In the subscription finance example above, this quantum would typically be tied to the amount of the beneficiary's unfunded capital commitment to the borrower/fund that is pledging the beneficiary's uncalled capital commitment. In contrast, in the NAV scenario described above, the amount of the ECL provider's funding commitment would likely be tied directly to the loan obligations (or a portion thereof).

Parent Creditworthiness. Lenders should also consider what requirements or covenants should be included in the loan documentation with respect to the ECL provider. Examples of these may include minimum net asset value and/or liquidity tests and various exclusion criteria for certain credit events pertaining to the ECL provider (*e.g.*, material judgments, insolvency proceedings, default on other indebtedness, etc.). The loan documents should similarly include reporting and disclosure requirements so a lender can directly monitor the ECL provider's creditworthiness and compliance with these provisions.

Lender Protections. To provide comfort that ECLs can be reliably called to pay lenders, and to address the risk that an ECL provider may try to avoid funding its commitments via the ECL in a default scenario, lenders should structure ECLs to include the following protections:

1. *Equity not debt* – specifying that the ECL provider's funding commitment is an equity obligation (*e.*, and not debt a commitment);

2. *Irrevocable and lender consent* – specifying that such equity commitments are irrevocable and any amendments to the ECL require lender consent;

3. *Waiver of defenses* – requiring the ECL provider to waive all defenses (including bankruptcy defenses) and all rights of set-off and counterclaims in connection with its funding obligations;

4. *Third-party beneficiaries* – making lenders third-party beneficiaries of the ECL;

5. *Reliance* **–** an acknowledgment of the lender's reliance on the parent's funding obligations under the ECL; and

6. *Pledge* **–** explicitly allowing assignment of the beneficiary's rights to enforce the ECL against the ECL provider to the lender.

These protections should be very familiar to much (if not all) of the fund finance community, as they essentially mirror the protections a lender would expect to see in the LPA of a fund pledging the unfunded capital commitments of its investors associated with a typical subscription credit facility collateral package. While there is little case law in the U.S. pertaining to the enforceability of ECLs specifically, investor equity commitments (whether contained in a limited partnership agreement or in an ECL) are assets of a fund, and the obligations thereunder have long been relied upon by lenders as a primary source of repayment from fund obligors.

Conclusion

As private markets continue to evolve and the fund finance industry along with it, we expect the prevalence of tailored fund finance facilities will continue to grow in order to work with different fund structures and meet specific sponsor demands. Given this trend, the recent uptick in ECL deployment and conversations shouldn't be surprising, as ECLs are a useful tool that allow sponsors and lenders flexibility to solve for a number of issues. Industry participants should get used to seeing these agreements (if they are not already) as it seems like they are here to stay.

Further Reading

See below for other *Fund Finance Friday* articles focused on different types of credit support in fund finance transactions:

1. **Can I Get Some (Credit) Support?**

2. **Upstream and Affiliate Guaranties in NAV Loans**

3. **Get Well, Keep Well**

4. **Equity Commitment Letters Under English Law: Beware of the Pitfalls!**