

International Insight: Private Funds / Alternative Investment Funds

COVID-19: The Fall Out - Defaulting Limited Partners - The Investor Perspective

A) Liquidity Crisis on the Horizon?

It may be too early to compare the COVID-19 crisis to the 2008 financial crisis that led to serial defaults of Limited Partners in private equity, debt, venture capital and infrastructure funds, but there are already early indicators that this pandemic may lead to a liquidity crisis for Limited Partners, for instance:

- capital calls being made early by General Partners to build cash reserves;
- capital calls occurring more frequently and in larger amounts in anticipation of Limited Partner defaults;
- portfolio companies requiring cash injections to manage their own liquidity issues;
- realisation events slowing as exit opportunities disappear and equity valuations become depressed; and
- distributions to Limited Partners that were intended to fund future capital calls drying up.

These factors contribute to Limited Partners facing the reality of having to fund multiple, and often larger, capital calls from various General Partners, thereby upending Limited Partners' traditional cash flow model and cash management strategies for private equity, debt, venture capital or infrastructure investing. As challenging as it may be for Limited Partners that have carefully constructed their fund portfolios, they may be confronted with the reality that they will be unable to meet all such capital calls. A decision may ultimately have to be made on which capital calls a Limited Partner is able to fund and on which capital calls it will have to default.

B) Which Funds to Fund?

Limited Partners will have many considerations when it comes to selecting an appropriate funding strategy. In our experience, some of the main investor considerations include (1) relationship, (2) legal, and (3) finance.

1. Relationship

Investors can generally be grouped into one of two categories: (1) those that have developed relationships with fund managers spanning a number of years (or even decades); and (2) those whose relationships are relatively new.

a) Fiduciary Relationship For All

While it may sound counterintuitive, from a capital funding perspective, it does not matter whether an investor is an established or new Limited Partner in a fund. Broadly speaking, General Partners are subject to a fiduciary duty to treat all investors the same. Any invitation or request for preferential treatment by a Limited Partner will have to be rejected by such General Partner unless such General Partner affords the same treatment to the other Limited Partners in the fund (or such Limited Partner has such rights granted to them in a side letter). As a result, any request by a Limited Partner for additional time to meet a capital call, or maybe even to be excused with respect to a drawdown, will need to be considered by the General Partner in light of its fiduciary duties to the fund as a whole.

b) New Investors

New investors in a private equity, debt, venture capital or infrastructure fund, that have only recently (i.e., less than 10 years ago) decided to invest in these asset classes with the objective of pursuing higher returns on their investment, may be facing pressure to meet multiple and larger capital calls for the first time, both in respect of such fund and across its portfolio of fund investments. As a result, these investors are more likely not to have planned, and prepared, for a potential default and therefore the popularity of and demand for these particular asset classes may have inadvertently exacerbated the potential for large scale Limited Partner defaults.

2. Legal

A fund's operating documents usually provide the General Partner with a variety of legal remedies through which it can impose gradations of monetary sanctions on a Limited Partner that finds itself unable to meet a capital call. These legal remedies are intended to "encourage" a Limited Partner to fund its capital commitment and include:

- a) Interest. Accepting a late contribution from the defaulting Limited Partner, usually with interest (which can be high) plus any expenses associated with the default, including attorney's fees.
- b) Distributions. Withholding of all distributions to the defaulting Limited Partner and offset against defaulted amount.
- c) Litigation. Suing for specific performance and consequential damages.
- d) Haircut. Diluting the defaulting Limited Partner's economic interest in the fund, including reducing the defaulting Limited Partner's capital account balance

(commonly by around 50% but in more extreme cases even by 100%) and apportioning such reduction *pro rata* among the non-defaulting Limited Partners.

- e) Sale. 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.

Given the broad range of possible legal remedies available to General Partners under their fund's operating documents, comparing one fund's combination of default provisions against the next fund can be challenging. We regularly advise on inquiries from investors on how they might be impacted by these default provisions and would be happy to assist with your particular concerns.

3. Finance

The financial impact of any potential default on funding a capital call will need to be considered in light of, and balanced against, the legal remedies available to the General Partner (including those outlined above). While as legal counsel we are not able to provide you with financial advice, some factors to consider include the following:

- a) Vintage

The most recently subscribed funds are often the first to be considered for default. The reasoning is often that if no capital, or only very little capital, has been called, the overall loss for the Limited Partner is less impactful. Further, these funds have been raised at a time when valuations were at their peak and the General Partner may have, relatively speaking, overpaid for some of the assets in the fund. Older funds, where Limited Partners already have received much of their distributions, and that often have underperforming or hard to sell assets remaining, are also candidates for a selective Limited Partner default.

- b) Funded Capital Commitment

The level of a Limited Partner's funded capital commitment will need to be considered as possible remedies applied by General Partners may include reduction of rights to receive distributions or a forced sale of the interest at a discounted value (see B.2 above).

- c) Capital Account Balance

The remaining capital account balance before the default should also be a factor and viewed in light of past distributions, as well as the funded and unfunded capital commitments of a Limited Partner in order to evaluate the overall loss position the Limited Partner may be exposed to.

C) The General Partner's Position

As we have already noted, the remedies that a General Partner can apply in response to a default in funding of capital by a Limited Partner can be extensive. However, General Partners will also

need to plan on shoring up the fund's own liquidity and capital base in order to continue operations effectively. Limited Partners should be aware of these so that they can plan and prepare accordingly. The options often considered or available to a General Partner include:

1. **Call Additional Capital.** Non-defaulting Limited Partners may face an increase in their called up capital by General Partners. However, that may not address longer-term liquidity issues of the fund if the defaulting Limited Partner's capital commitment is relatively large or large when considered in aggregate with the capital commitments of other defaulting Limited Partners.
2. **Re-invest Proceeds.** The fund documentation may permit re-investment of proceeds otherwise distributable to Limited Partners, or permit the distribution of proceeds that are subject to recall for re-investment. This approach may only work for those funds that have distributable proceeds.
3. **Borrow Funds.** A General Partner may access lines of credit available for short-term borrowing that can be utilised to cover temporary liquidity issues, or consider longer-term credit facilities as a way to mitigate liquidity issues.
4. **Waiver of Management Fee.** In order to ease the pressure on Limited Partners, a General Partner may consider reducing the amount of cash to pay fund expenses in the form of a complete or partial waiver of management fee. This is an option for General Partners that have management fee income from other funds to cover their operating costs.
5. **Re-open Fund or Create Annex Funds.** In the event of not only isolated but large scale Limited Partner defaults, General Partners have previously considered re-opening their funds in an attempt to raise additional capital or forming annex funds to co-invest with their existing funds. This strategy commonly involves Limited Partner consultation and complex issues regarding conflicts of interest and deal sharing/allocation.

D) The Secondary Market Sale

A Limited Partner that is not able to meet its obligations and faces a possible default on a fund's capital call should also consider proactively engaging with the General Partner on a potential sale of its interest. General Partners usually prefer, and even encourage or help facilitate, the sale of a Limited Partner interest in a negotiated, secondary market transaction. From the General Partner's perspective, it preserves the interest and the future capital commitment to the fund, and from the Limited Partner's perspective, it relieves such partner from its obligation and even provides it with additional liquidity. It also helps to avoid a possibly irreparable harm to the relationship between a General Partner and Limited Partner for the future.

The Limited Partner should, however, be mindful that while the General Partner may be able to help, by for example assisting in locating a willing buyer for the interest, the General Partner may not take on the role of broker, intermediary, or negotiator. The parties will need to come to an agreement on their own regarding the price to be paid for the interest.

E) Conclusion

A Limited Partner default usually requires major dedication of resources by such Limited Partner and also the General Partner in terms of management time and evaluation of legal and financial options. The better prepared each party is before an actual default occurs, the better and faster it will be able to determine the path forward and address any financial or legal issues. In order to be well prepared, we suggest that Limited Partners:

- review their fund portfolio;
- review fund operating agreements and side letters and understand ramifications of each course of action;
- consider identifying potential purchasers on the secondary market; and
- discuss options with experienced legal counsel.

Attorney advertising. The material contained in this Client Alert is only a general review of the subjects covered and does not constitute legal advice. No legal or business decision should be based on its contents.

For further information on investor default provisions and how they may impact your activities and investment portfolio, please reach out to a member of your Curtis team.



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