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FUND FINANCE FRIDAY

Lender Considerations Related to an Investment Manager's Rights

July 22, 2022 | Issue No. 185

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When we think about parties to a subscription credit facility (the "Facility"), all eyes are generally on the fund and the general partner (the "GP"), but the investment manager (the "Manager") is also a party to watch. For the reasons explained here, the role of the Manager can vary from deal to deal, and, depending on the terms of the fund documents, it can create risk for the Facility lender in a subscription deal. Here we will break down those risks and how incorporating certain terms into your credit agreement can mitigate these risks.

In a typical U.S. fund structure, a fund will have a GP and a Manager. The GP is typically delegated broad rights with respect to the fund pursuant to the fund's limited partnership agreement (or such other governing agreement) (the "LPA") to do any and all things deemed necessary or desirable by the GP in furtherance of the powers, objectives and purposes of the fund. Included in those rights is the right to delegate certain of its responsibilities with respect to managing the assets of the fund to the Manager. The relationship between the GP and the Manager regarding the fund is governed by a management agreement or an investment advisory agreement (the "Management Agreement").

The Management Agreement is entered into by and between the fund and the Manager. The rights delegated to the Manager are typically limited to identifying investment opportunities, purchasing, monitoring, evaluating and selling the fund's assets, and exercising any voting or consent rights with respect to such assets, in each case, subject to the terms and conditions set forth by the GP and/or the LPA. In an atypical situation, the rights granted to the Manager in the Management Agreement go beyond these aforementioned rights or the granting language in the Management Agreement is drafted ambiguously. Such ambiguity could lead to the language being interpreted as granting the Manager broader rights, which could potentially have a negative impact on the rights of the Facility lender.

The Facility will typically include covenants in the loan documents that are intended to be protective to the Facility lender's interests by limiting the fund's and GP's rights to take certain actions that could have an adverse effect on the Facility collateral. These include, but are not

limited to, the following: (i) prohibition of additional liens on the Facility collateral; (ii) limitations on the amount of other indebtedness the fund can incur; (iii) restrictions on cancelling, reducing, excusing or abating the capital commitment of an investor; (iv) limitations on distributions; (v) prohibition on withdrawing funds from the collateral accounts at certain times; and (vi) restrictions on calling capital during an event of default (the "Covenants"). The Covenants help to mitigate risks with respect to the collateral.

In a typical subscription deal, the Covenants typically apply only to the fund and the GP as a party to the Facility loan documents. In the ordinary course, the Manager is not a party to the Facility except with respect to acknowledging a standard covenant that requires the fund to subordinate any payments or advances of any kind on any debts or liabilities due to the Manager. Since the Manager is not otherwise a party to the Facility loan documents, the Manager is not bound by the Covenants, and the Facility lender does not have any recourse to the Manager pursuant to the Facility loan documents if the Manager were to engage in any actions that conflict with or violate the Covenants. One concern for the Facility lender is: if the Manager is not subject to the Facility loan documents, the Manager can issue a capital call to the investors of the Fund and direct the proceeds of such capital call to an account other than the collateral account pledged to the Facility lender. This is often referred to as collateral leakage.

To help protect against collateral leakage, the Manager can be joined to the credit agreement as a credit party. The Manager would be treated similar to the GP. The Covenants and certain other relevant covenants and representations and warranties would apply to the Manager. The Manager would be subject to recourse in the event of any breach of its contractual obligations under the Facility loan documents or any fraud, willful misrepresentation or willful misappropriation of proceeds from the Facility. In addition to becoming a credit party to the credit agreement, the Manager would also pledge any rights that it has with respect to the collateral to the Facility lender. These are minor changes to the Facility loan documents that can serve to be highly protective of the Facility lender's interests without impacting the day-to-day business of the Manager and its wherewithal to manage the fund.