Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

ILPA Model Presents Private Equity Fund Financing Hurdles

By **Ann Richardson Knox, Todd Bundrant and Mark Dempsey**
(January 31, 2020, 5:56 PM EST)


Ann Richardson Knox


Todd Bundrant


Mark Dempsey

The Institutional Limited Partners Association recently published a model limited partnership agreement, or MLPA, for private equity buyout funds.[1]

The MLPA followed the ILPA's publication of "Subscription Lines of Credit and Alignment of Interest: Considerations and Best Practices for Limited and General Partners," which reflected the increased usage of subscription-backed credit facilities, or SCFs — also known as capital call or capital commitment facilities — and outlined for the limited partner community the advantages of SCFs to investors in private equity funds and best practices relating thereto.

While the MLPA contemplates the possibility of fund-level indebtedness and SCFs by providing a placeholder for provisions relating thereto, it appears that the ILPA did not fully address provisions of a fund limited partnership agreement, or LPA, that are typically requested by lenders to funds and commonly incorporated by fund general partners in connection with such financing arrangements.

Due to the flexibility afforded to both LPs and the fund by virtue of SCFs and other fund-level financing arrangements, specific provisions required by lenders relating to such indebtedness have become common features in limited partnership agreements.

Certain provisions currently included in the MLPA, however, could pose challenges for GPs seeking to obtain fund-level leverage or seeking to include LPs in the borrowing base for a SCF. As a result, GPs and investors should be aware that strict adherence to certain MLPA provisions may conflict with lender expectations in such fund-level financing arrangements.

Provisions Relating to Indebtedness and Other Bankable Terms

The section addressing indebtedness under the MLPA is notable for both what is included and what it does not address. While there is language permitting fund-level leverage in Section 7.2, covering the limitation on indebtedness, the MLPA does not include the detail often required by lenders in the SCF market to make an

LPA bankable.[2]

As drafted, the MLPA limitation on indebtedness extends to all borrowings at the fund level, as well as guarantees at the fund level of portfolio company indebtedness. The MLPA has bracketed a suggested level of overall leverage at 15% of total commitments, which is lower than the 25%–35% leverage limitation associated with many fund strategies.

Indebtedness is subject to a six-month repayment requirement, which was also proposed in the ILPA SCF practices. Additionally, where a fund may seek to use letters of credit under an SCF, it may be desirable to specify whether the incurrence of the letter of credit, versus a draw thereunder, is similarly subject to any repayment requirement that the MLPA does not address.

There is a provision permitting pledges to support a SCF, although the language does not include a fulsome description of the collateral typically provided to a SCF lender.

While Section 7.2 authorizes a pledge of the right to make a capital call, it does not specifically authorize a pledge of the commitments and capital contributions, nor does it address a pledge of collateral accounts or a requirement for LPs to fund only into such pledged collateral account while an SCF is in place. It is also commonplace for LPAs to acknowledge that an SCF lender is relying on capital contributions as the primary source of repayment for SCF borrowings.

The MLPA notably does not provide any affirmative statement or acknowledgment that the obligation of LPs to fund capital contributions to a lender exercising remedies under an SCF is unconditional, or otherwise provide for typical waiver of setoff, counterclaim or defense to funding, including in an insolvency proceeding.

Such omissions can pose a barrier to an SCF given many SCF lenders will require such provisions to ensure that the obligation of an LP to make capital contributions will remain intact during a bankruptcy of the fund and not be categorized as a financial accommodation.

In the absence of such provisions, a lender may require LPs to execute investor letters, which, among other things, provide for an acknowledgment of the obligation to fund capital contributions without setoff, counterclaim or defense. Investor letters can increase the costs and burdens associated with an SCF as LPs often negotiate such letters individually or may decline entering into such letters, in which case their commitments may not be included in the borrowing base for the SCF.

Section 20.11 of the MLPA expressly excludes lenders or any other creditor of the fund as a third-party beneficiary of the terms of the agreement. It is common to include SCF lenders as third-party beneficiaries considering the express authorization to incur this fund-level indebtedness and the pledge of commitments and the obligation of LPs to fund capital contributions to repay such borrowings.

The MLPA provides in a footnote to Section 7.2 that LPs should not be required to disclose information to a lender that is not in the public domain without the prior written consent of the applicable LP. Due to constraints applicable to certain LPs, such investors may limit the obligation to provide financial information to a lender — other than publicly available financial statements — pursuant to their side letters. It is uncommon, however, to see a general prohibition on such information contained in the LPA itself.

Given SCF lenders require certain information to assess creditworthiness of LPs, such a general limitation may limit the ability of the GP and investors to collaborate with lenders to achieve the desired facility size and borrowing base, as the lender may reduce the advance rate against LPs without publicly available information or may not be able to include such LPs in the borrowing base at all.

The MLPA does not squarely address the full range of variables associated with increasingly complex fund structures and the corresponding impact on SCFs, such as the potential need to accommodate cascading pledges or cross-collateralize borrowings[3] due to Employee Retirement Income Security Act or tax concerns that arise with other fund entities, such as feeder funds or alternative investment vehicles. This may be attributable to the fact that the MLPA is a model document that is not intended to address these variables.

Additional Indebtedness-Related Provisions

In reviewing the MLPA, both GPs and LPs should also consider the following items impacting an SCF in the form agreement:

- With respect to Section 6.4 of the MLPA, reinvestment of distributable proceeds is limited to making portfolio investments, and consequently may not be included as part of the LP's remaining commitment otherwise available to support SCF borrowings, which is a common feature in many LPAs.

- The MLPA does not specify that a transfer by a partner of its interest may be subject to repayment of the portion of SCF borrowings attributable to such transferring partner as a condition to the transfer, although commonly set forth in LPAs for funds seeking leverage.

- Section 21.2 of the MLPA appears to contemplate that disputes arising thereunder may be subject to arbitration in certain circumstances, which if applied to all LPs would conflict with customary expectations regarding enforcement of rights and remedies contemplated by SCF Lenders in pricing such facilities.

Indebtedness Disclosure Provisions

As per the ILPA SCF practices, the MLPA focuses mainly on disclosure to LPs of the use of indebtedness at the fund level. The ILPA did include a number of requirements regarding SCFs and other indebtedness in Section 15.2, including the following:

- Disclosure of debt at fund and portfolio company level;
- Description of the use of proceeds of such credit facility indebtedness;
- Internal rate of return calculations net of credit facility indebtedness;
- Disclosure of outstanding uncalled capital;
- Disclosure of the number of days each credit facility drawdown is outstanding; and
- Disclosure of certain terms and conditions of such credit facility, including SCF fees.

These provisions are all consistent with the ILPA SCF practices, and we understand anecdotally that such information is now more readily available from most GPs — formally or informally — to LPs.

Fund Expenses/Capital Contributions Post-Commitment Period

Rather than have separate provisions for calling capital for the repayment of liabilities relating to an SCF both prior to and after events that give rise to a termination of the commitment period, such as a key person event, many LPAs include both principal and interest under an SCF as fund expenses that are subject to an obligation to fund capital contributions following termination of the commitment period.

The MLPA, however, only includes interest expense and fees for an SCF in the concept of fund expenses, according to Section 2.5.1.6 and Section 2.5.1.9. As a result, both GPs and lenders must take care that such items are separately addressed where necessary in the LPA to allow for the ability to call capital to satisfy liabilities incurred prior to the end of the commitment period at a minimum, and if needed for the fund to incur indebtedness post-commitment period — for follow-on or follow-up investments, for example — to permit the repayment of such liabilities incurred at such time with capital contributions.

According to Section 7.4 of the MLPA, all drawdowns post termination of the commitment period — not just those that relate to new Investments as the lead-in suggests — are restricted, and as drafted such provision would prohibit capital calls for liabilities incurred under an SCF except for fund expenses.

As noted above, fund expenses would not include the repayment of outstanding principal amounts under an SCF. This also appears to be inconsistent with the key person event provisions in Section 11.5, which specifies that after a suspension or termination of the commitment period, drawdown notices may be issued to “repay indebtedness and satisfy liabilities of the Fund, incurred prior to such suspension.”

Overcall Limitations

A common component of the analysis undertaken by lenders in determining credit risk associated with an SCF is to consider any limitations on the ability to require LPs to make up the shortfalls created by the failure of other LPs to fund capital contributions, commonly referred to as an overcall provision.

The MLPA includes overcall limitations both in the event an LP defaults in its obligation to make a capital contribution, and in the event an LP is excused from making a capital contribution.

With respect to the former, the Section 6.6.6 provides that nondefaulting partners are required to fund additional drawdowns not to exceed 50% “of the total Capital Contributions that such LP was originally required to make before the Drawdown of such additional amounts."

Section 6.7.3.5 includes a similar overcall limitation in the case of an excused limited partner. Given the overcall percentage is bracketed, it appears that ILPA acknowledges that LPs and GPs may wish to negotiate overcall limitations.

Regardless, while overcall limitations come in different forms, the proposed methodology based upon the percentage of prior capital call can present more significant SCF limitations as compared to a limitation based upon the percentage of the LP’s total commitment.[4]

Collateral Accounts and Temporary Investments

Section 7.3 of the MLPA reflects a requirement for the fund to invest cash only in temporary Investments. This may potentially conflict with the requirements of an SCF lender to direct capital contributions to a collateral account which may not be interest bearing.

Nevertheless, the spirit of this provision may still be effectuated in connection with an SCF considering that so long as there is no event of default, potential event of default or mandatory prepayment required, fund borrowers are generally permitted to withdraw funds from the collateral account and thereafter could deploy such funds in temporary investments.

Conclusion

According to the ILPA, the purpose for creating the MLPA is to establish a more efficient process for LPs and GPs establishing LPAs, which are typically bespoke contracts and the result of significant negotiations.[5]

It is important to note, however, that requirements for fund-level leverage are often individual to the purpose and strategy of a fund and as such are not uniform. Therefore, careful consideration should be given to limited partnership agreement provisions that may limit the ability of a fund to take advantage of a growing number of fund finance products available to achieve operational efficiency and optimize fund performance.

Ann Richardson Knox is a partner and global head of the fund finance team at Mayer Brown LLP.

Todd N. Bundrant and Mark C. Dempsey are partners at the firm.

[1] ILPA Model Limited Partnership Agreement, October 2019, https://ilpa.org/model-lpa/ (Oct. 30, 2019).

[2] See “Model LPA Provisions for Subscription Credit Facilities” in the Mayer Brown Fund Finance Market Review Spring 2019.

[3] However, Section 15.2.2.8 includes a mention of disclosure to LPs of cross-collateralized debt, which is not otherwise expressly permitted in the indebtedness section (see Section 7.2).

[4] For further discussion on overcall provisions for SCFs, see “Subscription Facilities: Analyzing Overcall Limitations Linked to Fund Concentration Limits” in the Mayer Brown Fund Finance Market Review Summer 2013

[5] See ILPA, ILPA Publishes Model Limited Partnership Agreement to Strengthen Alignment in the Private Equity Industry, Governance and Alignment of Interests for General and Limited Partners (Oct. 30, 2019).