Fund Finance

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Liquidity options for fund managers and investing professionals

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As the subscription facility market has grown, fund sponsors are increasingly interested in obtaining other means of liquidity for their businesses and their investing professionals. At the same time, lenders are deepening their relationships with these sponsors and expanding their product offerings to address these liquidity needs. These products range from working capital facilities for fund managers secured by their management fee income stream, to co-investment lines of credit for employees and investment professionals to finance their fund interests, to GP facilities that finance general partners' obligations to fund capital contributions.

This chapter aims to provide a summary of management lines of credit, employee co-investment lines (sometimes referred to as partner loan programs or PLPs), and GP facilities. We will also outline the key considerations, collateral security packages, fund obligations, administrative concerns, common points of lender diligence, and impact that each of these types of transactions may have on a fund's subscription facility.

Management lines of credit

Typically, a management company receives a management fee as compensation for advising and managing a fund and its portfolio of investments. The management fee is usually payable by the investors in a fund, based on a percentage of the capital commitments made by the investors to that fund. The fee is set forth in a partnership agreement or management/advisory agreement entered into by the fund and its manager, and may be paid indirectly by limited partners through the fund or directly to the fund manager.

A management line of credit often takes the form of a 'revolver' that provides liquidity to the fund manager to smooth cash flows and bridge expense obligations in between the quarterly and/or semi-annual payments of the management fee. Loan proceeds and letters of credit may be used by the fund manager for various working capital purposes, including meeting payroll obligations, paying operating and administrative expenses and satisfying lease obligations.

Management lines are typically secured by a pledge of:

(a) the management fees that a fund manager collects pursuant to the limited partnership agreement or other management/advisory agreement entered into with the funds managed by the fund manager; and
(b) the bank accounts into which such fees are deposited.

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The primary issue in negotiations relating to the collateral package revolves around whether the lender should be secured by: (a) the right to receive the management fees (which is often the lender's stated preference), together with the bank account into which such fees are deposited; or (b) only the bank account of the fund manager into which the management fees it earns are deposited. These negotiations stem from the fact that many management agreements contain a standard anti-assignment provision that prohibits the fund manager from assigning or pledging any of its rights under the management agreement.

These anti-assignment provisions reflect investor expectations that the fund in which they are investing will be managed by an affiliated fund manager, and not an assignee of that fund manager. Although a fund manager would never grant a lender a security interest in the fund manager's right to advise and manage a fund (and a lender would never want to receive such a lien and related liabilities), absent an express carve-out in the management agreement, the anti-assignment provision, on its face, prohibits a fund manager from pledging its right to receive management fees.

In the U.S., the Uniform Commercial Code contains override provisions that render such anti-assignment provisions unenforceable for the limited purposes of facilitating a financing. Therefore, as a technical matter, a fund manager may grant a lien on its right to receive management fees without violating such anti-assignment provision. However, many fund managers are concerned about the appearance of entering into a financing arrangement that runs counter to the express provisions of the negotiated management agreement.

Further, many fund managers believe that, in the absence of explicit authorization in the management agreement, an argument could be made that there has not been sufficient disclosure to investors that would permit the fund manager to pledge its right to receive management fees. In those instances, unless a fund manager is able to amend the anti-assignment provision in its management agreement to permit such a pledge, the fund manager should: (a) request that its lender limit the collateral solely to the bank account into which management fees are deposited, and the amounts on deposit in such bank account; and (b) covenant to instruct the relevant funds under management to deposit such fees into the pledged account.

In addition to collateral security, a lender may request that the underlying funds enter into side letters whereby they acknowledge the pledge of the management fees and agree to deposit such fees into the pledged account or, during the continuance of an event of default under the management line, as otherwise directed by the lender. If the lender does require such letters, the underlying funds should only agree to pay management fees when due and payable under the management agreement; they should not covenant to pay management fees into the pledged account or directly to the lender if the management fees have not yet been earned.

In some cases, a lender may also request a personal guarantee from one or more of the founding partners or members of the management company. If a guarantee is requested, particular attention will need to be paid to the exposure of those individuals, and their comfort in providing such credit support. Such an arrangement may be complicated if more than one individual is providing the guarantee.

Management lines may be attractive to both a lender and a fund manager in light of the overall relationship between the financial institution, on the one hand, and the fund sponsor and its investing professionals, on the other hand. For example, a proposed lender to a fund manager may already be a subscription facility lender to the funds under management. As

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a result of the lender's relationship with those underlying funds, the lender may already have a good understanding of the businesses and assets of the sponsor, the investors in the underlying funds and the overall strategies of the fund manager and the underlying funds and, consequently, may be more willing to provide a management line.

As part of its decision to provide a management working capital facility, a lender will also want to:

(1) diligence each management agreement;

(2) understand how fees are calculated, when they are paid and the composition of the assets under management;

(3) determine whether the facility will only finance (and be collateralized) by fees payable by funds under existing management agreements, or future funds as well; and

(4) identify those entities that will directly receive management fees and ensure that each such entity is joined as a borrower or credit party under the management line.

The lender may also want to ensure that the loan documentation for the fund manager's working capital facility includes covenants designed to provide the lender with comfort as to the creditworthiness of the fund manager and the stream of management fee income, as well as protect against adverse changes to the collateral package. Common covenants include:

(1) a prohibition on amendments to the management agreement that reduce the amount of management fees payable by the funds;

(2) limitations on postponing, cancelling, reducing or suspending the payment of management fees (with the understanding that carve-outs may be necessary to allow for exceptions that have already been incorporated into the management agreement); and

(3) a financial covenant applicable to the fund manager, such as minimum assets under management or a minimum amount of management fees payable in any given year.

If any of the funds under management are (or may become) borrowers under subscription facilities, the management company and its lender will need to be mindful of any subordination provisions in such facilities. For example, some subscription facility lenders seek to limit the payment by the funds of management fees during an event of default under the subscription facility if, at such time, there are loan obligations outstanding to subscription facility lenders. Understandably, in such circumstances, the subscription facility lenders want to be repaid before distributions are made to limited partners and fees are paid to affiliates of the funds. However, unlike distributions to investors, payments of management fees are in consideration for services rendered by the management company and, accordingly, should not be subordinated by a subscription facility.

The issue is larger, though, than the difference between a distribution and a service payment. It is in both the subscription lenders' and the funds' interests to permit the funds to pay the management fees to "keep the lights on", collect capital contributions and maintain the basic operations of the funds. Moreover, from the perspective of the lender to the management company, such a subordination provision could negatively impact its ability to be repaid.

Matters are further complicated if a fund is required to sign an acknowledgement letter pursuant to which it agrees to pay management fees, as and when due, into a pledged account that secures the management line. If the subscription facility limits the payment of

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management fees, any such acknowledgement letter will need to include an exception that takes into account such limitation. In light of these concerns, fund sponsors should resist any subscription facility limitations on the payment of management fees. If the parties do agree to any such limits as a commercial matter, those limits will need to be carefully crafted so that, absent extenuating circumstances, management fees can continue to be paid.

Employee co-investment / Partner loan programs

A fund sponsor may offer its employees and other investment professionals the opportunity to invest, directly or indirectly, into or alongside of its various funds. The fund sponsor may seek to make such co-investment opportunity more attractive by offering participants the ability to finance a portion of their capital contributions to such funds. Rather than loaning monies directly to these individuals, a sponsor may arrange for loans to be provided by a third party lender. As a general matter, lenders active in the co-investment facility space view these facilities as an opportunity to develop and strengthen their relationships with individual high net worth borrowers, as well as a chance to deepen their connection with a fund sponsor. Such arrangements are typically referred to as co-investment facilities, employee loan programs or partner loan programs.

Co-investment facilities are most often arranged and managed by the fund sponsor, but the loans are made directly by the lender to the participating employees and other investment professionals. The fund sponsor entity that is arranging the program executes a master facility agreement that sets forth the overall terms of the co-investment loan program, and each participating borrower signs an individual short-form loan agreement that sets forth the specific terms of its borrowings. Participants borrow under the line from time to time to satisfy a portion of their capital contribution obligations and, in return, secure their borrowings with a lien on all or a portion of their fund interests. The fund sponsor negotiates the form of loan documentation, coordinates borrowing requests that are timed with the calling of capital, and provides the lender with periodic reporting as to the fund interests pledged by the participants as well as information as to any payments of dividends and distributions in respect of such interests.

A co-investment lender will diligence potential borrowers to determine their creditworthiness to participate in the program, including whether the borrowers satisfy specific underwriting criteria, such as a minimum net worth and credit score. Potential borrowers will be asked to provide sufficient documentary support to evidence their creditworthiness, which may include the first few pages of their recent tax returns and K-1s. If the pool of participants is more junior (and, hence, deemed by the lender to be not as creditworthy as more senior partner professionals), the lender may request that a fund sponsor entity provide credit support for those participants' co-investment loans. Alternatively, the lender may structure the facility as an on-lending arrangement, whereby the lender loans monies directly to a fund sponsor entity which, in turn, on-lends such monies to the employees to finance a portion of their co-investment interests.

The percentage of interests financed by a lender varies depending on the program, but it is not uncommon for a partner loan program to permit individual borrowers to finance (or refinance) 50% to 70% of their required capital contributions. As a result, each capital contribution made by a borrower will be funded with a combination of loan proceeds and such borrower's available cash. In addition to an advance rate, the loan program may also include a maintenance test, with a corresponding requirement that a borrower make a mandatory prepayment (and/or post additional collateral) if the maintenance test is breached

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due to a decline in the value of the collateral securing such borrower's co-investment loans.

In addition to mandatory prepayments arising from a maintenance breach, partner loan programs often require that borrowers prepay their loans with negotiated percentages of each return of capital and distribution (other than tax-only distributions) that they receive. During an event of default, the lender may require that 100% of such amounts received be applied to such borrower's outstanding co-investment loan obligations. As the borrowers are individuals (or their estate-planning vehicles), these prepayment requirements are applied on a borrower-by-borrower basis. Similarly, a default by one borrower does not result in other borrowers being put into default under their co-investment loans.

The administrative burdens on the lender and the sponsor can be significant, especially in light of the number of employees that may participate in the loan program. The sponsor will need to provide the lender with advance notice of each capital call being financed with borrowings and each return of capital for which a mandatory prepayment is required. In addition, the lender will expect the sponsor to provide it with notice of any of the following events relating to a borrower: (a) death, disability or termination of employment (which may adversely affect the borrower's ability to repay its loans); (b) any transfer of fund interests to the borrower's estate planning vehicle (in which case, the vehicle would be expected to be joined as a borrower); and (c) any change in name or address of the borrower (which can affect the lender's security interest and trigger the need to file an amended UCC financing statement).

The typical sticking points for partner loan programs are:

(1) whether the sponsor is willing to provide a guarantee or other credit support for the co-investment loans;

(2) what percentage of cash dividends and distributions in respect of pledged fund interests is required to be applied as a mandatory prepayment of the co-investment loan and, if interests in more than one fund are pledged, whether that prepayment requirement should be traced to the underlying fund that made the dividend or distribution; and

(3) the nature of the consent provided by the general partner of the underlying funds.

As to point (1), many sponsors resist providing guarantees of their employees' debts. Similarly, sponsors are disinclined to enter into on-lending programs, as they would be the direct borrower *vis-à-vis* the co-investment lender. Although sponsors may want to encourage employee co-investment and are willing to arrange for financing, they are unwilling to shoulder the liability for those employee loans. Depending on the creditworthiness of the borrowers and the liquidity and transferability of the pledged fund interests, a sponsor may (albeit reluctantly) agree to buy back collateral or to remarket collateral. In these scenarios, the sponsor agrees that following an event of default by an employee borrower under the loan program, the sponsor will either purchase such employee's pledged fund interests or assist in marketing the fund interests to other potential qualified buyers, in each case with the proceeds of such sale being applied to repay the defaulting borrower's loan obligations under the co-investment facility.

As to point (2), loan programs vary as to whether the proceeds of a cash dividend or distribution by a co-investment fund should be applied to the employee's co-investment loans generally or only to the loan that was used to finance that fund interest. Some programs take a borrower-friendly approach and apply the mandatory prepayment requirement on a fund-by-fund, investment-by-investment basis (and look only to the affected percentage of the

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underlying interest held by that pledged fund). However, the tracking of those proceeds puts an administrative burden on the fund sponsor. As a result, many sponsors opt for a more simplified prepayment regime and apply the negotiated prepayment percentage to all payments received by a borrower in respect of its pledged fund interests. Not only is this approach administratively more convenient for the fund sponsor, the faster repayment of loans also eases the burden on the sponsor if it has provided credit support for the employee loans.

The most contentious issue is usually point (3). Banks customarily request that the general partners of each of the underlying funds consent to the pledge by the borrowers of their fund interests (a "GP Consent"). The consent to the pledge is not controversial, due to the fact that most limited partnership agreements require the consent of the general partner to effect any transfer, pledge or assignment of fund interests. However, the typical draft GP Consent that is initially served up by a co-investment lender also includes a consent by the general partner to the exercise of remedies by the lender upon foreclosure, including the transfer of the pledged fund interests to the lender or a third party.

This consent to foreclosure is problematic because the identity of the future transferee is not known at the time the GP Consent is signed. Even if the transferee upon foreclosure will be the lender, it is unknown at the time that the GP Consent is signed whether the lender will, at the time of foreclosure, be a permitted holder of the fund interests. Requiring the general partner to pre-agree to a transfer of fund interests to the lender or an unidentified third party also raises fiduciary duty issues for the general partner. The general partner is obligated under the limited partnership agreements of the underlying funds not to permit transfers that would violate applicable law or cause a tax, ERISA or other regulatory problem for such funds. Although a co-investment lender may want certainty as to its ability to foreclose during an event of default, care should be taken that the general partner does not permit, or pre-agree to, a transfer that would violate the express terms of the applicable limited partnership agreement.

A lender's ability to foreclose may be further complicated if the underlying pledged interest is an employee securities company ("ESC"). ESCs are employer-sponsored investment companies, the beneficial owners of which generally include only current and former employees. Although there is no prohibition on the pledge by an employee of its interest in an ESC, a lender is not a permitted owner of an ESC interest and, as such, cannot become the owner in a foreclosure.

There are potential solutions in the event that employees wish to finance their ESC interests. A co-investment lender may require that the sponsor provide a guarantee of the affected employee loans. With a guarantee, the lender will look to the guarantor, and not to a foreclosure on the pledged ESC interest, to satisfy the loan repayment obligation if the employee defaults.

Alternatively, the lender may impose a standstill in the co-investment loan documentation such that, during an event of default in respect of a borrower, the lender can collect distributions that would otherwise be payable to such borrower in respect of its pledged ESC interest, and the sponsor has the option (but not the obligation) to buy back the ESC interest or convert it into an interest that may be foreclosed upon by the lender, in either case with the proceeds being used to repay the affected employee loan. Both options depend on the willingness of the sponsor to provide a guarantee or other credit support, and the latter option may require specific authorizing language in the applicable limited partnership agreement as to the ability to convert the ESC interest.

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Partner loan programs and fund-level subscription facilities can impact one another in two ways. First, if interests in a fund borrower are pledged to secure a partner loan program, the fund general partner may need to disclose such pledge to the subscription facility lender. That pledge may result in the affected partner being excluded from the borrowing base calculation for the subscription facility. Even if the pledge, in and of itself, does not result in such an exclusion from the borrowing base, in the event of a transfer of such fund interest in a foreclosure, the partner will be excluded from the borrowing base on account of such transfer. Second, as previously mentioned, subscription facilities commonly prohibit fund borrowers from making distributions to partners during certain defaults. As a result, a co-investment lender should be mindful that any such subordination of payments to partners may adversely affect its ability to be repaid.

GP financing

Over the last several years, as funds have grown in size and investors have made larger commitments to those funds, investors increasingly expect fund sponsors to have greater financial commitments to the funds they establish. As a result of these increasing general partner commitments, a fund sponsor may find it advantageous to finance a portion of that capital commitment. A lender that already has a relationship with the fund sponsor, whether as a subscription facility lender or otherwise, may want to further that relationship by providing a GP financing. Moreover, as a result of the existing relationship, the lender may have sufficient comfort and information regarding the general partner and its creditworthiness as well as that of the underlying fund.

Similar to the employee co-investment loan program described above, with a GP financing a general partner looks to a lender to provide it with liquidity to meet its uncalled capital contribution obligations. In return, the lender may require that the general partner grant a lien on its interest in the underlying fund. One point of tension, however, is that most fund limited partnership agreements prohibit the fund's general partner from "transferring" its general partnership interest. A pledge by the general partner of its general partnership interest in the fund could be considered a transfer in violation of the limited partnership agreement.

To solve this issue, the limited partnership agreement may be amended to bifurcate the general partner's interest into a general partnership interest (with the associated carried interest) and a limited partnership interest. The general partner would only pledge its limited partnership interest to secure the GP financing. Once the interest has been so bifurcated, the GP financing is much like an employee co-investment loan program discussed above. Like an employee, the general partner is financing its limited partnership interest in the fund and securing that financing with a lien on its limited partnership interest.

Bifurcating the general partner's interest is not only helpful from the perspective of the limited partnership agreement prohibition on transfers, it also enables a general partner to secure its GP financing without pledging its carry. Such bifurcation also avoids running afoul of the typical subscription facility negative covenant prohibiting the general partner of the fund borrower from granting a lien on its general partnership interest. As with any partner loan program, fund sponsors should be mindful that the pledge by the general partner of its limited partnership interest in a fund may result in the general partner being excluded from the borrowing base in the fund's subscription facility. Also, if the general partner subsequently transfers any portion of its limited partnership interest, such transfer will be subject to any applicable covenants in the subscription facility.

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Considerations across all types of financings:

- Verbiage can be misleading – the term "GP financing" is often used as an omnibus reference to different types of lending arrangements. For example, a GP financing may be confused with a management line, since the general partner and the manager may be the same entity. On the other hand, investing professionals at a sponsor can invest through the general partner, so a facility providing liquidity to those individuals may also be referred to as a GP line of credit. Also, the terms "co-investment loan program" and "partner loan program" may be used to describe a financing by a general partner or by an employee or other investing professional of its interest in a fund. As a result, when discussing financing options with a potential lender, the parties should be specific about which entity or person is borrowing and what collateral or other credit support is available for the borrowing.
- As with subscription facilities, the financing options described in this chapter are all examples of relationship lending. Because these facilities are often bilateral, an existing subscription facility lender may be a good contact point as it has likely already diligenced the funds as well as their investors, investments and strategies, is familiar with the management team, and has an incentive to provide good terms and service.
- Regardless of whether a sponsor is contemplating a management line, a partner loan program or a GP financing, it is advisable to liaise with fund counsel and determine whether third party investors have received adequate disclosure about the potential financings, and their impact on the investors and the funds in which they are investing.
- Sponsors should be mindful of potential conflicts of interest. If a lender offers a subscription facility, a management line of credit and a partner loan program as a package deal, sponsors should consider whether the terms of each offered facility are in the best interest of the borrower thereunder. For example, a fund sponsor should not agree to above-market pricing for a fund subscription facility in order to receive below-market pricing for a management line or partner loan program.
- Lenders in the GP financing and other partner loan program spaces must recognize that the fund interests pledged as collateral are relatively illiquid, particularly in comparison to a management line which is collateralized by management fees paid in cash. As a result, a lender is more likely to finance fund interests when its relationship with the sponsor is significant and long-standing, and the lender has sufficient comfort and information regarding the fund strategy, collateral value and creditworthiness of the loan parties.
- Partner loan programs, in particular, can be administratively burdensome, time-consuming and require a significant allocation of resources, particularly if there is a large pool of employees and other investment professionals expecting to participate.
- Plan ahead. If a management line is contemplated, a sponsor should make sure during the fundraising period for a fund that the form of management agreement permits a pledge of the right to receive management fees. If a partner loan program is envisioned, a sponsor will want to coordinate with its fund formation and tax counsel to determine the vehicles in which employees should invest, which interests can be pledged to support their loans and, if necessary as a credit matter, which sponsor entity can provide a guarantee or other credit support. Similarly, if the GP expects to have a separate financing, the fund sponsor will want to structure the underlying fund partnership agreement so as to bifurcate the general partner's interest, to allow for a limited partnership interest to be pledged as collateral.

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Mary and her team regularly work on a wide variety of fund level financings, including secured and unsecured subscription (or capital call) facilities, with borrowing capacity for the fund as well as its parallel funds, alternative investment vehicles and portfolio companies.
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Strategic partner