C A D W A L A D E R

A Key Person Will Never Walk Alone . . .

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For those that are not aware, Liverpool Football Club have now officially won their record equalling 20th English league football title.

For the benefit of non-fans of association football or soccer ("soccer" of course being the slang abbreviation of association), last summer U.S.-backed Liverpool FC lost their legendary manager, Jurgen Klopp, who left them to take a role at the Red Bull organisation as their Global Head of Soccer.

During his time at Liverpool, Jurgen Klopp had taken the club back to the heights of the 1980s, winning both the European Cup and their first league title during the Premier League era. To many in the soccer world he was viewed as the key person to their success, many feeling that a long rebuild would be required before Liverpool would ever be at that level of success again, a sentiment that was compounded by their rivals' own recruitment. However, considered appointments by their U.S.-backers, including that of Arne Slot (a relative unknown) as their new manager, as well as faith in some of the existing talent, paid off, with Liverpool now very much back on top, a situation very few would have predicted last summer. Liverpool now look in a strong position to improve even more this summer and to continue to build on this already very impressive success in such a short space of time.

So what has Liverpool winning a league title got to do with funds and fund finance?

Well, these are industries where success can rely heavily on key personnel and the impact such individuals can have on an organisation (it not being lost on us at Cadwalader that such circumstances can very much also arise in the legal industry too). Success for a fund can be driven by one or a group of key individuals in an organisation whose skills, experience, judgment, knowledge and leadership is integral to the success of the fund in its investment strategy. Investors will typically commit capital based on the expertise of these key persons, their track record and investment philosophy. It is often considered that a fund's success is tied more to who is managing the capital than where the capital is deployed, a possible example of this being someone like Warren Buffet of Berkshire Hathaway.

Having such a key person(s) at the helm of a fund's decision-making process provides for both operation and institutional continuity that investors and fund finance lenders will rely upon; however, the prevailing economic volatility and ecosystem around funds has very much brought into sharp focus the significance of key person events in limited partnership agreements and the protective mechanisms built into fund finance facilities as a consequence.

Why are key person events of interest now?

In stable markets, a key person event was historically seen as rare and often procedural but tighter fundraising conditions (leading to investors using their bargaining power to negotiate broader key person definitions) and pressures on asset valuations are increasing the performance burden on fund managers, heightening the likelihood of senior departures and/or reorganisations. This coupled with investors increasingly monitoring the stability of a sponsor, especially in a climate where we have longer fund lifecycles, has meant greater focus on the identity of key persons, as investors look to ensure that during a downturn or times of volatility trusted individuals remain involved in the management of the fund.

Key person events have also garnered more interest alongside the growth in the use of continuation vehicles where investors in those vehicles tie their investment(s) to the expertise of specific key persons who already have the acquired experience and knowledge of such assets.

In recent years there have also been a number of high-profile departures from some of the more established sponsors in a world with leading individuals either simply retiring or looking to set up their own funds with similar investment strategies. There are also some generational transitions which are facing the world's biggest funds as the junior tiers look to move up to leadership roles at such sponsors. Even in respect of these new funds that have been established, although technically first time funds, they have often managed to raise considerable amounts of capital due to the track record of their founders, meaning their creditworthiness will be a function of those founders and hence even greater scrutiny required of the key person provisions.

What is a key person event and how can it be triggered?

A key person event, which can also be referred to as a "key man" event, occurs when one or more key persons deemed vital to the fund's management cease to devote all of their business time and efforts to the activities of the fund. It is clear that in the case of resignation, termination, death or permanent disability, an individual will be unable to devote their time to the fund. In such circumstances, though this language in the limited partnership agreement (the "LPA") is not meant to mean that an individual must work exclusively for the fund and LPAs can often provide carve-outs to allow for such individuals to give time to other activities such as charity, but this drafting is meant to cover that the individual's professional time is predominately spent on the activities of the fund. The Institutional Limited Partners Association (the "ILPA") guidelines go further and make it clear that such an individual should not act as a general partner for a separate fund managed by the same firm with substantially equivalent investment objectives during the investment period of the fund in which they are a key person.

The specific threshold and number of key persons that will trigger a key person event will vary between funds, usually based on fund size and the perceived importance of certain individuals to the sponsor. It not being uncommon for larger sponsors, given their size, to have a tiered approach with senior and junior tiers specifying key persons in each tier, with a key person event being a breach of a certain threshold of these tiers or a mix of both no longer being involved with the activities of the fund.

The LPA may also include a time threshold (30 days) before such event is officially triggered.

What are the consequences of triggering a key person event?

Once a key person event is triggered under the LPA, the consequences typically include an automatic suspension of the investment period, ensuring that no new investments can be made (but the fund may continue managing existing ones). Though it should be noted that for a minority of funds, it may not be an automatic suspension of the investment period but that they actually require a vote to do so. For the investment period to restart, it should typically require investor consent, ILPA having advised that the threshold consent should be that of a supermajority, with such vote usually being coupled with a proposed solution put forward by the general partner, such as identifying replacements for the key persons and approving such replacements. To the extent no remediation can be found, then there is a risk that the fund could face early wind down or early termination with any existing investments sold off. It should be noted that some extremely sponsor-friendly LPAs do contain provisions for the automatic reinstatement of the investment period after a certain time period unless the investors vote for the investment period to be suspended further or terminated. Therefore, a clear understanding of how the investment period is suspended and if it requires a vote or is automatically reinstated should be a key part of any subscription line lender's due diligence.

The ability to no longer be able to make new investments while a key person event is continuing will have a significant commercial impact, creating uncertainty of execution, possibly a disruption to the investment strategy and not to mention the potential for missed opportunities. In these circumstances, especially for smaller funds, the absence of key decision-makers may also give rise to uncertainty around governance and decision-making which may result in a decline in asset performance and/or possibly effect relations with any co-invest partner, especially if such key person was significant in the management of such assets.

The impact of a poorly handled key person event could also lead to a loss of investor confidence, which could result in requests for early withdrawals (in the case of open-ended funds), investors showing greater resistance to meeting drawdown notices and damage any attempt at existing (should the fund not yet have reached final close) or future fundraising efforts.

Implications for Fund Finance Facilities

It is always worth noting that, in addition to evaluating the credit support provided by the uncalled commitments of the investors, lenders are fundamentally also taking credit risk on the individuals running the fund, relying heavily on the operational stability and institutional continuity of sponsors. A key person event can threaten both, as stated above, the occurrence of a key person event can prompt concerns over investment performance, decision-making, and fundraising prospects. To mitigate the risks associated with a key person event, lenders will often include certain protections in the credit agreement to help them reassess their exposure and take protective action, these will typically include:

- Key person notification requirements: the inclusion of notification requirements on the occurrence of a key person event and any votes taken to suspend or permanently terminate the investment period. As flagged above, attention will need to be given to the processes included in the LPA in respect of whether the suspension and/or reinstatement of the investment period is automatic or subject to a vote— this is to ensure that the protections included in the credit agreement are correctly tailored to the comfort levels of the lenders;
- A drawstop to further utilisation: Notwithstanding that under the LPA investors may still be technically obligated to meet drawdown notices to repay debt, lenders may still look to include a drawstop for any further utilisations on the occurrence of a key person event on the basis that there may be a perceived increased credit risk given the operational uncertainty and to the extent corrective steps are not agreed in respect of the key person event, from a practical perspective a lender will wish to avoid potentially having to, in an enforcement scenario, take action to recover a larger amount at a time when investor behaviour may diverge from expectations, especially if the fund has taken a reputational hit due to the key person departures;
- The inclusion of a mandatory prepayment event / event of default: Should a key person event be unresolved and therefore continuing, under the credit agreement this will trigger either a mandatory prepayment event or an event of default. The LPA may include a time period to allow for a replacement to be appointed and the reinstatement of the investment period. Whilst a time period may be agreed by lenders for inclusion in the credit agreement, this will typically be a shorter period than that specified in the LPA. This provides a buffer for repayment in the event the key person event will not be corrected and investment period permanently terminated.

In addition to the above, it is not controversial that a well drafted fund finance facility will include several covenants which seek to regulate the operators of the fund to ensure they are appropriately engaged in managing the fund. It is often the case that a failure by a fund employee to provide their capital contributions for their carried interest will be given a shorter grace period than that given to an investor. The reason for this is that lenders take the view that any indication that a fund is no longer backed by its carried interest partners is a sign of a struggling fund that lack of confidence will spread to the investors may be unwilling to back. Key man provisions should also be considered in the context of such provisions, which ensure that the team in which the lender has credit approved to run the fund, remain actively engaged in the management of that fund.

In conclusion, key person provisions in LPAs and their corresponding provisions in fund finance facilities are no longer just boilerplate legal language — they are critical components of risk management in an uncertain economic climate and times of tighter fundraising. However, as is evident with Liverpool FC, the loss of a key person does not have to be fatal to an organisation. With considered appointments and provided the correct contractual processes and protections are in place, an organisation may actually emerge more improved if the key persons can be replaced with even better personnel.

Meanwhile, reports in the English sports press have suggested that Jurgen Klopp is “already unhappy and worn out” with his new role.