CADWALADER

Fund Finance
Friday

Subscription Finance Loan Agreements Series, Part 8: Key Person Events

September 20, 2019 | Issue No. 46

“Key Person” (or similar) provisions are a common feature of Leveraged Finance Facilities as well as of Funds Finance Facilities. While the fundamental concerns around this are similar in each of the leverage and the funds markets, the way in which they impact is quite different. The fundamental concern in each market (at least for the lenders) is that if they have made facilities available (for whatever purpose) in reliance on there being a particular group of persons within the borrower or – in the case of fund facilities – a related general partner or manager who will deliver the financial or business outcome required to ensure the facilities are utilised and repaid, and if some or all of that group ceases to be involved in the business, then there is a change for the worse in the risk profile of the facilities. At that point, the lenders (in either market) will want to ensure that that risk is mitigated (usually by a combination of giving some time for the borrower or related parties to find suitable replacements and/or by imposing draw stops or even defaults if the requisite action is not effected within a specific timeframe).

So far so similar, but after that the reasons for the approach and the solutions will diverge between the two markets. In the leverage market (very broadly), the lender’s credit issue is primarily only with the fact that the particular “key” persons ceasing to be involved in the business will adversely affect the conduct or the success of that business. In the subscription finance market, the lenders’ credit issue is primarily (although not only) with the impact that the absence of any particular “key” persons will have on the commitments of the investors – so, to a much greater extent than in a Leveraged Finance Facility, the lenders will only have an issue to the extent that the investors have an issue.

As with many other facets of the subscription finance market, if there are specific “Key Persons” that are deemed important enough to affect the nature of the fund’s business and the purposes for which the investor’s commitments can be paid (and this is not always the case), this will be set out in the fund’s constitutional documents. Although the treatment differs slightly from fund to fund, the broad features will be the same:

- The documents will identify those people who are regarded as “key” executives within the fund and thus expected to spend a majority or substantively all of their time running the fund.
- They will then define an issue (often described as a “Key Person Event” or similar) as occurring if a specified number of those people cease to be involved to the extent required in the fund. Occasionally, the “number” will be replaced by a points system (whereby so many points are attributed to each “Key Person” and then people representing a sufficient number of points cease to be involved to the extent required), but the principle is the same.
- Once the “Key Person Event” has occurred, the fund may continue to operate for a period, but the activities that it can pursue are often strictly curtailed. For example, it is common to restrict expenditure on investments to “follow on” investments (or to investments that have already been committed) after a “Key Person Event” occurs. Usually, investors can still be called on to repay fund borrowing during the period but this should be carefully checked. Similarly, the constitutional documents should be checked to confirm whether investors will be required to pay in commitments to fund drawdowns made after the “Key Person Event” occurs. Often, this obligation may only be imposed provided the drawdown is used for one of the restrictive purposes referenced above.
- After a defined period (the period can vary considerably but is usually anything up to 180 days), either the investor committee or another representative body (or the investors themselves) will be required to make a decision as to whether or not to continue the fund while the “Key Person Event” is continuing, or to accept the continuation of the “Key Person Event,” to require steps to be taken to remedy the “Key Person Event” or even to end the fund’s investment period.

Lenders need to be fully informed across these provisions and carefully consider how to ensure that they “match” them to the extent necessary in their facility documentation. Historically, it was quite common for lenders to impose a full-

draw stop on the occurrence of a “Key Person Event” and to require termination/repayment of the facility if a specified period had elapsed without the “Key Person Event” being effectively remedied. That period often (but not always) matched the period for a final decision set out in the fund’s constitutional documents. In more recent times, the market has generally moved to an approach that is more directly reflective of the underlying treatment in the fund’s constitutional documents. So the “standard” approach now will involve a limited-draw stop (so restricting the purposes of utilisations after a “Key Person Event” to match the more restrictive purposes for which investor commitments can be called after the occurrence of the “Key Person Event” but not removing the ability to draw altogether), with the full-draw stop (and potential termination of the facility) only when and if the period allowed for the more restricted activities of the fund to continue has come to an end without resolution.

That said, and in light of recent events, there are circumstances in which lenders might still want to adopt a more historic approach (and impose a complete-draw stop and even a termination event when a “Key Person Event” occurs rather than only after a suitable period has elapsed). This is particularly worth consideration if the reasons for the departure of “Key Persons” is something other than “normal course.” So, if for example “Key Persons” are departing the fund as a result of allegations of mismanagement or misconduct (not necessarily against them specifically but just generally in respect of the relevant fund or its management), then lenders may want to have the right to take more immediate and drastic action. On a similar theme, lenders may also want to consider whether, if that type of situation were to arise, the trigger should match whatever the definition of “Key Person Event” is in the underlying fund constitutional documents (which may require the departure of a number of “Key Persons” before the event is triggered) or should be capable of being triggered on the departure of any one “Key Person” for these reasons. Finally, it is worth stressing that while these may be “ideal” solutions, this is an area where, for a number of reasons, actually tying down terms that are sufficiently “certain” to be accepted by both sides of the facilities may be problematic.