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Article

Management Fee Subordination: Potential Issues with Subscription Credit Facilities and Management Fee Lines of Credit

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A management fee credit facility (a "Management Fee Facility") is a loan made by a bank or other financial institution (a "Lender") to the management company or investment advisor (collectively, a "Management Company") that is typically the sponsor (or affiliated therewith) (a "Sponsor") of a private equity fund (a "Fund"). The Lender under a Management Fee Facility is typically secured by, among other things, a pledge from the general partner (the "General Partner") or Management Company of its rights to receive management fees under the Fund's limited partnership agreement (a "Partnership Agreement") or other applicable management or investment advisory agreement. The Fund itself may have a subscription credit facility (a "Subscription Facility"), also known as a "capital call facility," for which the collateral package is the commitments of the limited partners in the Fund (the "Investors") to make capital contributions when called by the General Partner.[2] A Lender under a Subscription Facility typically requires a covenant that restricts payments by a Fund in respect of other debt or obligations owed to affiliates of the Fund (including, without limitation, to its General Partner or the related Management Company in respect of fees) following the occurrence and during the continuance of an event of default, any potential event of default and/or other mandatory prepayment events thereunder, essentially subordinating such payments to the obligations owing to the Lender under the Subscription Facility (a "Subordination Provision"). A Subordination Provision may be problematic for the General Partner or Management Company because the Lender under a Management Fee Facility will be reluctant to permit the subordination of the payment streams needed to make payments owed to such Lender to payments owed to a Lender under a Subscription Facility. This article will discuss the potential tension between a Management Fee Facility and a Subscription Facility in the context of a Subordination Provision and suggest a few possible solutions that would allow the Fund, General Partner/Management Company and Lender(s) to permit the two different facilities to coexist and benefit each party in interest.

Management Fees Generally

The ability of any Fund to invest and provide returns to its Investors is necessarily dependent on the guidance of the General Partner or Management Company regarding how the capital of the Fund will be invested. The General Partner and/or Management Company will receive a fee as compensation for discovering and evaluating investment opportunities and conducting other management responsibilities along with providing general back-office support to a Fund (such fees collectively, the "Management Fee"). The Management Fee may be applied by the General Partner or Management Company to pay its operating expenses and the salaries of the employees and investment professionals employed thereby. Payment of the Management Fee is typically either made directly to the General Partner and/or Management Company by an Investor or it may be paid through the Fund in the form of a capital call pursuant to the subscription agreement that each Investor has with the Fund. The General Partner or Management Company will typically receive payment of the Management Fee from the Investors in the Fund on either a quarterly or semiannual basis.

The Management Fee is usually charged on a per-Investor basis and is often calculated by multiplying a percentage (historically between 1.5 percent and 2 percent per annum) by such Investor's capital commitment. The Management Fee is appropriately calculated to cover the cost of operating the General Partner or Management Company.

Note that not all payments to the General Partner or Management Company constitute Management Fees. A General Partner or Management Company may also receive a performance payment (often referred to as the "promote" or "carried interest") as compensation for achieving returns above a certain benchmark (a "Performance Fee"). Once a Fund is able to return the capital of an Investor and a certain percentage of profit on such capital, the General Partner or Management Company may participate in any returns above this preferred or hurdle return. The Performance Fee is generally separate and distinct from the Management Fee and is not typically included as collateral or a payment stream in a Management Fee Facility.

Subscription Facilities and the Subordination Provision

A Subscription Facility is beneficial to a Fund (and thus the General Partner and Management Company) for many different reasons, including its ability to provide bridge financing that allows the Fund to quickly capitalize on an investment opportunity by providing access to capital on a faster basis (sometimes as early as the next day) than would normally be available from Investors under the terms of the Fund's Partnership Agreement. Typically, each Investor will have up to ten business days to fund its capital commitment following a capital call by the Fund. The mechanics related to calling capital from Investors necessarily require a Fund to delay (or have sufficient advance notice of) any investment and may limit the investment opportunities of a Fund simply due to this timing restriction. A Subscription Facility will eliminate or significantly reduce this delay. The Lender under a Subscription Facility will advance capital to the Fund and rely on the ability of the Fund to call capital from Investors as the source of repayment. The collateral package given to a Lender under a Subscription Facility by the Fund will include the collateral assignment of the right to make capital calls upon Investors to repay the amounts advanced to the Fund under the Subscription Facility.

The loan documentation for the Subscription Facility will often include a Subordination Provision, which will typically extend to the Management Fee. If the Fund were to make a payment of the Management Fee following the occurrence and during the continuance of an event of default, potential default or other mandatory prepayment event under a Subscription Facility, such payment will likely violate the Subordination Provision. Lenders, however, are increasingly willing to include a carve-out to the Subordination Provision that allows for payment of the Management Fee by the Fund despite the existence of an event that triggers the Subordination Provision under the Subscription Facility. The inclusion of this carve-out by Lenders for payment of the Management Fee (but typically not permitting payment of any Performance Fee) while the Subordination Provision is effective has become a market trend because payment of the Management Fee is viewed by Lenders as critical to the Fund's ability to continue to operate. In contrast, Lenders generally view the Performance Fee as excess compensation that constitutes a share of the profit of the Fund and not as a payment that is necessary for the General Partner or Management Company to continue to function.

Permitting the payment of the Management Fee, even during an event of default, can be viewed as an alignment of interests for all parties that goes beyond keeping the Fund operational. The Lender has a vested interest in permitting the Fund to manage its investments and continue to operate the Fund so as to maximize the potential source of repayment of obligations owed to the Lender under the Subscription Facility. Achieving this result to maximum effect can realistically only be achieved if the General Partner and/or Management Company can continue to pay its employees and keep the Fund functioning. If the General Partner or Management Company is not paid for its services during this critical period, the ability to receive payment on the Fund's obligations to the Lender under the Subscription Facility or capture potential profits for Investors (and a potential Performance Fee for the General Partner/Management Company), in each case, could be severely impaired. While recognizing the mutually beneficial aspect of permitting the payment of the Management Fee, a Lender may be hesitant to allow unrestricted payments in respect thereof. In such instances, the Lender may place a cap on the dollar amount the Fund is permitted to pay in respect of the Management Fee on either a quarterly or annual basis or the cap may only be effective during the occurrence and continuance of an event of default under the Subscription Facility.

While the market trend recognizes the benefits of exempting the payment of the Management Fee from the Subordination Provision of a Subscription Facility during times of stress, the Partnership Agreement of the Fund increasingly includes restrictions on paying Management Fees. These so-called "overcall" restrictions prohibit capital calls with respect to Management Fees on non-defaulting Investors to offset the shortfall created when another Investor defaults in its capital commitment to the Fund.[3] An overcall restriction becomes problematic for a Lender under a Subscription Facility because the terms of a Subscription Facility will often permit the payment of Management Fees with the proceeds of any borrowing under the Subscription Facility. If the Partnership Agreement of the Fund, however, includes an overcall restriction, the Lender can only rely on the non-defaulting Investors for purposes of repaying the obligations under the Subscription Facility attributable to the payment of the Management Fee.[4] Due to this risk, Lenders may consider limiting the payment of Management Fees with the proceeds of any borrowing under the Subscription Facility. Another approach to mitigating a Lender's exposure to the overcall restriction risk is to require an accelerated repayment period (a "clean-up call") in respect of any borrowings under a Subscription Facility that are earmarked for payment of the Management Fee.[5]

Placing caps on Management Fee payments, prohibiting borrowings under a Subscription Facility to pay Management Fees or implementing a clean-up call feature are all solutions that can be successfully used under a Subscription Facility to permit payment of the Management Fee while mitigating the risk exposure of a Lender.

Management Fee Facilities and the Restrictive Agreement Covenant

The Management Fee is typically paid by Investors in the Fund on either a quarterly or semiannual basis, however the General Partner's or Management Company's ongoing expenses related to managing the Fund (from managing and evaluating investments to paying employee salaries) must be paid on a more frequent basis. The General Partner or Management Company may use the proceeds of the Management Fee to pay a variety of different costs associated with its business, such as providing general working capital, funding its own capital contribution to a

Fund, and facilitating the buy-out of partners and/or mergers and acquisitions. A Management Fee Facility allows the Management Company or Sponsor to receive consistent cash flow that would otherwise be unavailable if relying on the standard Management Fee payment schedule and is typically structured as a revolving loan commitment from the Lender, secured by a pledge by the General Partner or Management Company of its right to receive payment of the Management Fee from one or several Funds.[6] Generally, a Lender will only provide a Management Fee Facility to a Management Company or Sponsor that can demonstrate a proven history of receiving Management Fees; it is unlikely that a first-time Sponsor will find a Lender willing to provide financing based on the anticipated and as-of-yet undocumented receipt of Management Fees.

A Management Fee Facility will often include covenants that are designed to give the Lender comfort that the payment stream of each Management Fee securing the facility will continue to be paid to the General Partner or Management Company for the duration of the Management Fee Facility. These covenants may take the form of a requirement that (i) the General Partner or Management Company receive a minimum amount of income from the Management Fees, (ii) a certain ratio of the Management Fees received to the aggregate commitments of the Investors in each Fund that are paying the Management Fee is maintained or (iii) the Fund maintain a minimum net asset level. A negative covenant with respect to entering into "restrictive agreements" is another common restriction found in a Management Fee Facility. This type of covenant, which is analogous to a negative pledge, restricts the General Partner or Management Company from entering into, or permitting to exist, any agreement or other arrangement that prohibits, restricts or imposes any condition upon the ability of any Fund to pay Management Fees to the General Partner or Management Company (a "Restrictive Agreement Covenant"). If the General Partner and/or Management Company agree to include a Subordination Provision under a Subscription Facility for a Fund from which the Management Fees are part of the collateral package granted to the Lender under a Management Fee Facility, the General Partner/Management Company would most likely breach the Restrictive Agreement Covenant in such instance.

Addressing the Subordination Provision/ Restrictive Agreement Covenant Conflict

The conflict between the Subordination Provision that is often included in a Subscription Facility and the Restrictive Agreement Covenant included in a Management Fee Facility presents challenges to both Management Companies/Sponsors and Lenders in attempting to accommodate both facilities. A Lender may be willing to provide a blanket carve-out to the Restrictive Agreement Covenant for any Subscription Facility that may include a Subordination Provision, recognizing that the ability of the Fund to secure financing under a Subscription Facility contributes to the success (and the continued payment of Management Fees) of a Fund. A Lender may also be willing to grandfather on a case-by-case basis existing Subscription Facilities that include a Subordination Provision for any Fund that will contribute Management Fees to the borrowing base for a Management Fee Facility following diligence related to such Subscription Facility and similarly evaluate any new Subscription Facilities for eligibility under a Management Fee Facility. In the instance where the Lender under a Fund's Subscription Facility is also the Lender under the Management Fee Facility for such Fund's General Partner/Management Company, the Lender may include a blanket carve-out from the Restrictive Agreement Covenant with respect to the Management Fees that are subject to a Subordination Provision in the Subscription Facility for such Fund due to the Lender's familiarity with the overall structure of the Subscription Facility and its Investors.

A Management Fee Facility can also be structured in a manner that will (i) reduce the Lender's exposure to Management Fees that may be subject to a Subordination Provision or (ii) otherwise reduce the Lender's reliance on Management Fees to secure repayment from the General Partner or Management Company. The former may be accomplished by simply providing a reduced advance rate for any Management Fees subject to a Subordination Provision under a Subscription Facility. The latter may be achieved by diversifying the payment streams that secure a Management Fee Facility. In this diversification scenario, the Lender may elect to expand the collateral package under the Management Fee Facility by receiving a pledge from the General Partner/Management Company that also includes the Performance Fee discussed above, payments with respect to co-investments or other payment streams in addition to the Management Fee. In some cases, the Lender may actually receive a guaranty by one or more of the principals in the General Partner/Management Company or even the Sponsor as another form of support. Each of these approaches provides the General Partner/Management Company and the Lender flexibility to structure a Management Fee Facility that both acknowledges and accommodates Subordination Provisions.

Conclusion

The tension between a Subordination Provision and a Restrictive Agreement Covenant, if properly addressed, should not prevent a Management Company/Sponsor from obtaining financing for a Fund under a Subscription Facility while also permitting it to receive regular cash flow by leveraging Management Fees paid by Investors in such Fund or other income streams. Experienced legal counsel can help both the Management Company/Sponsor and the Lender navigate these issues and suggest structures and proposals that will support borrowing capacity for the Management Company/Sponsor under a Management Fee Facility while ensuring the Lender will also be properly secured.

Endnotes

1 Jon Rosaluk is counsel in Mayer Brown's Chicago office and a member of the Banking & Finance practice. Mark is counsel in the Banking & Finance and Fund Formation & Investment Management practices. Frank Falbo concentrates his practice on private investment funds, joint ventures and other corporate and securities transactions.

2 For a detailed update on current trends and developments in the subscription credit facility market and fund finance market, please see Mayer Brown's *Fund Finance Market Review Spring 2016*.

3 The non-defaulting Investor will likely object to paying the management fees owed by a defaulting Investor, and overcall limitations are increasingly included in the Fund's Partnership Agreement. Further discussion of overcall limitations in respect of management fees can be found in the "Subscription Credit Facility Market Review" in Mayer Brown's *Fund Finance Market Review Spring 2016*.

4 Note that, typically, the Partnership Agreement of a Fund will make each Investor obligated to repay any amounts owing under a Subscription Facility by the Fund up to the total capital commitment of such Investor; an overcall restriction may negate this if the amounts owing under the Subscription Facility are in respect of the payment of the Management Fee that is attributable to a defaulting investor.

5 Borrowings under a Subscription Facility are not generally required to be repaid (barring the occurrence of an event of default or other triggering event) prior to maturity of the loan. A clean-up call feature may require that any borrowings that are made in order to pay the Management Fee be repaid within 90 days.

6 For a detailed description and examination of management fee credit facilities, please see "Management Fee Credit Facilities" in Mayer Brown's *Fund Finance Market Review Winter 2014*.

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