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Key person terms among credit managers

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Many private closed-end credit funds have "key person" provisions designed to assure investors whose capital commitments are locked up for significant periods of time that the crucial investment team members will continue to manage fund assets throughout the investment period of the fund.

These provisions can take a variety of approaches and are often heavily negotiated by investors. This article analyzes an in-depth Ropes & Gray survey of 100 credit managers to determine trends in such "key person" terms in credit funds.

KEY PERSONS

While including a "key person" provision may depend on facts specific to each fund strategy and manager, the vast majority (95%) of the funds surveyed included a "key person" term, indicating that most investors expect to see some level of key person protection in closed-end credit funds.

While 8% of the "key person" terms applied throughout the term of the fund, offering protection during the wind-down of the portfolio, 92% of the "key person" terms applied only during the investment period.

KEY PERSON TRIGGER

Questions regarding the time and devotion standard, to which fund the key person standard applies, or if the standard applies more broadly to a strategy or to the manager's activities arise when managers apply a key person standard in credit funds.

For credit fund managers, structures with multiple funds or accounts with overlapping strategies are common. As a result, a devotion of time standard tying all or a substantial majority of a key person's time to a single fund is unusual.

For example, our survey found that a majority of the funds with key persons (55%) had time and devotion standards tied to the manager and its business as a whole, and not to an individual fund.

SINGLE PERSON KEY PERSON

An important issue for many managers whose strategies are closely tied to one portfolio manager is the business concerns caused by the potential departure or illness of a single individual triggering a "key person" event — namely, a breach of a time or devotion requirement that gives investors certain protective rights, which could include limiting the fund's ability to make new investments, requiring wind-up or giving investors other protective rights.

Triggering a key person event is particularly concerning to larger managers who view their products as more institutional and less tied to specific business team members if such an event would cause the departure of a single employee to adversely affect the manager's ability to continue to manage a fund.

> 95% of the funds surveyed included a "key person" term, indicating that most investors expect to see some level of key person protection.

In addition to wanting to reserve flexibility in staffing, managers are also hesitant to give individual team members the negotiating power they would have if a fund were subject to a single key person.

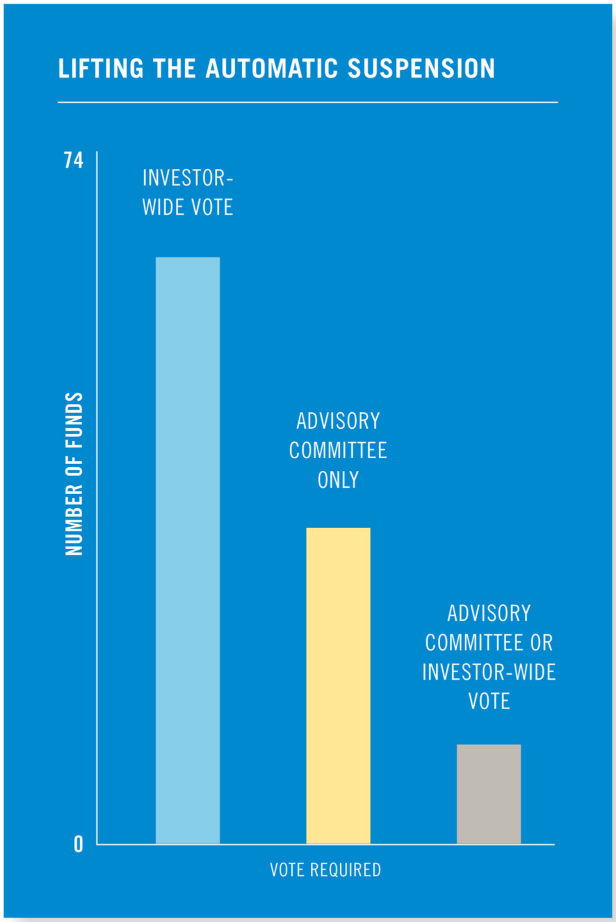
Perhaps not surprisingly, only 14% of the funds had a key person provision that was exclusively tied to a single founder or principal (i.e., a "1 out of 1" person trigger), while 28% of the funds had a key person provision tied to any one individual out of a particular group (i.e., a "1 out of 2" person trigger).

In our experience, this also varies within managers, depending on the particular strategy and investment team dynamic.

LIFTING A KEY PERSON TRIGGER

Once triggered, the key person provisions most commonly resulted in automatic suspension of the investment period (74% of the surveyed funds).

While many investors prefer automatic suspension, as it can be difficult to coalesce around an investor vote, managers often prefer the opposite — that investors need to act — particularly if they believe they can continue to manage the strategy successfully.



SPECIAL CONSEQUENCES WERE UNUSUAL

During a suspension period due to a key person event, a majority of credit managers were permitted to draw down to the same extent as would otherwise be permitted under the fund's governing documents after the expiration of the investment period for certain follow-on and protective investments (63%).

This reflects the view that, regardless of whether a key person event has been triggered, managers and investors are aligned in wanting the continued ability to protect the portfolio.

However, in a few funds, additional restrictions were imposed on activities during a suspension period to provide investors with stronger protections in decision-making if key persons are no longer making decisions for the portfolio.

For example, 13 funds prohibited follow-on investments following a key person event, while 2 funds required advisory committee approval of any follow-on investments during the suspension period.

It is not surprising that such restrictions were less common, where they tie a manager's hands in continuing to run

the fund and could have a negative impact on the fund, particularly in credit where it may be necessary to make investment decisions on a shorter time frame from other strategies.

The occurrence of a key person event triggering other special consequences was more unusual, but included (i) the right to terminate the fund (8 funds), (ii) the right to re move the fund general partner/manager (2 funds), and (iii) a reduction in management fees (4 funds).

Other unusual consequences following a key person event included (i) a reduction in the incentive allocation (1 fund); (ii) termination of the general partner's right to consent, on behalf of the fund, to an Investment Advisers Act "assignment" under the investment management agreement (1 fund); (iii) lowering the voting threshold to terminate the fund from a supermajority to a majority of investors (1 fund); and (iv) suspension of the general partner's ability to launch a fund with a substantially similar strategy for six months (1 fund).

CONCLUSION

While key person provisions and their negotiation can be bespoke to a particular strategy, adviser, investment team and investor dynamic, our survey did find certain trends. Notably, key person terms in closed-end private credit funds as well as automatic investment period suspensions were prevalent.

In addition, we found that the key person provision commonly applies only during the investment period and that most credit funds maintained some ability to make protective and follow-on investments even after a key person event.

We also found that devotion of time standards limiting portfolio managers' abilities to manage more than one fund were very unusual, and a majority of key person standards were tied to employment with the manager, not management of the fund.

We also found that consequences such as reduction in fees or carry, removal of the manager, or termination of the fund, were unusual in the marketplace.

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