

## FUND FINANCE FRIDAY

## A Closer Look at Management Fee Facilities

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As financing activity in the hedge fund and private equity fund space continues at a robust pace, we are seeing a significant volume of requests for more bespoke financings. Among those requests has been a steady stream of inquiries and questions from lenders regarding management fee facilities. We discuss below what a management fee line is and highlight some of the issues we frequently discuss with clients looking to provide such facilities.

### What Is a Management Fee Facility?

While for subscription and NAV lines the borrower is an investment fund, the borrower for a management fee line is the management company providing management services to a group of investment funds. The management company earns a management fee (typically a percentage of the asset value of the fund) from each fund, which fee accrues monthly or quarterly and is paid out to the management company periodically (quarterly, semi-annually or annually). The terms of these management fees are typically documented in one of two places, either the constituent documents of the investment funds or in a separate investment management agreement. The management company will pledge as collateral for its obligations under the facility its rights to receive the management fee (and, in some cases, other fees to which the management company is entitled), and such fees will be directed to a cash account that is pledged to, and subject to the control of, the lender.

### What Are Management Fee Facilities Used For?

Management companies use the proceeds of management fee facilities for different purposes. Traditionally, such facilities have been used to manage day-to-day operational expenses, including paying salaries, rent, fees to service providers and other general administrative expenses. Another common use of such facilities has been to fund end-of-year bonus and tax payments. Increasingly, though, we have seen requests for facilities to support more substantial, high-priority projects, such as upgrades to internal technology, funding of additional equity investments in investment funds, acceleration of payouts to the management company principals and even acquisitions of other investment advisers or management companies.

Generally, our lender clients are not looking to maintain lines of business focused on management fee facilities, but instead to provide one-off solutions for fund managers in the context of a broader financing relationship.

### **What Type of Legal Due Diligence Is Required?**

Legal due diligence for management fee facilities typically focuses on the following areas:

- **Pledge restrictions:** It is important to review fee agreements to determine whether pledges of fee payments are prohibited or require consent. If the management company and the fund are U.S. entities, and the fee agreement is governed by U.S. law, the lender may be comfortable that provisions of the Uniform Commercial Code are effective to override such restrictions and provide the lender an effective pledge of limited-scope rights to fee payments under the fee agreements. But for non-U.S. entities, or where the fee agreement is governed by non-U.S. law, it may be necessary to amend the fee agreements and/or obtain any required consents. Apart from the security interest analysis, it is also important to determine whether the pledge of fee payments may violate the fee agreement in a manner that could have adverse contractual consequences.
- **Fee amounts:** We often check the amounts specified in the fee agreements to confirm they line up with aggregate fee projections being provided by the management companies. In addition, fee amounts actually payable may be offset by other income streams directed to the management company or the general partner of the investment funds, such as consulting or advisory fees received from underlying portfolio companies in which the funds invest. To the extent such offsets exist, fee projections may need to be adjusted. Alternatively, the lender may require a pledge of such alternative fee streams.
- **Termination rights:** It is critical to understand the circumstances under which a management company may be replaced or a fee agreement terminated. Management fee facilities are secured by future expected fee streams, so a termination of the management relationship that produces such fee streams constitutes the most significant risk to the ability of the management company to repay.

### **What Supplemental Credit Support Can a Borrower Provide?**

This depends on the structure of the fund group and the willingness of the borrower and its affiliates to provide supplemental credit support. We see a range of approaches to supplemental credit support, including:

- **Guaranty:** The obligations of the management company may be guaranteed by an affiliated entity (such as the general partner for the investment funds) or by the principals that own the management company;
- **Pledge of equity interests:** The management company may pledge its equity in certain of the funds that it manages, or the rights to distributions in respect of such equity interests. Certain funds may require that the managing partner and/or general partner maintain a minimum level of equity ownership in the fund. In the event that the facility involves a pledge of equity, it is important to understand how a foreclosure may impact compliance with that minimum equity requirement, as this may raise fiduciary and contractual issues for the management company in entering into the facility.

- Pledge of other fee streams: Some fund management groups have multiple management entities that provide services to the funds or to the management company itself, such as licensing use of investment analytics, data feeds and intellectual property; providing administrative, technical and clerical services; providing accounting, tax and legal services; providing use of technological equipment, office-related facilities, services and supplies. These services may produce additional fee streams that can be pledged as collateral in support of the management company loan.
- Covenant to call capital: In the case of private equity funds, investors in the fund are typically required to contribute capital to the extent necessary for the fund to pay management fees. A covenant from the investment funds to maintain sufficient uncalled capital, and to call capital to the extent necessary for the fund to pay management fees on a timely basis, may provide additional comfort to the lender.

### **What Other Terms Are Typical in These Facilities?**

Not surprisingly, a primary focus of lenders is the management of the credit risk of the management company. An insolvent management company will likely be unable to continue servicing the funds that it manages in order to maintain the management fee streams. Even if the management company is able to continue managing its funds, there is a risk that any fees earned following a bankruptcy of the management company would be deemed general property of the estate of the management company to which the lender does not have a priority security interest. While many of the protections in this respect come in the form of covenants that are common to credit agreements generally (limitations on other indebtedness and liens, cross-default triggers and judgment triggers), management fee facilities may also include additional protections in the form of minimum net equity requirements and floors as to the aggregate value of fee producing assets managed by the management company. Many facilities also include periodic clean-down requirements pursuant to which the full balance of the facility must be paid down with a specified frequency.

Another point of focus is construction of the borrowing base. Facilities for large, diversified management companies that have long track records tend to look a lot like corporate loans with a focus on trailing EBITDA. But a number of facilities we have worked on have applied a forward-looking borrowing base, seeking to quantify expected fee receipts over a specified period. This forward-looking approach relies on a combination of a real-time snapshot of fee-producing assets under management and management projections as to expected performance and realizations over the relevant period. Projected fee earnings may also be adjusted to reflect maturity periods for funds as well as (in the case of hedge funds) redemption terms to which investors are subject (including redemption frequencies, notice periods and investor-level gates).

Finally, a frequent point of discussion is the ability of the management company to waive and reduce management fees and to wind up funds. Managers want to maintain maximum flexibility in the management of investor relationships and investment terms, while lenders want to ensure that the management company will not reduce fees or terminate funds in a manner that will leave the management company unable to repay its debts to the lender. And neither party wants to impose restrictions that could be deemed in breach of the management company's fiduciary duties. As a result, such limitations are often extensively negotiated and tailored to the facts and circumstances of the particular management company and its related funds.