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Article

Management Fee Credit Facilities

By Kristin Rylko[1]

As the subscription credit facility market matures,[2] lenders seeking a competitive advantage are expanding their product offerings to private equity funds (a "Fund") from traditional capital call facilities made to closed-end Funds to other financing products, including lines of credit to open-ended Funds, separate-account vehicles and net asset value facilities.[3] Another emerging product gaining traction in the market with some Fund sponsors (a "Sponsor") is a so-called management fee credit facility (a "Facility"). A Facility is a loan made by a bank or other financial institution (a "Lender") to the general partner (the "General Partner") of the Fund or a Sponsor-affiliated management company or investment advisor (collectively, the "Management Company") of a Fund, and has a collateral package that is distinct from other types of security arrangements commonly associated with Fund Financings.

The basic collateral package for a Facility consists of the General Partner's or Management Company's, as applicable, right to receive management fees ("Management Fees") under the Fund's limited partnership agreement (the "Partnership Agreement") or other applicable management or investment advisory agreement (the "Management Agreement"), and rights related thereto, together with a pledge over the deposit account into which the Management Fees are paid (the "Collateral Account"). A control agreement among the General Partner or Management Company, the Lender and the depository bank would be needed to perfect the Lender's security interest in the Collateral Account. Additionally, since the General Partner, the Management Company or another Sponsor-affiliated entity (a "Special Limited Partner") generally has an equity investment in the Fund, the security for a Facility may also include a pledge by such entity or other Sponsor-affiliated investing entity's right to receive distributions from the Fund and, in some instances, its limited partnership interest.

Background

In a typical Fund structure, the General Partner or the Management Company receives Management Fees as compensation for evaluating potential investment opportunities, providing investment advisory services and attending to the day-to-day activities of managing the Fund.[4] The Management Fee also covers operating expenses (such as overhead, travel and other general administrative expenses) as well as salaries for the Management Company's investment professionals and other employees. The Management Fee payable by an Investor is often determined by multiplying a percentage[5] times such Investor's capital commitment. In addition, some Management Fee structures include a component that is based on the Fund's performance so as to provide additional incentive to the General Partner or the Management Company to maximize the Fund's performance.

Facilities are becoming increasingly popular for a number of reasons. First, Sponsors may find a Facility attractive because it provides the Sponsor (or applicable affiliated entity) with immediate capital to smooth its cash flow and pay operating expenses in between the typically quarterly or semiannual payments of the Management Fees it receives. Second, post-economic downturn, Investors are increasingly interested in seeing Sponsors make larger investments in the Funds they manage to increase their "skin in the game" and further align the Sponsor's and Investors' interests in maximizing Fund performance. By leveraging the income stream from future expected Management Fees, a Facility may help enable a Sponsor or its Special Limited Partner to make a larger commitment to a Fund than it otherwise may be able to commit. Also, to the extent a Sponsor or its Special Limited Partner is an Investor in a Fund, a Facility may be drawn on short notice to permit the Sponsor or Special Limited Partner to honor a capital call prior to receipt of cash from the principals or employees that ultimately constitute the Sponsor or Special Limited Partner. From the Lender's perspective, aside from earning revenue from the fees and interest income generated by a Facility, providing a Facility to a Fund is also a chance for the Lender to broaden its relationship with the Sponsor and develop a deeper understanding of the Sponsor's business and its potential financing needs. This in turn may lead to opportunities for a Facility Lender to provide other products such as subscription credit facilities, net asset value facilities, portfolio-company level financings or perhaps even private wealth products to the Sponsor's principals.

While there are many potential benefits to both a Sponsor and a Lender associated with a Facility, it is important to note that a Facility is best-suited for established Sponsors that have significant Fund management experience and a proven track record of receipt of the Management Fees, ideally from a diverse platform of Funds. Management experience and an uninterrupted history of receiving the Management Fees are important because the Lender is ultimately looking to the Management Fees as the source of repayment of the Facility in underwriting the risk associated with lending to a particular Sponsor.

Even though Management Fee performance history and management experience of a particular Sponsor may make it an ideal candidate for a Facility, as more fully described below, not all Funds will have Partnership Agreements, Management Agreements or Management Fee structures that are suitable for a Facility. Further, some Partnership Agreements limit the General Partner's or Special Limited Partner's right to pledge its equity interest in the Fund, although, a pledge of any distributions associated with such equity interest may be possible. Thus, the Partnership Agreement and/or Management Agreement must be carefully analyzed to confirm that the intended collateral can be granted to the Lender and the Lender will be able to adequately enforce its rights against the collateral.

Structure and Loan Documentation

Facilities are typically structured as revolving lines of credit to the General Partner or Management Company (depending on the Fund's structure), secured by a pledge by the General Partner or the Management Company of its right to receive the Management Fees and the account into which such Management Fees are paid. If the Sponsor group has made an investment in the Fund through a Special Limited Partner or other affiliated entity, the collateral package may also include a pledge of the right to receive distributions from the Fund and the account into which such distributions are paid. If the Sponsor manages more than one Fund, the collateral package may include Management Fee streams from multiple Funds and the right to distributions from those Funds.

The basic loan closing documentation for a Facility will typically consist of (i) a credit agreement, (ii) a security agreement pursuant to which the General Partner or the Management Company assigns its rights under the Partnership Agreement or the Management Agreement, as applicable, to receive and enforce the payment of Management Fees and proceeds thereof, (iii) a pledge of the Collateral Account into which Management Fees are to be paid, (iv) a control agreement covering the Collateral Account to perfect the Lender's security interest therein and permit the blocking of such account by the Lender, (v) a security agreement from the Special Limited Partner or other Sponsor-affiliated entity pledging its right to receive distributions from the Fund, if it is the part of the collateral package, together with a pledge of the deposit account into which such distributions are to be paid and a control agreement covering such account, (vi) Uniform Commercial Code financing statement(s) filed against the applicable pledging entities, and (vii) and customary opinion letters, certified constituent documentation of the Fund and pledging entities, evidence of authority and related diligence items.

In addition to the traditional collateral package, it is not uncommon for a Lender to receive a personal guarantee by one or more of the principals in the General Partner, the Management Company or Sponsor to support the Facility. The extent of such a guaranty is often negotiated, and it is not unusual for a principal's guaranty to be limited to a capped amount based on its pro rata ownership percentage of the underlying Fund and the related outstanding balance of the Facility, as opposed to a more traditional unlimited (or joint and several) guaranty of the Facility. A guaranty may also be delivered by the Special Limited Partner, the General Partner or the Sponsor, depending on the structure of the Facility and the identity of the borrower under the Facility.

The terms of a Facility will typically include customary representations, warranties, affirmative and negative covenants and events of default that a Lender would expect to see in any secured financing, along with a few provisions that are tailored to address the unique features of a Facility's collateral package. Such provisions may include a requirement that the General Partner or the Management Company receive a minimum amount of Management Fee income, or that the amount of Management Fees received does not fall below a certain specified percentage of the aggregate commitments of the Fund's Investors. A Facility will normally include limitations on amending the Partnership Agreement or the Management Agreement, and prohibitions on terminating or waiving the General Partner or the Management Company's right to receive payment of Management Fees. Additionally, so that the Lender can monitor the Fund's overall performance (and have advance warning of potential performance issues that may give rise to a reduction in Management Fees or Investors balking at paying Management Fees), a Facility will usually require regular financial reporting and may also include a minimum net asset value test with respect to the Fund's investments or a similar financial covenant with respect to the General Partner, Management Company or Special Limited Partner, as applicable, and its investment in the Fund. Some Facilities that include a pledge of distribution rights may contain a maximum loan-to-value or similar metric measured by looking at the Special Limited Partner's pro rata share of the underlying portfolio investments in the Fund.

Partnership Agreement & Management Agreement Diligence

As part of due diligence for any Facility, a Lender must carefully review the Partnership Agreement and Management Agreement for any restrictions on the right of the General Partner or the Management Company to pledge its right to receive Management Fees or the Special Limited Partner's ability to pledge its right to distributions. For example, a potentially problematic, though not uncommon, restriction is that the General Partner or Special Limited Partner cannot pledge its economic interest in the

Fund, which would include its equity interest, without the consent of a certain percentage of the other Investors in the Fund. Some Partnership Agreements allow for such pledges without the consent of the other Investors while others do not. To the extent Investor consent is required, it may be an impediment to entering into a Facility.

In addition, the Partnership Agreement or the Management Agreement should be reviewed to determine how Management Fees are paid, and whether they may vary over time. For example, the Management Fee may decrease upon termination of the period in which the Fund is permitted to make new investments. It is important for the Lender to understand whether Management Fees are paid by the Investors directly to the General Partner or the Management Company, or if Management Fees flow through the Fund and/or the General Partner (or another affiliated entity) to the Management Company, as applicable, so that the relevant Fund-related entities are included within the scope of the collateral documents to minimize potential leakage, if necessary.

Some Partnership Agreements provide for Management Fee offsets, whereby receipt by the Sponsor, its principals, employees or other affiliates of advisory, break-up or other similar fees and income related to the investment activities of the Fund may reduce the amount of the Management Fee. The Partnership Agreement and the Management Agreement should be reviewed to determine if such offsets exist, and the Lender should consider whether the loan documentation should prohibit the General Partner or the Management Company from applying any discretionary offsets if possible. Alternatively, the Lender may consider requesting that any such advisory fees or other income or proceeds that may be offset against Management Fees be included as part of the collateral package in addition to Management Fees if the Fund's documents permit it.

In underwriting a Facility, Lenders will want to keep in mind that while the Partnership Agreement and the Management Agreement will dictate whether a Facility is permissible and how and when Management Fees are to be paid, exogenous events may occur that could affect the payment of Management Fees. For example, in the late 2000s during the market downturn, Sponsors with troubled Funds in fact suspended or eliminated their Management Fees. Even though such activities would be prohibited by the loan documentation for a typical Facility, it is important for Lenders to consider the overall investment and economic environment in which a Fund operates, as market conditions may stress the underlying underwriting assumptions of a Facility.

Conclusion

While Management Fee Facilities have not been very common to date, they are becoming increasingly popular and offer an opportunity for a Lender to kick off or expand its relationship with a Fund Sponsor. With a careful review of the relevant operating and constituent documentation of a Fund, it may be possible to structure a Management Fee Facility to offer a seasoned Fund Sponsor increased liquidity while satisfying a Lender's underwriting criteria. Please don't hesitate to contact any of the authors with questions regarding these Facilities, including the various structures that can be implemented in connection with their establishment.

Endnotes

1 Kristin Rylko is a partner in Mayer Brown's Banking & Finance practice.

2 A subscription credit facility, also known as a capital call facility, is a loan made by a bank or other credit institution to a private equity fund, for which the collateral package is the unfunded commitments of the limited partners in the fund (the "Investors") to make capital contributions when called by the fund's general partner (as opposed to the underlying investment assets of the fund). For a more detailed description of the subscription credit facility market and features of the subscription credit facility product in general, please see Mayer Brown's Fund Finance

Markets Legal Update "Summer 2013 Subscription Credit Facility Market Review."

3 For an in-depth analysis of certain alternative Fund financing products, please see Mayer Brown's Fund Finance Market Legal Updates "Structuring a Subscription Credit Facility for Open-Ended Funds," "Separate Accounts vs. Commingled Funds: Similarities and Differences in the Context of Credit Facilities" and "Net Asset Value Credit Facilities."

4 Depending on the Fund's structure, Management Fees may be paid by the Investors through the Fund or GP to the Management Company or directly to the Management Company.

5 Historically, the percentage has usually ranged from 1.5% to 2% per annum.