SEWARD & KISSEL LLP

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CLO/CDO Practice Group:

Double-Dipping Issues Relating to CLO and CDO Management Fees

In collateralized loan and collateralized debt obligation ("CDO") transactions, it is common for an investment manager (the "Manager") to act as collateral manager for the CDO, and for one or more private investment or hedge funds (the "Hedge Funds") managed by the Manager or one or more of its affiliates (the "Manager Affiliate" and together with the Manager, the "Manager Entities") to acquire the most subordinated class of notes issued by the CDO (the "CDO Equity"). In its capacity as manager of the CDO, the Manager will typically receive a senior collateral management fee (the "CDO Senior Fee") and a subordinated collateral management fee (the "CDO Subordinated Fee"), both of which are based upon the aggregate "principal balance" of the assets in the CDO portfolio. Frequently, the Manager will also receive an incentive management fee (the "CDO Incentive Fee" and collectively with the CDO Senior Fee and the CDO Subordinated Fee, the "CDO Fees") based upon the post-closing performance of the CDO vehicle. The CDO Incentive Fee is customarily payable from the proceeds of the CDO collateral after the holders of the CDO Equity have received a specified internal rate of return on their investment. The CDO Incentive Fee is usually expressed as a percentage of the proceeds of the CDO collateral available to pay principal and interest on the CDO Equity after the more senior classes of notes and certain other transaction parties have been paid in accordance the CDO's "priority of payments". In its capacity as manager of the Hedge Funds, the Manager or a Manager Affiliate will typically be entitled to both a base fee (the "Hedge Fund Base Fee") based upon a percentage of the related Hedge Fund's net asset value and an incentive fee (the "Hedge Fund Incentive Fee" and together with the Hedge Fund Base Fee, the "Hedge Fund Fees") based upon a percentage of the related Hedge Fund's annual net profits. The practice whereby a Manager collects CDO Fees while at the same time collecting Hedge Fund Fees (either for its own account or for the account of a Manager Affiliate) is often referred to as "double-dipping".

If Manager Entities wish to receive and retain both the CDO Fees and the Hedge Fund Fees, it is important that the offering materials utilized in connection with the offering of the CDO Equity and the other more senior classes of notes issued by the CDO (together with the CDO Equity, the "CDO Notes"), as well as the offering materials with respect to the related Hedge Fund shares, adequately disclose that double-dipping will occur. However, many

Managers have determined that double-dipping is inappropriate from a business perspective, and may also raise conflicts with their fiduciary duties to Hedge Fund investors.

Managers have taken a number of approaches to avoid or mitigate double-dipping. The following is a brief overview of certain of these approaches.

1. Waiver of CDO Fees Based upon the Percentage of CDO Equity Acquired. A number of Managers have elected to waive all CDO Fees in situations where one or more of the Hedge Funds managed by a Manager Entity have purchased 100% of the CDO Equity for the purpose of leveraging certain Hedge Fund assets. This leveraging was achieved by transferring eligible assets from the Hedge Funds to the CDO, and using the proceeds of the transfers to purchase all of the CDO Equity. As a result, the related Hedge Funds were entitled to the residual return on the entire CDO portfolio, a fact that likely influenced the Manager's decision to waive the CDO Fees in this context. It should be noted, however, that in these situations, the CDO Equity represented only a small portion of both the total CDO Notes issued and the total assets in the CDO portfolio. This could therefore be viewed as a rather conservative approach to avoid double-dipping.

In situations where the related Hedge Funds have purchased less than 100% of the CDO Equity, some Managers have chosen to waive the portion of the CDO Senior Fee and the CDO Subordinated Fee representing the percentage of the total aggregate principal amount of CDO Equity purchased by the related Hedge Funds. In this context, Managers have generally elected to retain their CDO Incentive Fees. This strategy is also somewhat conservative, particularly in situations where the CDO was not established to leverage the related Hedge Funds, or where the sale of the CDO Equity to such Hedge Funds was nonessential to the closing of the CDO transaction. In these cases, the rationale set forth above supporting the waiver of the CDO Fees where the related Hedge Funds own 100% of the CDO Equity is absent.

2. Waiver of Hedge Fund Fees Based on Market Value of CDO Notes Acquired. Other Managers have elected to waive the portion of the Hedge Fund Base Fees that are attributable to the market value of the CDO Notes owned by the related Hedge Funds by subtracting the aggregate market value of the CDO Notes (as determined by the Manager in accordance with the organizational documents of the related Hedge Fund) from the computation of net asset value for purposes of determining the amount of the Hedge Fund Base Fee. The Hedge Fund Incentive Fee has generally not been reduced in this context.

Unlike alternative 1 above, this approach reduces the Manager's fees by isolating the market value of the assets that could potentially be subjected to double-dipping. This strategy is also consistent with the manner in which Hedge Funds generally deal with the allocation of assets to other money managers (*i.e.*, no additional management fees are charged, but incentive fees are generally charged at both the other money manager and Hedge Fund levels). There should, of course, be adequate disclosure of this arrangement in the Hedge Fund offering documents.

3. Waiver of CDO Senior Fees Based upon the Percentage of Total CDO Notes Acquired. In certain other cases, Managers have waived CDO Senior Fees based upon the percentage of the aggregate principal balance of all CDO Notes purchased by the related Hedge Funds, a less precise approach than alternative 2 above. The Hedge Fund Incentive Fee has generally not been reduced in this context.

4. Waiver of Hedge Fund Fees Based only upon Proportion of CDO Subordinated Fees and CDO Incentive Fees. A number of Managers have taken the view that if the related Hedge Funds own less than fifty percent (50%) of the CDO Equity on the closing date of the CDO transaction, then the Manager is entitled to receive and retain all CDO Fees, without any corresponding reduction to the Hedge Fund Fees. The Manager's rationale for electing not to waive any portion of the Hedge Fund Fees in this context is based upon the view that the Manager has earned its CDO Fees by providing services in respect of all classes of CDO Notes, not just the CDO Equity.

On the other hand, if the related Hedge Funds own fifty percent (50%) or more of the CDO Equity on the closing date, Managers have generally chosen to waive the related Hedge Fund Fee in an amount equal to the product of (x) the amount of the CDO Subordinated Fees and CDO Incentive Fees received by the Manager, and (y) the percentage of the CDO Equity owned by the related Hedge Funds. In these cases, the Hedge Funds have generally acquired such a significant proportion of the CDO Equity due to a failure to locate other CDO Equity investors. Managers have therefore agreed to waive a portion of the Hedge Fund Fee based on the premise that the acquisition of the CDO Equity was essential for the closing of the CDO transaction, and thereby beneficial to the Manager. Generally, Managers have continued to waive the Hedge Fund Fees in the manner set forth above even if the related Hedge Funds' percentage ownership in the CDO Equity falls below fifty percent (50%) after the closing of the CDO transaction.

In conclusion, Managers have taken a variety of approaches in order to avoid or mitigate double-dipping. A particular Manager’s strategy should be predicated upon its fiduciary duties to investors as well as its reasonable business determination as to the degree to which double-dipping has inappropriately benefited the Manager. In addition, a Manager’s approach to double-dipping must be consistent with the disclosure set forth in the offering documents for both the Hedge Funds and the CDO.

If you have any questions or would like to further discuss any of these approaches, please do not hesitate to call either Greg Cioffi at (212) 574-1439, or John Tavss at (212) 574-1261.