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Limited Partner Defaults in Private Equity Funds

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The current global COVID-19 pandemic continues to have a major impact on a wide variety of economic activities. For private equity funds, investor uncertainty and the need to preserve cash may drive limited partners ("LPs") to question their obligations to fund capital calls.

When subscribing to a private equity fund, an LP will usually commit to make a total capital commitment of a specified amount. This capital commitment is typically contributed to the fund over time, pursuant to drawdown notices or capital calls issued by the fund's general partner ("GP"). Such notices or calls are most commonly made as investments for the fund are identified. An LP default occurs when an LP fails to fund such a drawdown notice.

Historically, LP default cases appear to be relatively rare. This is not least because of (i) the harsh consequences of a default in the typical private equity fund Limited Partnership Agreement ("LPA") (*see below*), and (ii) the obvious reputational ramifications of an LP default on that LP's acceptance as an investor into a private equity fund in the future.

Despite the current economic uncertainty, GPs will likely continue to draw down capital from LPs to complete smaller investments, bolt-on acquisitions, and possibly to fund amounts that had previously been satisfied by credit facilities. Certain LPs may find themselves overstretched or simply unwilling to fund their calls in the coming weeks and months.

Also, while not precisely an example of capital call defaults, the current environment has likely delayed the first closings of many new funds, with investors in a "wait and see mode" prior to any formal commitment.

Consequences of default

A market standard private equity fund LPA will usually include detailed provisions to address LP defaults. The LPA will typically provide for some time period for the defaulting LP to "cure" its default and the GP will usually have the power to assess penalty interest on late payment. Most default scenarios would usually end here. However, if the LP continues to be in default after any applicable "cure" period, the GP will have wider powers, including potentially some of the following:

<u>Sale of LP interest</u> – The GP could cause the sale of the LP's interest in the fund or a portion thereof, either to other LPs (who may have a right of first refusal) or other third parties. The sale price would typically be fixed at the lesser of fair value or prior book value, net of sale expenses (with the defaulting LP potentially required to make up any additional cost not obtained). However, this may not be a sufficient deterrent, and therefore the LPA will likely include other potential options.

<u>Reallocation of capital call</u> – The GP, or another LP or third party (or a combination thereof) could fund the capital call instead, and acquire a preferred interest in the relevant investment in place of the defaulting LP (who will normally remain liable to fund future capital calls).

Compulsory redemption – The GP could cause the defaulting LP to forfeit its existing interest in the fund (or a significant portion thereof, including its right to vote on any issue) for the benefit of all other LPs on a pro rata basis. This could be exercised as a standalone power, or combined with cancellation of the LP's remaining commitment (and liability to fund future capital calls) – removing the LP and its commitment from the fund. However, some GPs may prefer not to exercise this power as it reduces total commitments to the fund, and therefore both the investment ability of the fund and management fees.

Other remedies – The LPA may reserve the GP's rights to all other remedies to enforce the defaulting LP's obligation to fund the capital call (e.g. pursuing the defaulting LP for specific performance (depending on the jurisdiction of the fund)). Other specific powers may be set out in the LPA and vary depending on the nature of the fund, including power to compel the defaulting LP to make a short-term loan to the fund, or withholding and offsetting future fund distributions against the default amount.

Liability for costs – In addition, the GP will likely have the power to require that the defaulting LP bears all out-of-pocket expenses incurred by or on behalf of the fund with respect to the default, including the costs of arranging any bridge financing.

The impact on the defaulting LP of any of these measures will vary depending on the age of the fund, the proportion of capital already drawn, the LP's portion of the entire fund, and the value of investments already made and expected to be made. For a relatively new fund where LPs have only funded a small amount, the loss of the entire investment may not be significant compared to the value of being released from future capital calls. A similar calculation may apply where fund investments have lost substantial value. On the other hand, in a mature fund with good investments, loss of LP interests may be costly.

Finally, LPs unable to face capital calls may seek to sell or otherwise transfer their LP interests. Depending on the fund, its investment profile, and amounts remaining to be drawn, the LP may be required to pay amounts to the buyer to relieve the LP of its future obligations to fund.

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