Financing Management Fees

February 23, 2024

By **Chad Stackhouse**
Partner | Fund Finance

The primary purpose of a capital call facility is to provide bridge financing to a fund borrower that may be drawn upon, in lieu of calling capital, to make investments in accordance with the fund's business purpose. In addition to providing a fund borrower with a readily available source of credit to quickly fund investments, a capital call facility also provides a fund borrower with the ability to leverage the fees and expenses of the partnership. In particular, many fund borrowers will look to the credit facility to finance the payment of management fees by the limited partners to the investment manager. It is therefore important for lender's counsel to confirm that the fund borrower's limited partnership agreement (a) authorizes the fund borrower to incur indebtedness for the payment of management fees and (b) doesn't contain management fee overcall limitations. Lender's counsel should also confirm with the lender that the credit facility use of proceeds contemplates the financing of management fees and the credit agreement appropriately reflects and permits the credit extensions to be used to finance management fees of the partnership.

A management fee is typically an annual fee that the partners of the fund borrower contractually agree to pay as compensation to the management company for managing the business affairs of the partnership. The services rendered by the management company for the partnership commonly include evaluating potential portfolio investment opportunities, providing investment advisory services, and managing the day-to-day activities of the fund. The management fee covers the cost of these services, the operating expenses, and employee salaries of the partnership. In addition, the management fee may be structured to provide additional monetary benefits to the fund manager based on achieving certain performance milestones and economic returns. The amount of the management fee payable by an investor is often determined by multiplying a percentage times such investor's capital commitment. The management fee is usually payable by the partners on a quarterly basis. We typically see management fees between 2 - 3% of total capital commitments. Management fees are not an insignificant cost for many funds and therefore a fund borrower may contemplate using a capital call facility to finance its management fees. If so, it is always preferable to raise such potential usage with a prospective lender as part of the due diligence phase to confirm interests are aligned on this point and that the capital call facility use of proceeds covenant is drafted appropriately to permit the financing of partnership fees and expenses, including the management fees of the partnership. Unlike other fees and expenses incurred by the partnership, there may not be clear language in the fund borrower's limited partnership agreement that would permit the fund borrower to incur indebtedness for financing management fees. If so, the fund manager should discuss with fund borrower's counsel during the fund formation process the inclusion of specific references to management fees in the indebtedness section of the limited partnership agreement. In addition, both parties should be mindful of any management fee overcall limitations requested by the fund partners which could hinder a fund borrower's ability to access the credit facility to leverage the management fees.

A capital call facility that contemplates a use a proceeds to fund management fees is a useful feature for both a fund borrower and a lender. Both parties interests are aligned in making sure the fund performs as expected and is efficiently managed whether it is calling capital to make investments in accordance with the limited partnership agreement or paying fees and expenses to vendors or management fees to the investment manager. A lender is incentivized from a relationship and credit standpoint to support the fund borrower's business objectives and in achieving these goals to ensure a predictable and reliable source of repayment from a vetted borrowing base. Compared to the dollar amounts called for investment purposes, management fee dollar amounts are relatively small and have a built in mitigating cap. A typical use of proceeds provision in a credit agreement for a capital call facility may include one or more general categories of permitted uses such as for working capital purposes or to fund the general business purposes of a fund borrower only as expressly permitted under the fund borrower's limited partnership agreement or for which a capital call may be made to fund the repayment of credit extensions. A fund borrower's financing of fees and expenses, including the payment of management fees, would be captured under the foregoing categories so long as the limited partnership agreement permitted such financing. To avoid any uncertainty, a limited partnership agreement should specifically authorize a fund to incur indebtedness for borrowed money to finance fees and expenses including management fees of the partnership. A typical lender friendly limited partnership agreement formulation would be as follows:

"*The partnership may incur indebtedness for borrowed money but only to the extent such indebtedness is used to fund an Investment or pay Partnership Expenses pending receipt of Capital Contributions from the Partners pursuant to a*

Capital Call Notice"

Although not specifically mentioned in the indebtedness section, in the above example but commonly found in limited partnership agreements, the definition of "Partnership Expenses" will include a broad category referencing all fees, costs, and expenses of the partnership and in many cases explicitly include management fees. Lender's counsel must therefore provide a careful and thorough review of the limited partnership agreement to (a) confirm that the fund borrower is authorized to incur indebtedness to finance its management fees and (b) determine if there are any overcall limitations with respect to management fees.

A diligent and thorough review of a limited partnership agreement to determine the overcall rights and any restrictions thereto must be performed by performed by lender's counsel and discussed upfront with any lender considering a potential capital call facility. When a limited partner fails to fund a capital call, a general partner has a number of actions that it may take in accordance with the limited partnership agreement to remedy the capital shortfall caused by the defaulting limited partner. One of the remedial actions available to the general partner is to issue another capital call or to "overcall" additional capital from the non-defaulting limited partners to cover the capital shortfall of the defaulting partner. The general partner's ability to utilize an overcall to make up for capital call shortfalls ensures that the fund will continue to operate and make investments in the ordinary course, including servicing any debt obligations owing to a lender. However, if a limited partnership agreement or side letter contains overcall limitations, the effectiveness of the general partner's ability to overcall from the non-defaulting partners may be insufficient to make up for any shortfall. As we have previously reported, the occurrence of overcall limitations in limited partnership agreements is meaningful and must be discussed as a credit exception during any underwriting of a capital call facility. The most common forms of overcall limitations are (a) placing limits on the dollar amount that a general partner can overcall from non-defaulting partners as a percentage of such partners original capital call, (b) concentration investment linked overcall limitations that cap a non-defaulting partner's obligation to fund an overcall in excess of the investment concentration limit set forth in the limited partnership agreement, and (c) management fee overcall limitations which prohibit the general partner from overcalling the defaulting partners unpaid portion of the management fees. We have recently seen an increasing number of limited partnership agreements contain a prohibition on overcalling for management fee. A common management fee overcall formulation is:

"A General Partner may issue additional Capital Call Notices to each Non-Defaulting Limited Partner to make a contribution equal to such Non-Defaulting Partner's pro-rata portion of the Defaulting Partner's unfunded Capital Contribution; provided that no Limited Partner will be required to make a Capital Contribution with respect to a Defaulting Partner's share of the Management Fee"

It seems reasonable from a limited partner's perspective to not have to pay the management fee of another limited partner as there is no corresponding economic benefit to the non-defaulting partner. However, for a capital call lender, that would otherwise have a use of proceeds section that permits borrowings to pay management fees, the expectation is that the management fees would treated similarly to the true up called for the investment and that any management fee overcall limitation would not extend to a capital call to repay borrowings. If the fund borrower and lender are unable to agree on alternatives that would mitigate the lender's credit risk, lenders will be reluctant to lend into this type of situation and will prohibit the use of loan proceeds to fund management fees. A few alternatives that we have seen in the market include (a) a specific exception to the complete non-overcall for management fees that the non-defaulting partners shall remain absolutely and unconditionally obligated to fund capital contributions called for the for the purpose of repaying any indebtedness for borrowed money used to fund management fees, (b) shorter clean down periods, (c) providing a cap on the amounts available to be advance for management fees, and (d) requiring that the investment manager promptly return to the lender or the fund borrower any defaulting partner's pro-rata share of the management fees. With management fee overcall limitations increasing in the market, it would be advantageous for both the sponsor and lender that anticipate the proceeds of the capital call facility to be used in part to finance management fees to confirm early on in their discussions that the limited partnership agreement will provide for an acceptable alternative to any such overcall limitations.

Final Final Answer: Loans Are Not Securities

February 23, 2024

By **Leah Edelboim**
Partner | Fund Finance

A lawsuit that has worked its way through New York federal courts since 2017, including up to the Second Circuit Court of Appeals, has met its final stop at the United States Supreme Court.

This week, the Supreme Court denied a petition for a writ of certiorari in the *Kirchner* case. This case raised the question of whether broadly syndicated term loans are “securities” and therefore should be subject to state and federal securities regulations.

We previously reported **here** that we had a final answer to whether a term loan is a security when, last summer, the Second Circuit Court of Appeals affirmed a 2020 decision from the U.S. District Court for the Southern District of New York which held that broadly syndicated term loans are not securities. Most legal and regulatory experts expected that the Court’s decision would be the end of this litigation.

Now the Supreme Court has spoken, or perhaps we should say has declined to speak, and therefore we have our final *final* answer. Without providing any explanation, the Court declined to grant the petition that Kirschner submitted for the Supreme Court to hear the case.

For our non-lawyer readers out there, when parties are not satisfied by a ruling of a lower court they have to file a petition with the U.S. Supreme Court asking the Court to hear (and therefore determine) their case. The way this is generally done is to ask the court to grant a writ of certiorari, which is a request that the Supreme Court order the lower court in question to send the case record to the Supreme Court for review. Generally speaking, unlike other courts where you can file an original lawsuit or file an appeal of a decision of a lower court by following court procedure, the Supreme Court is not obligated to hear all cases and it can be choosy about the cases that it does hear. To put it in perspective, according to the Court, it is asked to review thousands of cases each year and it generally actually hears less than 100.

When the Supreme Court declines to grant a petition for certiorari, the existing decision in the case will stand as final, which is what has happened here. Hence, final answer: syndicated term loans are NOT securities.

Loan market constituents have been watching this case over the years with great interest. The Loan Syndications Tradition Association ("LSTA") has been quite vocal in this case and has urged that a determination that syndicated term loans are securities could pose an case as an “existential threat” to the $1.4 trillion syndicated loan market in the U.S. with the fear that a determination that securities laws should apply to the syndicated loan market would completely upend that market as we know it. We explained the implications in one of our previous articles on this case **here**.

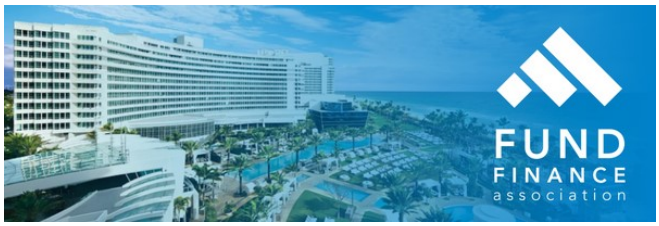
The LSTA and others filed amicus briefs in support of their position when the case was before the Second Circuit Court of Appeals. The case generated a great deal of excitement when the Court asked that the SEC weigh in on the question before it. After a number of extensions of time, the SEC declined to comment.

It is interesting to note that this is not the first time the Supreme Court was ask to grant a petition of certiorari on this topic. In 1992, the Second Circuit Court of Appeals found in *Banco Espanol de Credito v. Security Pacific National Bank* that loan participations are not securities. An appeal was filed following the Court’s decision and the Supreme Court denied certiori in that case. Perhaps more significantly, in that case, in the context of briefings submitted to the court, the SEC had indicated that loans could be securities although court ultimately ruled the other way.

You can read about the different phases of the case as we reported them here in Fund Finance Friday **here**.

We Look Forward to Seeing You at the Welcome Reception at FFA Miami!

February 23, 2024



We look forward to seeing you next week at The 13th Annual Global Fund Finance Symposium on February 26-29, 2024 in Miami Beach. Join our Fund Finance lawyers at the Global Symposium for an engaging event filled with discussions on the latest market trends, networking opportunities and, of course, some fun in the sun!

Cadwalader is proud to be a sponsor of the Welcome Reception on Monday, February 26 from 6:00 PM – 10:00 PM on the Ocean Lawn. We hope to see you there! **Add it to your calendar.**

Be sure to catch Cadwalader partner **Brian Foster** speaking on the panel:

NAV Lending to Buyout Funds
(Fundlevel, Back-Leverage, LBO)
Tuesday, February 27
1:40 PM - 2:25 PM EST

Visit the FFA website **here** for more and we'll see you soon!

Fund Finance Expert Talk by Michael Mbayi Features Mike Mascia

February 23, 2024

The most recent episode of the Fund Finance Expert Talk by Michael Mbayi is live. In this episode, the Head of Banking & Finance of the Luxembourg law firm Praxio Law & Tax, speaks with Mike Mascia, Co-Head Fund Finance at Everbank and Board Member of the Fund Finance Association.

Tune into this episode if you want to learn about:

- Mike's entrepreneurial journey in the industry from the outset,
- Tips to build a global fund finance legal practice,
- Client development for a lawyer,
- Market trends,
- What is on the pipeline for the FFA.

Watch at it now **here**!

Register Now for FFA U: Asia-Pacific

February 23, 2024

Registration is open for the 2024 FFA U: Asia-Pacific! We look forward to welcoming you to the virtual half-day sessions on March 20th & March 21st, followed by in-person networking receptions held in Hong Kong, Singapore, and Sydney by the FFA NextGen Committee.

Register **now**.

Networking: 21 March 2024, held in-person in Hong Kong, Singapore, and Sydney by FFA NextGen Committee (limited capacity)

- Hong Kong: Liberty Exchange Kitchen & Bar Shop 103, 1/F & 205 – 206 2/F, Two Exchange Square Podium, 8 Connaught Road Central, Hong Kong
- Singapore: (more details to follow)
- Sydney: Rooftop on Botswana Shop 8.05 MLC Centre, 19-29 Martin Pl, Sydney, NSW 2000

Time: 06:00 pm - 8:00 pm HKT/SGT/AEDT

What to Expect:

- Insightful Lectures: Learn from senior practitioners in the field through engaging and informative lecture sessions.
- Comprehensive Coverage: From deciphering fund formation and structures to navigating transaction credit documentation and addressing investor concerns, our course covers a broad spectrum of crucial aspects of Fund Finance, with a focus on capital call/subscription financing.

Dates: 20 & 21 March 2024

Time: 09:00 am - 12:45 pm HKT/SGT

Agenda: Virtual Lectures

Cost: USD$200

WFF EMEA: Register Now for Inaugural Irish Networking Event

February 23, 2024

Women in Fund Finance EMEA and Maples Group are pleased to invite you to the first WFF Industry Gathering in Ireland. The evening will include networking drinks and canapes, and keynote address from Joan Kehoe, CEO and Founder of alchelyst.

This event is open to all genders and for members and prospective members of Women in Fund Finance, the Fund Finance Association, Diversity in Fund Finance and NextGen. We hope you will be able to join us for what promises to be a wonderful evening!

Register **here**.

Event Details

Location: Museum of Literature Ireland, 86 St. Stephen's Green, Dublin 2, DX02 XY 43, Ireland

Date: Wednesday, 17th April, 2024

Time: 6:00PM - 9:00PM GMT