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FUND FINANCE FRIDAY

Change of Control – Back to Basics

December 8, 2023

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This year has seen a significant amount of consolidation of sponsors in the private equity market, and this is a trend that is predicted to continue throughout 2024 and beyond.

While nearly all fund finance transactions have change-of -control triggers, such mergers and takeovers between sponsors can present a number of issues in established financings which, at their extreme, may ultimately result in such financing transactions coming to an end.

In this article, we seek to explore some considerations around the impact that private equity manager consolidation may have on fund financings (although it is worth keeping in mind that public listings of an asset manager may also trigger a change of control.)

Why Change-of-Control Provisions are Needed

When establishing a fund financing arrangement with a sponsor (whether subscription line facility, a NAV financing or another type of fund financing), lenders naturally have a clear interest in the sponsor (the "Original Sponsor") managing the relevant borrower (the "Borrower") and its related GPs and managers regardless of the strength of the collateral package supporting the financing. Part of the reasoning for this is that the relevant lender(s) have existing relationships with the Original Sponsor, they have reviewed and analysed the performance of the Original Sponsor and the lenders have taken comfort that the Original Sponsor has 'skin in the game' (by way of ultimate ownership and entitlement to profits.)

Even if limited partners of the Borrower are fully supportive of a change to the Original Sponsor, a change in sponsor (whether directly or indirectly) (such new sponsor being the "New Sponsor") can affect how lenders view the financing going forward and may result in other unintended consequences (such as a lender being over-exposed to a particular sponsor (such as the New Sponsor) or being exposed to sponsors who may not align with the lender's strategy and which was not foreseen at the outset of the financing.)

For this reason, credit agreements regularly include mechanics focusing on a change of control (and this is also LMA standard) and the effect of such provisions are to provide the lender(s) with a right to take action if the Borrower ultimately comes under new ownership (whether directly or indirectly). As such, typically the intention of such provisions is to capture instances where the majority of the ultimate ownership of the Original Sponsor changes as opposed to restructurings whereby the majority of the ultimate ownership of the Original Sponsor remains the same and there is a sell-down of minor interests in the Original Sponsor, or where the existing interest holders in the Original Sponsor seek to transfer interests amongst themselves.

What is a Change of Control?

The two main components of change-of-control provision are:

1. what constitutes ‘change’; and
2. what constitutes ‘control’.

The concept of ‘control’ in fund financing transactions typically follows the standard LMA formulation (including casting or controlling the casting of a specified percentage of the maximum number of votes that may be cast at a general meeting, appointing or removing all or the majority of the directors of a General Partner or Manager or other managing entity relevant to the Borrower (each a “Managing Entity”) and holding beneficially the majority of the issued share capital (or equivalent) of a Managing Entity). However, the language may be adapted to fit the circumstances of the transaction (including any changes arising out of due diligence). The percentage threshold will nearly always be set at a controlling stake (so more than 50%) and may well be set at 100%.

The concept of ‘change’ varies from financing agreement to financing agreement:

1. quite commonly, a ‘change’ is described as when “any person or group of persons acting in concert gains control (directly or indirectly) of a Managing Entity”; but
2. some deals refer to a ‘change’ as being when “[holding entity of a Managing Entity] (being the “Holding Entity”) ceases to control (directly or indirectly) a Managing Entity”.

Whether or not the change-of-control mechanic applies due to a merger or takeover will depend upon both the ‘control’ limb and ‘change’ limb of the provision being applicable to the circumstances.

It is quite clear that any merger or takeover of an asset manager is likely to trigger a change-of-control event under the first formulation of ‘change’ summarised above (given that the ultimate majority ownership of the relevant Managing Entity will be different to that existing when the relevant financing was put in place). However, this may not be the case under the second formulation of ‘control’ outlined above, as the Holding Entity (being the immediate shareholder of the Managing Entity) may well remain the same after a purchase or merger, as it is the party sitting above that Holding Entity changing rather than the Holding Entity itself.

Rarely, the facility agreement may provide that the change of control is linked to how a change of control is defined under the relevant limited partnership agreement. If this formulation is used, care should be taken to ensure that the mechanics within the partnership agreement align with any concerns a lender may have if the ultimate ownership of the Original Sponsor

were to change during the life of the financing – this includes any restrictions within the financing agreement in respect of amending provisions of the partnership agreement.

Consequences of a Change of Control Under Facility Documentation

Many facility agreements contain an information undertaking requiring the Borrower (or another party related to the Borrower) to notify the lender(s) in advance if steps are taken towards a change of control. This advance warning aids both the lender(s) and sponsors to enter into discussions around the future change of control and consider the implications under the financing arrangements as well as possible solutions.

Regardless of whether or not the information undertaking is included, facility agreements (especially in the European market) will normally contain a change-of-control mandatory prepayment event (although in some deals change of control will trigger an event of default rather than a mandatory prepayment – where drafted as an event of default, the parties should be aware that this has the potential to then trigger a cross-default which could then impact other financings relevant to the Borrower or entities related to the Borrower).

Again, this mandatory prepayment event is largely drafted using the LMA formulation requiring the Borrower (or another entity on behalf of the Borrower) to notify the lender(s) of the occurrence of the change of control, and then either the commitments will automatically cancel or, increasingly, each lender will be given an individual option to decide whether to elect that its commitments be cancelled with repayment of all amounts owing to the cancelling lenders within a specified time. Such election provisions will generally contain a time period in which the election must be made, measured from notification of the change of control, to avoid a position where lenders have an evergreen exit right following the change in ownership.

As a mandatory prepayment, if amounts are not repaid within such applicable timeframe then this would ordinarily trigger a non-payment event of default potentially allowing the lender(s) to enforce the supporting collateral package.

Further Considerations

As part of the preparation of a change of control (or even as part of the change of control itself), one or more Managing Entities that are party to the existing financing may be replaced. Finance documents commonly include mechanics to replace a Managing Entity, subject to the fulfilment of certain conditions, including the provision of replacement security documents or side letters – the replacement process itself can be time consuming (especially if new jurisdictions are involved) and the effectiveness of the replacement of a Managing Entity under the finance documents should be aligned with the timing of the replacement of the Managing Entity generally to preserve the continuity of the collateral package and avoid breaches under the financing arrangements.

Given the impact on a financing that can result from a change of control, early conversations around a potential change of control event between the Borrower and the lender(s) are important. This can help both parties to consider and discuss the impact on the existing financing and the appetite for the lender(s) to continue to provide the financing following the change of control. Further, on syndicated deals, if one or more (but not all) lenders are unwilling to continue to provide the financing then an early conversation could provide the facility

bookrunner and/or the Borrower time to seek alternative lender(s) willing to provide financing. Similarly, if the sole or all lenders are not willing to provide financing following the forthcoming change of control then the Borrower would have more time to seek replacement financing.