

Facing up to reality



Howard Beber



Scott Jones



Ira Bogner

Now is the time to consider limited partner defaults and liquidity issues, according to Howard Beber, Scott Jones and Ira Bogner of Proskauer Rose

Given the current economic climate, many fund managers are closely examining the creditworthiness of their limited partners and considering the possibility of limited partner defaults on capital commitments. Those fund managers that have not considered these issues would be wise to do so.

Much has been made in the press recently of potential defaults by limited partners because of the severe worldwide financial conditions and corresponding liquidity constraints. Indeed, according to public reports, certain limited partners have “encouraged” fund managers to reduce capital calls in the near term. In addition, some managers have responded to limited partner pressure by either decreasing fund sizes or restructuring funds to allow certain limited partners to reduce commitments (and others to increase their commitments).

Furthermore, activity in the secondary market for limited partner interests is at unprecedented levels, albeit at significantly depressed valuations. What we have not yet seen is a publicised default by a high-profile limited partner, but you can be sure that this situation is being discussed often and quietly. What should a fund manager do?

This article summarises relevant issues for fund managers with limited partners who are, or may be, facing liquidity problems. It first focuses on liquidity issues for a fund if a limited partner defaults and then addresses default remedies available to fund managers. Defaults (or potential defaults) raise many complex legal and factual issues to consider, only some of which are addressed here. In addition, certain legal issues may be viewed differently depending on both the jurisdiction of the fund and the relevant limited partner. The focus of this article is on funds organised in Delaware, although many of the general principles would apply to funds organised in other jurisdictions. Fund managers are encouraged to seek assistance from experienced counsel to help navigate through the challenging legal issues inherent in any default situation.

Addressing fund liquidity concerns

If a limited partner defaults, the most immediate issue a fund faces is the reduced amount of capital available to make investments and otherwise manage the fund. Depending on the circumstances, a fund's liquidity constraints may be limited to the short term, such as covering a missed capital call to fund a pending investment. If, however, a defaulting limited partner has a relatively large uncalled capital commitment, the liquidity issues could be much more severe, with significant long-term effects on both the fund and the non-defaulting partners. The following are several options that may be available to fund managers to address liquidity concerns.

Call additional capital from non-defaulting limited partners:

If a limited partner defaults or indicates it is not going to meet a capital call, most fund agreements permit the fund manager to call additional capital from non-defaulting limited partners (up to their remaining uncalled commitments). This can provide a temporary solution, but these "make-up" contributions are sometimes limited and do not address longer-term liquidity issues if the defaulting limited partner's capital commitment is relatively large.

Re-invest proceeds: Many fund agreements permit fund managers to re-invest proceeds otherwise distributable to limited partners, usually within certain limitations set forth in the fund's partnership agreement. Alternatively, some fund agreements permit a fund manager to distribute proceeds that are subject to recall for reinvestments. This approach, however, may be a solution only for those funds fortunate enough to have distributable proceeds.

Borrow funds: Many funds have existing lines of credit available for short-term borrowing that can be utilised to cover temporary liquidity issues. In addition, fund managers have begun to consider longer-term credit facilities as a way to mitigate liquidity issues and certain banks have shown willingness to loan funds in this context under the right circumstances. Such banks, however, often require guarantees from fund managers. Of course, if the fund has tax-exempt investors, the fund manager may be obligated to avoid realising "unrelated business taxable income" (UBTI), which may result from borrowing, particularly longer-term indebtedness.

Defer or waive a portion of the management fee: One way to make more cash available for investments is to reduce the amount of cash used to pay fund expenses. Accordingly, fund managers might consider deferring or waiving some or all of the management fee, particularly if the management fees from other funds are sufficient to support management company operations. There are potential tax and accounting implications associated with this alternative – including taxable constructive receipt of waived fees and additional income tax on deferred fees – so a fund that is considering waiving or deferring the management fee should consult its tax advisers and accountants.

Re-open fund or create annex funds: Many fund managers are contemplating re-opening their funds in an attempt to raise additional capital or forming annex funds to co-invest with their existing funds. This strategy involves complex issues regarding conflicts of interest and deal sharing that should be considered. Recently, certain annex fund investors have been requiring premium economic terms in exchange for their additional capital, and this trend is likely to continue.

Restructure fund: In response to pressure from limited partners, certain fund managers have sought amendments to fund agreements to permit all limited partners to either reduce or increase their subscriptions to the fund. Typically, reducing limited partners face a penalty or economic "haircut" with a corresponding benefit for those limited partners increasing their commitment. This can be an attractive approach for funds with limited partners willing to increase their support in exchange for additional upside. It should be noted that fund managers rarely have the right to unilaterally reduce a limited partner's commitment to a fund on a one-off basis without offering the same opportunity to all limited partners.

Cross-over investing: Another alternative is for a fund manager with multiple funds to use one or more funds with available capital to make follow-on investments in portfolio companies of funds with liquidity issues. The limited partnership agreement for both funds must be reviewed to determine whether "cross-over investing" requires the approval of either fund's advisory committee or limited partners. Many fund managers avoid cross-over investing because of the inherent conflicts that can exist when two funds with common managers but different investors invest in the same company,

particularly when one of the funds has capital to continue to support the company through additional rounds of financing and the other does not. When cross-over investing is allowed, there may be a requirement for the participation of a new, independent investor to validate both the pricing and the merits of the investment.

Defer capital calls: Many fund managers are considering deferring capital calls to the extent practicable. This is not, however, a particularly attractive approach and raises fiduciary duty concerns given that limited partners without liquidity concerns continue to expect fund managers to put capital to work in attractive investment opportunities.

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Default remedies

In addition to addressing the fund’s liquidity concerns in anticipation, or as a result of, a limited partner default, fund managers should review the potential legal remedies available against a defaulting limited partner. While such remedies may differ depending on the fund’s jurisdiction of organisation, and in some cases, like bankruptcy, on the particular circumstances surrounding the limited partner, courts generally will respect the remedies set forth in the fund’s operative legal documents.

For example, Delaware law provides broad discretion for partnership agreements to define remedies for defaulting partners, including remedies that may be unenforceable as “penalty” provisions in other areas of law. So-called penalty provisions are particularly severe and are intended to deter a party from breaching an agreement, as opposed to typical contract remedies intended to estimate the amount of loss expected to be suffered in the event of default (e.g., making the non-defaulting parties whole).

While not free from doubt, Cayman Islands law and English law, on the other hand, typically will not enforce penalty provisions. The distinction between a penalty and an enforceable remedy under such laws in the context of private investment funds is not clear and has generally not been tested in courts. Nonetheless, most partnership agreements governed by Cayman Islands or English law contain default provisions similar to those typically included in partnership agreements governed by Delaware law.

Fund managers should carefully review their fund’s limited partnership agreement (or other governing documents) and discuss the default provisions with counsel and other advisors. In the absence of specific default remedies, in the event of a default, a fund manager’s sole options are to commence litigation against the defaulting limited partner or provide assistance in finding a suitable purchaser for the defaulting partner’s interest. Thankfully, most fund agreements provide significant provisions regarding limited partner defaults. These provisions, however, have historically not been heavily negotiated and because of the lack of defaults in the industry, have not been implemented very often. Recognising that no single remedy will suit all fact patterns, partnership agreements typically provide

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fund managers with flexibility to apply one or more remedies in their discretion (or no remedy at all). Common options include the following:

- ◆ accepting a late contribution from the defaulting limited partner, usually with interest plus any expenses associated with the default, including attorney's fees;
- ◆ requiring the defaulting limited partner to sell its entire interest in the fund to other limited partners or third parties at a discount, such as the lesser of the fair market value or the pre-default capital account balance of the defaulting limited partner;
- ◆ diluting the defaulting limited partner's economic interest in the fund, including reducing the capital account balance (or a portion thereof) of the defaulting limited partner and apportioning such reduction among the non-defaulting partners;
- ◆ redeeming the defaulting limited partner's interest without payment or for nominal value paid with a non-recourse promissory note payable after the fund's liquidation; and
- ◆ suing for specific performance and consequential damages.

Regardless of the default remedy, most fund agreements permit the fund manager to withhold future distributions from the defaulting limited partner until liquidation of the fund and apply such withheld distributions to cover any remaining unfunded capital commitments. Furthermore, fund agreements should include a power of attorney granted to the fund manager to execute any legal agreements on behalf of a defaulting limited partner in connection with a default remedy.

Litigation is rarely an attractive option. It is costly, can generate unwanted publicity and give rise to creative counter-claims and defences. If a buyer cannot be found for a defaulting partner's interest, the other default remedies may not be particularly helpful for a fund with liquidity concerns. The most common default remedy involves an economic "haircut" on the defaulting partner's capital account balance and its entitlement to share in future distributions, and sometimes a reduction in the defaulting partner's capital commitment. In certain circumstances, this remedy can be attractive to both fund managers

and non-defaulting limited partners because it (i) is self executing with readily determinable results; (ii) involves little time or expense to implement; and (iii) can provide a benefit to the non-defaulting limited partners whose capital accounts are typically increased by the amount of the default charge. However, this remedy offers little deterrence if it is early in the fund's life and the defaulting partner has a small amount of contributed capital at risk, because in that situation it may be more palatable for the limited partner to walk away from the commitment.

Accordingly, in most default situations, a fund manager's best option is to assist the limited partner in finding a buyer for its interest. Sales to existing limited partners are typically more desirable than sales to third parties because current investors are familiar with the fund and fund manager and generally will be able to close a transaction more quickly than a third party.

Nevertheless, many fund managers have established relationships with secondary buyers that stand ready to purchase defaulting interests. Unfortunately, secondary sales have become increasingly difficult due to the tremendous volume of limited partner interests available on the secondary market and depressed valuations. In addition, certain tax and ERISA concerns described below should be considered as they may affect a fund manager's ability to approve a sale to a particular buyer. Investments in almost any fund of recent vintage, with a relatively large amount of uncalled capital, will be very difficult to sell on the secondary market; although a market has started to develop for so-called "young secondaries".

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Fiduciary duties

While the default provisions of a typical partnership agreement permit the fund manager to select which remedy to apply (if any), fund managers may have certain fiduciary duties that could be implicated in default situations, particularly if similarly situated limited partners are treated differently. While Delaware law permits parties to agree that the provisions of a partnership agreement modify or supersede fiduciary duties, such agreements do not eliminate the implied contractual covenant of good faith and fair dealing. Those duties may come into question if a fund manager is benefiting significantly from the application of a particular default remedy or if similarly situated limited partners are treated differently.

To be sure, circumstances may make it appropriate to treat limited partners differently. For example, treating a limited partner with a small capital commitment differently from an anchor limited partner may be justified based on a relative cost-benefit analysis. In addition, treating a limited partner that is experiencing temporary liquidity issues and is working in good faith to resolve them differently from a limited partner simply refusing to meet its obligations may be perfectly reasonable. Further, as discussed below, the treatment of bankrupt limited partners or those with particular regulatory concerns warrants special consideration. On the other hand, treating one limited partner more favorably than another because the fund manager stands to benefit from such treatment would probably not be viewed well by courts. Fund managers would be prudent to discuss these issues with experienced counsel.

What if the limited partner has filed for bankruptcy protection?

In the US, funds are created and governed mostly under state law (typically Delaware). In certain circumstances such as bankruptcy, however, partnerships and other business entities are subject to federal law, which pre-empts state law. A bankruptcy filing by a limited partner may present significant obstacles to the enforcement of the default remedies contained in a partnership agreement. When a limited partner files for relief under the US Bankruptcy

Code, the limited partner obtains the benefits of an “automatic stay.” This is a statutory injunction that broadly enjoins parties from taking actions and exercising remedies against the entity that filed for bankruptcy protection, or any of its property, wherever located. The stay goes into effect automatically upon the bankruptcy filing; no court action is necessary. Enforcing default remedies, and perhaps even the mere sending of notice of intent to enforce such remedies, might be prohibited by the automatic stay. Additionally, a court could order damages and other sanctions for violations of the automatic stay.

Therefore, before implementing remedies against a defaulting limited partner that has filed for bankruptcy protection, it is prudent for fund managers to consult with an insolvency practitioner which can help determine whether a particular remedy can be enforced, how to obtain relief from the automatic stay and how to preserve the fund’s rights in the bankruptcy proceeding.

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Other issues to consider

Defaults by limited partners have wide-ranging effects on the fund and the non-defaulting limited partners. Unless another party assumes the defaulting partner's interest and its remaining obligation to contribute capital to the fund, the fund will have less capital available than originally anticipated. This may have serious repercussions on the fund's ability to execute its intended portfolio construction strategy and to support existing portfolio companies. In addition, many default provisions effectively reduce or eliminate the remaining capital commitment of the defaulting partner, which correspondingly reduces the aggregate commitments to the fund. Such reductions could inadvertently cause the fund to exceed investment limitations and diversification requirements, many of which are based upon aggregate commitments.

Careful attention must be paid to the effect of a default on the management fee payable to the fund manager, which also is typically based on aggregate commitments. Some fund agreements are drafted in a manner that would reduce the management fees payable in the event of a defaulting limited partner, while others are not. In the latter case, the non-defaulting limited partners would bear a larger portion of the management fee than originally expected. For example, if the fund's management fee is 2 percent of aggregate capital commitments and one or more limited partners default, unless the fund agreement specifically provides that a default will reduce aggregate commitments, then the management fee would not be reduced. In such a case, since the management fee is a fund obligation, the non-defaulting limited partners will be required to bear the portion of the management fee previously borne by the defaulting limited partner. This is often a surprising result for non-defaulting limited partners, but is sometimes rationalised by fund managers as a *quid pro quo* for the benefit received by the non-defaulting limited partners if all or a portion of the defaulting limited partner's capital account is re-allocated among them.

Finally, a reduction in the available capital or size of the fund may inadvertently trigger regulatory concerns or ownership limitations relating to bank holding companies or ERISA and could impact

covenants or trigger notice requirements in credit facilities, insurance policies, side letter agreements (in particular, "most favored nation" provisions) or other legal documents.

ERISA considerations

Prior to exercising any rights with respect to a limited partner default, fund managers should consider potential issues that may arise under ERISA. Private equity funds typically rely on one of two exceptions for the fund to avoid holding "plan assets" of ERISA investors: (i) the "venture capital operating company" (VCOC) exception or (ii) the less than "25 percent benefit plan investor participation" exception (the "less than 25 percent test").

To satisfy the "less than 25 percent test", generally less than 25 percent of the value of each class of equity interest in the fund must be held by ERISA plans and other "benefit plan investors". On at least one day during a 90-day period that occurs annually, a fund relying on the VCOC exception must (among other requirements) have at least 50 percent of its assets valued at cost invested in "operating companies" in which the fund has contractual "management rights" (the "50 percent test"). If a fund is relying on the "less than 25 percent test", the fund manager should consider whether imposing a particular default remedy (capital commitment reduction, proposed transfer, redemption, etc.) could impact the fund's ability to utilise this exception. In

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evaluating default remedies that would include a reduction in the aggregate capital commitments to the fund, fund managers relying on the VCOC exception should keep in mind how any reduction in capital commitments could impact the fund's ability to satisfy the 50 percent test. Also, a fund that is required to rely on the VCOC exception prior to a redemption or transfer because of the level of ERISA investor participation may be permitted to rely on the "less than 25 percent test" exception after a default or transfer assuming the fund's governing documents permit reliance on either exception.

In addition, ERISA investors are subject to rules that prohibit such investors from engaging in certain transactions with certain parties. Fund managers should consult with ERISA experts to consider whether: (i) the exercise of default remedies in the event of a default by an ERISA investor or (ii) the transfer of an interest in the fund by an ERISA investor, could result in a non-exempt "prohibited transaction". Also, ERISA experts should be consulted to address unique issues that can arise in the context of a default associated with a pension plan termination.

Tax considerations

In addition to UBTI that may arise from fund borrowing and tax issues associated with fee waivers or deferrals, a fund that is treated as a partnership for US tax purposes must be careful that transfers of defaulting partner interests do not run a foul of the "publicly traded partnership" (PTP) tax rules. If a fund is classified as a PTP, it generally will be taxed in the US as a corporation rather than a "flow-through" vehicle. This tax treatment would probably have a very adverse tax effect on not only the fund's limited partners but also the fund manager. The tax rules, however, contain a number of "safe harbours" for certain types of transfers (or for a fund generally based upon its composition or income) that protect the fund from being taxed as a corporation.

In addition, transfers of defaulting partner interests may trigger mandatory tax basis adjustments for the fund, which can be quite onerous and expensive from a tax administration perspective. However, a number of funds (so-called "electing investment partnerships") may qualify for an exception to these mandatory adjustments. Nevertheless, in such a case, the transferor must

report any losses on the transfer to the fund, with a corresponding disallowance of losses to the transferee. Finally, certain transfers in excess of 50 percent of the interests in a fund can cause a technical tax termination of the partnership, potentially triggering additional tax return obligations, re-filing of tax elections and other unintended consequences.

Accordingly, fund managers should review potential transfers with their tax advisors in light of the PTP rules, mandatory basis adjustments, loss disallowances and technical tax terminations.

Conclusion

A limited partner default (or threatened default) can present a tremendous drain on a fund manager's time and attention and can create significant legal and business issues for a fund. Fund managers should have an action plan in place before a default occurs including the following:

- ◆ Review limited partner lists to identify any potential issues;
- ◆ Survey financially healthy limited partners and other potential purchasers on the secondary market;
- ◆ Review limited partnership agreements and side letters and understand available alternatives and ramifications of each course of action; and
- ◆ Discuss alternatives with experienced counsel. ■

Contacts:

Howard J. Beber
T: +1 617 526 9754
E: hbeber@proskauer.com

Scott S. Jones
T: +1 617 526 9772
E: sjones@proskauer.com

Ira G. Bogner
T: +1 212 969 3947
E: ibogner@proskauer.com