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FUND FINANCE | Management Fee Lines of Credit and Partner Co-Investment Loan Programs in a Time of Uncertainty

I. Introduction

The outbreak of COVID-19 has caused widespread disruptions to economic activity worldwide, which has in turn impacted local and global financial markets. The fund finance market has nevertheless seen significant activity notwithstanding (or because of) COVID-19 in the first half of 2020.[1] While the long-term impact of COVID-19 on local and global financial markets remains unclear, we have seen an uptick in the use of management fee lines of credit and partner loan programs by market participants to bridge the near-term liquidity needs of private equity fund sponsors (each a “Sponsor”) and loan program participants. This Legal Update will provide a general overview of management fee lines of credit and partner loan programs and highlight some of the benefits and other factors to consider in light of recent financial market volatility.

II. Overview of Management Fee Lines of Credit

A management fee line of credit (a “MFLOC”)[2] is typically a revolving credit facility provided by a bank or other financial institution (a “Lender”) to the general partner (the “General Partner”) of a closed-end private equity fund (a “Fund”) or a Sponsor-affiliated management company or investment advisor (collectively, the “Management Company”) of a Fund. As the name suggests, the basic collateral package for a MFLOC consists of the management fees paid to the General Partner or Management Company, as applicable (“Management Fees”), under the Fund’s limited partnership agreement or other applicable management or investment advisory agreement, together with a pledge over the deposit account into which the Management Fees are paid. Additionally, because the General Partner, the Management Company, or another Sponsor-affiliated entity (a “Special Limited Partner”) customarily holds an equity interest in the Fund, a MFLOC may also include a pledge by such entity or other Sponsor-affiliated investing entity's distributions from the Fund, including carried interest, and, in some instances, its limited partnership interest, itself.

Management Fees are typically paid by the Fund or the Fund's investors as compensation to the General Partner or the Management Company for evaluating investment opportunities, providing investment advisory services, and attending to the day-to-day activities of managing the Fund. The Management Fee also covers operating expenses, including salaries for the Management Company's employees. The calculation of the Management Fee of a Fund is often based on a percentage of the total capital committed to the Fund during the Fund's active investment period, with such calculation being based on a percentage of the Fund's invested capital or assets under management during the harvest period.

Sponsors find MFLOC useful for a variety of reasons. MFLOCs can be used to smooth cash flow between the typically quarterly or semiannual payments of Management Fees. In addition, MFLOC may be employed to finance a strategic transaction, dividend recapitalization, or to buy out a retiring principal.

III. Management Fee Lines of Credit in a Time of Uncertainty

While Sponsors have traditionally found MFLOCs attractive because of their cash management benefits, recently Sponsors have expressed interest in MFLOCs as a similar means to ensure normalized cash flow during this period of uncertainty when the impact of COVID-19-related market turmoil on valuations and Fund performance (and thus potentially Management Fee payment streams) is not fully known. To the extent Management Fee income streams may be temporarily reduced as a result of a decline in the value of the Fund's assets due to COVID-19, MFLOCs can provide the liquidity needed in order to maintain normal operations, pay employees, and "keep the lights on." It is worth noting that during the recent economic downturn, we have not yet seen an uptick in borrowers seeking waivers on financial covenants set forth in their MFLOC, or requests to reduce the thresholds set forth therein. We have, however, occasionally seen Sponsors agree to reduce or delay the payment of Management Fees during times of poor portfolio performance. To the extent the Lender under a MFLOC is relying on Management Fee income as a source of repayment, the Lender should consider including a prohibition on the ability of the Sponsor to waive, reduce, or defer the payment of Management Fees. Likewise, the Lender may want to diligence the extent to which any subordination provisions set forth in other debt instruments of the relevant Fund entities may have the effect of reducing or prohibiting the payment of Management Fees.

As we saw during the great recession, investors continue to be interested in seeing Sponsors make meaningful investments in the Funds they manage to have "skin in the game" and further align the Sponsor's and Investors' interests in maximizing Fund performance. The total amount Sponsors are committing to contribute to the Funds they manage is increasing not only because the percentage that a Sponsor's capital commitment represents of all capital commitments to a Fund has been increasing in absolute terms, but also because as overall Fund size has increased, so too has the total dollar amount a Sponsor is required to commit. By leveraging the income stream from future expected Management Fees, a MFLOC may help enable a Sponsor or its Special Limited Partner to make a larger commitment to a Fund than it otherwise may be able to commit. Similar to the partner loan programs discussed below, to the extent a Sponsor or its Special Limited Partner is an investor in a Fund, a MFLOC may be drawn on short notice to permit the Sponsor or Special Limited Partner to honor a capital call prior to receipt of cash from the principals or employees that ultimately constitute the Sponsor or Special Limited Partner.

MFLOCs remain attractive to Lenders during the pandemic, not only as a means to earn revenue from the fees and interest income generated by the facility, but as an opportunity to broaden the Lender's relationship with the Sponsor and develop a deeper understanding of the Sponsor's business and its potential liquidity needs. MCLOCs in turn may lead to additional business opportunities for the Lender to provide other fund finance products such as subscription credit facilities, net asset value facilities, portfolio-company level financings, partner loan programs, or private wealth products to the Sponsor's principals. We see a broad array of Lenders in the fund finance market willing to offer MFLOCs, especially to established Sponsors with a proven track record of successfully managing multiple Funds over time.

IV. Overview of Partner Co-Investment Loan Programs

A partner loan program (a "PLP")[3], also sometimes referred to as a partner or employee co-investment facility, is often structured as a line of credit extended by a Lender, the proceeds of which are used to make direct or indirect investments in Funds managed by a particular Sponsor. Many PLPs are structured as loans to an individual member, principal, or employee (collectively, a "Participant") of a General Partner, Management Company, or Sponsor. Such PLPs are frequently established on a platform basis, permitting multiple Participants to partake in the facility under consistent documentation. A PLP may alternatively be structured as a line of credit extended by a Lender directly to a General Partner, a Sponsor-affiliated Special Limited Partner, or a Management Company (collectively, a "Sponsor Vehicle") for the ultimate benefit of such Sponsor Vehicle's partners or employees. In loan structures where a Sponsor Vehicle is the borrower, individual principals of the Sponsor Vehicle will often guarantee the Sponsor Vehicle's obligations, and, in some cases, the Sponsor Vehicle may make a back-to-back loan to the principals. A PLP may also feature a corporate-level guaranty from the Sponsor Vehicle or a buy-back agreement pursuant to which the Sponsor Vehicle agrees to purchase a defaulting Participant's equity interest a Fund, the proceeds of which shall be paid by the Sponsor Vehicle to the Lender to satisfy the obligations of such defaulting Participant.

For PLPs offered to individual Participant borrowers, the loan proceeds are typically funded directly by the Lender into a segregated deposit account held by the applicable Sponsor Vehicle or Fund, and not to the Participants. This avoids the need for the individual Participant borrowers to transfer loan proceeds from their own account to the Fund or Sponsor Vehicle, and permits the Fund or applicable Sponsor Vehicle to quickly deploy capital and avoid having to monitor separate wires. Regardless of the structure of the facility, PLPs can provide certainty that the Participants or the Sponsor Vehicle (on behalf of its principals or employees) will timely meet capital contribution requests by drawing on the line of credit.

When security is taken, the collateral package for a PLP typically includes a pledge by the Participant of its limited partnership interest in the Fund or the relevant Sponsor Vehicle, including the right to receive distributions from the underlying Fund or Sponsor Vehicle, as applicable. In the case of a

Sponsor Vehicle borrower, the collateral may instead include a pledge of any limited partnership interest the Sponsor Vehicle holds in the Fund, the Sponsor Vehicle's right to receive distributions from the Fund, any Management Fees or other fees payable to such Sponsor Vehicle, and potentially any right to receive carried interest payments, as applicable. The security package also usually includes a pledge over the account into which Fund distributions and other relevant payments are made, and some instances, is secured only by such account. If a PLP is unsecured, the facility documentation will frequently include a negative pledge over each Participant's or Sponsor Vehicle's partnership interest in the Fund to give the Lender comfort that other creditors will not have a competing secured priority interest over the economic benefits associates with such partnership interest.

V. Partner Loan Programs in a Time of Uncertainty

To the extent that recent market volatility has stressed a Participant's ability to readily honor a capital call issued by a General Partner, or has created perceived uncertainty as to whether such a capital call will in fact be honored (whether such uncertainly is a result of an actual decline in the creditworthiness of certain Participants[4] or a result of current market conditions generally), a PLP may provide helpful liquidity. PLPs offer Participants the means to fund capital contributions while reducing or eliminating the need and time to gather the personal funds needed in order to honor a capital call, or a portion thereof to the extent the PLP requires the Participants to fund a percentage of each capital call with cash on hand. Likewise, to the extent that recent market dislocations have delayed or reduced Fund distributions to a Participant or impacted other sources of personal capital, a PLP offers a line of credit that may assist such a Participant in meeting its funding obligations. From the Fund or Sponsor Vehicle perspective, a PLP may provide additional comfort that Participants will be able to honor capital calls, thus providing greater certainty that liquidity will be available to quickly pursue investment opportunities. A PLP may also provide the Sponsor with comfort that it can satisfy its own commitment obligations, which often include investments by Participants and Sponsor Vehicles.

As noted above, Fund investors continue to push Sponsors to make larger investments in the Funds they manage.[5] In order to finance the Sponsor's commitment to the Fund, the Sponsor may incur indebtedness or, alternatively, engage in a "GP-stakes" transaction whereby, a third-party financial partner acquires a minority interest in the Sponsor (thus taking some of the risk of Sponsor performance as well as a piece of the carry away from the Sponsor). As between these two financing options, all things being equal, an investor may view a loan that must be repaid as providing better alignment of interest between the Sponsor and the investors than financing the commitment through a GP-stakes arrangement. Likewise, a Sponsor may prefer to leverage its own investment rather than dilute its ownership percentage pursuant to a GP-stakes transaction.

Ultimately, PLPs remain popular with Sponsors as a means to finance the total amount of capital committed to such Funds in a turbulent economic environment, while providing certainly of funding by Participants and administrative benefits. PLPs offer Lenders some of the same benefits of MFLOCs described above, including allowing a Lender to strengthen its relationship with a Sponsor and its principals and to better understand such Sponsor's business, which may in turn lead to future opportunities to provide additional financing services.

VI. Conclusion

Notwithstanding the economic challenges presented by COVID-19, MFLOCs and PLPs, properly structured, can provide liquidity solutions for General Partners, Management Companies, Sponsors, and Participants and allow Lenders and their customers the opportunity to maintain and expand productive relationships. These products may also provide liquidity for Sponsors and Participants to engage in opportunistic transactions to better weather recent market disruptions, including by providing capital that may be deployed into new investment strategies. Experienced legal counsel can help guide this analysis and suggest how best to navigate the landscape created by COVID-19 to both address short-term challenges and capitalize on long-term opportunities.

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If you wish to receive regular updates on the range of the complex issues confronting businesses in the face of the novel coronavirus, please subscribe to our COVID-19 "Special Interest" mailing list.

And for any legal questions related to this pandemic, please contact the authors of this Legal Update or Mayer Brown's COVID-19 Core Response Team at FW-SIG-COVID-19-Core-Response-Team@mayerbrown.com.

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[1] For a detailed update on current trends and developments in the fund finance market as a result of COVID-19, please see Mayer Brown's *Fund Finance Market Update: Fund Finance in the Era of COVID-19*, available at www.mayerbrown.com.

[2] For a detailed discussion of MFLOCs, please see Mayer Brown's *Fund Finance Market Update: Management Fee Credit Facilities*, available at www.mayerbrown.com.

[3] For a detailed discussion of PLPs, please see Mayer Brown's *Fund Finance Market Update: Partner and Employee Co-Investment Loan Programs for Private Investment Funds*, available at www.mayerbrown.com.

[4] It has been reported that a number of high-profile funds may be facing potential GP clawback obligations, *see e.g., What it means when a fund 'falls out of carry'* by Carmela Mendoza, Private Equity News & Analysis, May 12, 2020, News Alert. The potential for such GP clawback liability is a factor Lenders may want to consider when reviewing the overall credit complexion of the obligors under a PLP.

[5] *See, e.g., Private equity GPs putting more skin in the game with rising personal commitments, says Investec report*, https://www.privateequitywire.co.uk/2018/03/02/261775/private-equity-gps-putting-more-skin-game-rising-personal-commitments-says.