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Who's in Control?

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We are all accustomed to seeing change of control as a mandatory prepayment event, if not an event of default, under subscription line facilities. Even the strongest sponsors accept that a lender's analysis of a transaction is based on the current management of the fund, such that any change in control should trigger at least the right to prepayment and cancellation. While there are often points for negotiation, this premise is almost universal. It is arguably of even more importance in a fund financing, as compared with a corporate loan, given the reliance that lenders place on the GP's relationship with LPs.

The question, in light of recent market developments, is, does that mandatory prepayment event get lenders to where they need to be?

The first point to consider here is whether the "change of control" trigger should include not only a change in the ownership (direct or indirect) of the GP or manager, but also any of their direct or indirect holding companies becoming insolvent. A liquidator or trustee-in-bankruptcy being appointed in respect of any such entity could clearly have a significant impact on the actual control of the GP/manager (and thereby the fund), and including this as a trigger would provide the added benefit of giving the lender better visibility over what is going on higher up in the sponsor group. Given the potential impact of such an event on the operation and continued financing of the fund, lenders should also consider making it an EoD if the GP/manager (or any affiliate) fails to fund a capital call or there is a material adverse effect on its ability to do so.

As a second and related point, where an entity on which an investor is reliant (directly or indirectly) in order to fund a capital call is insolvent, should that investor be included in the borrowing base? We are increasingly seeing that question answered in the negative, but as with all the points raised in this article, there is no "one-size-fits-all" approach to these questions.

Finally, recent events have also highlighted the need to cast the net farther than the borrowing fund and look at what is happening in other funds managed by the same manager (or its affiliates). For example, lenders should think about the extent to which concerns around corporate governance that lead to significant unrest among LPs in related funds should be taken into account and give lenders the ability to protect themselves. Some options to consider include excluding from the borrowing base:

- defaulting LPs in related funds, even if there is no current default vis-à-vis the borrowing fund;
- LPs who refuse to fund a capital call to the borrowing fund or a related fund;
- LPs who express material concerns about the management of the borrowing fund or a related fund’s business and/or operations; and/or
- LPs who ask to inspect the borrowing fund’s books on the grounds that it suspects material inaccuracies or misrepresentations.

Clearly there is a balance to be struck and, while this article by no means sets out the full menu of options (some of which will be more contentious with sponsors than others), time will tell how these issues play out in the new world of fund finance.