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Positioning Investment Funds for Future Financing: Key Operating Agreement Provisions

Borrowing Authority, Ability to Make Capital Calls,
Third-Party Beneficiary and Other Provisions Important to Lenders

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Positioning Investment Funds for Future Financing:

Key Limited Partnership Agreement Provisions

March 13, 2019

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Part I: Introduction



Introduction – Background

- Subscription credit facilities vs. other types of debt incurred by a fund:
 - Unique collateral
 - Different purposes
- Private equity and other similar investment funds (a “Fund”) are increasingly interested in entering into subscription credit facilities (each, a “Subscription Facility”) to provide the Fund with leverage and short-term liquidity. Funds often need financing quickly to facilitate making investments and may use these facilities to bridge capital calls.



Introduction – Background

- The first step in determining if a Subscription Facility is a viable option for a Fund is to diligence the limited partnership agreement or other organizational document of the Fund (the “LPA”).
- Subscription Facility lenders usually require that specific concepts and language be included in the LPA in order to provide a Subscription Facility without additional credit support, such as investor consent letters.
- A properly drafted LPA can expedite the closing of such financing, reduce transaction costs and lead to a more favorable pricing/structural package.



Introduction – Background

- In general, the lender will want to see in the Fund’s LPA that:
 - The Fund can incur and repay indebtedness;
 - The Fund can grant a security interest to the lender in the applicable collateral (e.g., for a capital call collateral package, the uncalled capital commitments of the Fund’s limited partners (the “Investors”), the general partner’s right to call capital (and enforce the payment thereof), and the collateral account); and
 - The Lender will be considered to be a third-party beneficiary concerning all funding provisions.
- If the lender is not satisfied with the provisions in the LPA, the lender may require the Fund to amend its LPA, which would require the Fund to obtain the Investors’ consent for the amendment, leading to delays in obtaining financing and increased costs for the Fund.



Introduction – Topic Overview

- In this presentation, we will:
 - Examine and explain some of the most important LPA provisions that lenders may require;
 - Provide model LPA Subscription Facility language; and
 - Discuss certain obstacles that may arise depending on the language included in LPAs.



Part II: LPA Credit Facility Provisions and Model Language



LPA Credit Facility Provisions and Model Language

Ideally, the LPA will include the following key concepts:

- **Key Concept #1:** Explicitly permit the incurrence of indebtedness by the Fund in connection with a Subscription Facility as a borrower and/or guarantor.
- **Key Concept #2:** Specifically contemplate a Subscription Facility and the related pledge of collateral and include corresponding acknowledgments from the Investors of the Fund's pledge to a lender of the uncalled capital commitments to the Fund, the general partner's related right to call capital (accompanied by the right to enforce the payment thereof), and the collateral account into which the Investors will fund their commitments in response to a capital call.



LPA Credit Facility Provisions and Model Language

- **Key Concept #3:** Authorize joint and several borrowings (or cross-collateralization) with alternative investment vehicles and parallel funds.
 - This is key in order to provide one Subscription Facility to an entire Fund complex.
- **Key Concept #4:** Include an acknowledgement by the Investors that they are obligated to fund their capital contributions into a collateral account of the Fund that will be pledged to the lender as security under the Subscription Facility loan documents.



LPA Credit Facility Provisions and Model Language

- Model Language for Key Concepts ##1-4: “The Fund and General Partner shall be authorized to incur Indebtedness under such terms as they may elect, including, but not limited to, on a joint and several basis with Parallel Funds, Alternative Investment Vehicles and other affiliates of the Fund. In connection therewith, the Fund and General Partner shall be authorized to pledge, charge, mortgage, assign, transfer and grant security interests to a lender in (i) all Capital Commitments of the Partners, the General Partner’s right to initiate Capital Calls and collect the Capital Contributions of the Limited Partners and to enforce their obligations to make Capital Contributions to the Fund; (ii) the Subscription Agreements and in the Partners’ obligations to make Capital Contributions thereunder; and (iii) a Fund collateral account (the “Collateral Account”) into which the payment by the Limited Partners of their uncalled Capital Commitments are to be made (any such financing, a “Subscription Facility”).”



LPA Credit Facility Provisions and Model Language

- **Key Concept #5:** Include an explicit agreement by the Investors to fund their capital contributions without setoff, counterclaim or defense, including certain defenses under bankruptcy.
 - This is a key provision for a lender because its underwrite is primarily based on the creditworthiness of the Fund’s Investors—and thus disputes between Investors and the general partner should not be a risk that is allocated to the Subscription Facility lender.
- **Key Concept #6:** Acknowledge that the lender is relying on the capital contributions as its primary source of repayment.
 - This language is important to lender analysis, as such language was referenced by one of the key court decisions that has examined Subscription Facilities.



LPA Credit Facility Provisions and Model Language

- **Key Concept #7:** Include an acknowledgement by the Investors that each Investor's investment is a commercial act and that any sovereign immunity the Investor may have will not apply to the making of capital contributions.
- **Key Concept #8:** subordinate any claim an Investor might have against the Fund to the lender.



LPA Credit Facility Provisions and Model Language

- Model Language for Key Concepts ##5-8: “Each Limited Partner understands, acknowledges and agrees, in connection with any Subscription Facility, that (i) it shall remain absolutely and unconditionally obligated to fund Capital Contributions duly called by the General Partner or by the lender (as collateral assignee) under a Subscription Facility (including, without limitation, those required as a result of the failure of any other Limited Partner to advance funds with respect to a call for a Capital Contribution), without setoff, counterclaim or defense, including without limitation any defense of fraud or mistake, or any defense under any bankruptcy or insolvency law, including Section 365 of the Bankruptcy Code, subject in all cases to the Limited Partners’ rights to assert such claims against the Fund in one or more separate actions; provided that, any such claims shall be subordinate to all payments due to the lenders under a Subscription Facility; (ii) the lender under the Subscription Facility is extending credit to the Fund in reliance on such Limited Partner’s funding of its Capital Contributions as such lender’s primary source of repayment;...”
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LPA Credit Facility Provisions and Model Language

- Model Language for Key Concepts ##5-8 (continued): “...(iii) so long as the Subscription Facility or obligations thereunder remain outstanding, all payments made by such Limited Partner pursuant to this Partnership Agreement or its Subscription Agreement shall be made to the Collateral Account, and any payments not made to the Collateral Account will not satisfy such Limited Partner’s obligation to fund its Capital Commitment; (iv) the making and performance of the obligations under the Partnership Agreement and the Subscription Agreement constitute private and commercial acts rather than governmental or public acts; (v) neither it nor any of its properties or revenues has any right of immunity from suit, court jurisdiction, execution of a judgment or from any other legal process with respect to its obligations under the Partnership Agreement or the Subscription Agreement, including the obligation to make Capital Contributions; (vi) any termination, reduction or release of its Capital Commitment may require the consent of the lenders under and pursuant to a Subscription Facility; and (vii) all claims it may have against the Fund, the General Partner or any affiliate thereof shall be subordinate to all payments due to the lenders under a Subscription Facility.”



LPA Credit Facility Provisions and Model Language

- **Key Concept #9:** Include an acknowledgement by the Investors that their capital contribution obligations are legal, valid, binding and enforceable obligations.
 - Model Language: Each Limited Partner hereby represents and warrants that (i) it has the power and requisite authority to execute, deliver and perform its respective obligations (including the Capital Contribution obligations) under this Partnership Agreement and its Subscription Agreement and (ii) its Subscription Agreement and this Partnership Agreement (including the Capital Contribution obligations) constitute such Partner's legal, valid and binding obligation, enforceable against such Partner in accordance with their terms, subject to applicable bankruptcy, insolvency, reorganization, moratorium or other laws affecting creditors' rights generally and to general principles of equity.



LPA Credit Facility Provisions and Model Language

- **Key Concept #10:** Provide for an Investor's delivery of financial information, confirmation of the amount of its uncalled capital commitment, an investor consent letter and, with respect to certain pension plan Investors, certain representations or confirmations relating to ERISA requirements.
 - Receipt of these deliverables from an Investor may offer comfort to a Lender in including such Investor in the borrowing base.
 - Limitations on an Investor's obligation to deliver such items can impact the Fund's anticipated borrowing base and credit availability.



LPA Credit Facility Provisions and Model Language

- Model Language for Key Concept #10: “Each Limited Partner further agrees to deliver, if requested by the General Partner for provision to the third-party lender, (i) its most recent financials; (ii) a certificate confirming the remaining amount of its uncalled Capital Commitment; and (iii) an investor letter and/or authority documentation relating to its entry into its Subscription Agreement and this Partnership Agreement, and such other instruments as the General Partner or such lender may reasonably require in order to effect any such borrowings by the Fund or any of its Subsidiaries. In addition, in connection with any Subscription Facility, each ERISA Partner confirms that a fiduciary of such ERISA Partner has confirmed that (A) it made its own determination that such ERISA Partner’s investment in the Fund and execution of this Partnership Agreement were made on terms that are no less favorable to such ERISA Partner than those that could be obtained in arm’s-length transactions with unrelated parties; (B) the decision to invest in the Fund and to execute and deliver this Partnership Agreement was made by such fiduciary; (C) such ERISA Partner (or commingled funds of related plans): (x) has no less than \$100,000,000 of assets and (y) not more than five percent (5%) of the assets of such ERISA Partner (or commingled fund) have been invested in the Fund; and (D) no Subscription Facility lender (1) has had any influence, authority or control over such ERISA Partner’s investment in the Fund or (2) has rendered investment advice with respect to such ERISA Partner’s investment in the Fund.”



LPA Credit Facility Provisions and Model Language

- **Key Concept #11:** Specifically carve out any overall limitations in the LPA relating to management fees, defaulting Investors or excused Investors with respect to capital calls to repay indebtedness incurred under the Subscription Facility.
 - Overall limitations limit the ability of the Fund to call capital from its Investors to make up for shortfalls created by other Investors' failure to fund their capital calls.
 - Credit implications: overall limitations conflict with a lender's general expectation that each Investor is jointly and severally obligated to fund capital calls up to the full amount of its uncalled capital commitment. They can result in greater due diligence time and expense and less favorable Subscription Facility terms and pricing.
 - The proposed debt carve-out should also be included or cross-referenced in the LPA's overall provision directly in order for the LPA not to internally conflict.



LPA Credit Facility Provisions and Model Language

- **Key Concept #12:** Provide that any Investor transfer or withdrawal from the Fund may be subject to a capital contribution to repay obligations under the Subscription Facility.
 - A change in the investor pool resulting from an investor transfer or withdrawal can impact the borrowing base (as the new Investor may not get borrowing base credit or may have a different advance rate applied to it) and result in a borrowing base deficiency, requiring the Fund to make a prepayment under the Subscription Facility.
 - So, it is important to be able to call capital from the existing Investor for debt incurred while such Investor still held its commitment.



LPA Credit Facility Provisions and Model Language

- Model Language for Key Concepts ##11 and 12: “Notwithstanding anything in this Partnership Agreement, its Subscription Agreement or any Side Letter to the contrary, each Limited Partner acknowledges and agrees that (i) any excuse right or other limitation with respect to any Capital Contribution (including the payment of any management fee) shall not be applicable with respect to any Capital Call the purpose of which is to repay amounts due under the Subscription Facility, regardless of whether the related Capital Call is issued by the General Partner or the lender (as collateral assignee) under the Subscription Facility; and (ii) in the event such Limited Partner is entitled to transfer its interest or withdraw from the Fund pursuant to any provision of this Partnership Agreement, its Subscription Agreement or its Side Letter, prior to the effectiveness of such transfer or withdrawal, as applicable, such Partner shall be obligated to fund such Capital Contributions as may be required under the terms of the Subscription Facility as a result of such transfer or withdrawal; *provided*, that in no event shall any amounts funded by such Limited Partner exceed its uncalled Capital Commitment.”



LPA Credit Facility Provisions and Model Language

- **Key Concept #13:** Establish that the lenders are third-party beneficiaries of the LPA, and if there is “no third-party beneficiary” language in the LPA, the lenders should be adequately carved out of such limitation.
 - Model Language: “Notwithstanding anything herein to the contrary, including Section [Insert 3rd Party Beneficiary Provision], each lender and other secured party under a Subscription Facility shall be an express and intended third-party beneficiary.”



LPA Credit Facility Provisions and Model Language

- **Key Concept #14:** If the fund complex is such that it would be useful to add qualified borrowers (i.e., entities that can borrow but do not pledge any security) to the facility, the LPA should explicitly allow the Fund to guaranty portfolio companies or AIVs.



LPA Credit Facility Provisions and Model Language

- While some of these provisions may not be strictly necessary in order to authorize and/or structure a Subscription Facility, they provide Subscription Facility lenders desired clarity and comfort on key points.
- Accordingly, even though a Fund might be authorized to incur indebtedness and pledge assets generally via the broad authorizing terms of the LPA and/or by virtue of relevant governing law, adding specific Subscription Facility provisions will assist the Fund in obtaining the most advantageous structures and pricing.



Part III: Other Important LPA Provisions from A Lender's Perspective



Other Important LPA Provisions

- **Commitment Period and Key Person Events**

- Lenders will examine the Fund’s commitment period to determine whether capital calls for the purpose of repaying indebtedness (including principal, interest and fees incurred under a credit facility) are explicitly authorized during the commitment period, any suspension of the commitment period (i.e., after a key person event) or after the termination of the commitment period.
- Many LPAs will explicitly address interest and fees through the definition of “Partnership Expenses” but will not explicitly address principal.
 - Clarifying this ambiguity or otherwise providing that Subscription Facility indebtedness may be repaid following any suspension or termination of the commitment period will provide the most flexible terms under the Subscription Facility.



Other Important LPA Provisions

- **Debt Limitations**

- Any limitations in the LPA on the incurrence of indebtedness are scrutinized by lenders, including any limits on the amount of debt and/or guarantees that may be incurred and the amount of time debt may remain outstanding (commonly known as “clean-down” provisions).
- Many LPAs carve out Subscription Facility debt from their debt limitations, especially if the debt is short term, in order to give the Fund maximum flexibility in using the Subscription Facility to bridge asset purchases quickly and effectively.



Other Important LPA Provisions

- **Remedies**

- Subscription Facility lenders will look to see if the LPA provides adequate predefined remedies if an Investor fails to comply with the terms of the LPA, including failing to make capital contributions.
- For a commingled fund with a large number of Investors, standard remedies include, among other things, an ability to charge default interest, reduce the Investor's capital account and sell the Investor's interest in the Fund at a reduced price.



Other Important LPA Provisions

- **Remedies (continued)**

- It is key that the LPA explicitly provides that non-defaulting Investors may be called on (up to their uncalled capital commitments) to make up any deficiency caused by a defaulting Investor.
- The ability to exercise this remedy could be subject to an overcall provision (as discussed earlier), so repayment of debt would ideally be carved out from the overcall provision.
- Similar provisions should apply to any excused Investors.



Other Important LPA Provisions

- **Recallable Capital**

- If the LPA includes a concept by which an Investor may elect to reinvest interest distributions and/or principal distributions that it receives from the Fund, the LPA should specifically address that such reinvested amounts will increase the uncalled capital commitment of such Investor.
- The concerns for a lender over recallable capital are that:
 - It must be clear how such amounts impact the uncalled capital commitments (and thus the calculations of the borrowing base); and
 - The Investors need to understand that the calculation works in this way, in order to avoid an Investor failing to fund a capital call on the belief that it has already fully contributed such amounts and thus did not need to recontribute (in its view) such amount.



Other Important LPA Provisions

- **Exit Provisions**

- The issue from a Lender's perspective with investor transfers and withdrawals (whether in a closed fund or open-ended fund) is that changes in the investor base and/or the amount of the capital commitments directly impact the borrowing base and can alter the creditworthiness of the investor base.
- A lender will prefer to see limits on transfers and withdrawals in the LPA so that the borrowing base remains more stable.
- Avoid deemed/automatic general partner consent to a transfer/withdrawal.
- Compliance with any necessary mandatory prepayment under a credit facility prior to a transfer is important.



Other Important LPA Provisions

- **Exit Provisions (continued)**

- One potential way to address this issue in the LPA is to limit investor transfers or withdrawals to being made only in the following circumstances:
 - The general partner has given its consent; and/or
 - The general partner or Fund has determined that such transfer/withdrawal will not negatively impact its ability to repay its obligations (i.e., that it will have sufficient liquidity after such transfer) or result in a material impact on the Fund's ability to borrow under any credit facility.
- Credit facility documentation can address redemption and withdrawal rights for Investors in an open-ended fund by adding additional investor exclusion events, mandatory clean-up calls (to reduce amounts outstanding under the credit facility), covenants and events of default.



Conclusion



Conclusion

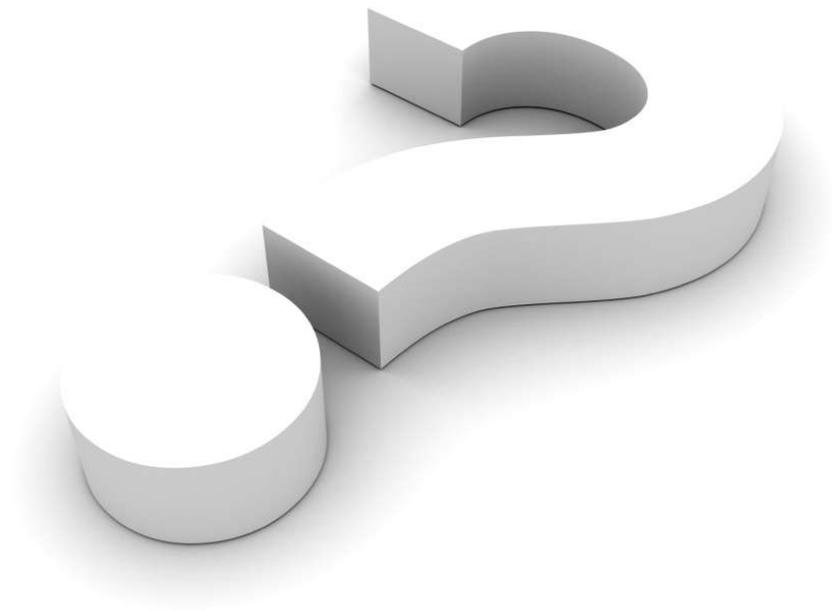
- Adequately addressing the foregoing concepts directly in the LPA will help a Fund obtain more competitive bids that provide the greatest amount of flexibility for its Subscription Facility needs and most likely avoid the need for investor consent letters.
- Note, however, that even if the LPA contains these ideal provisions, investor consent letters are often nonetheless required by the market for highly concentrated investor pools (including single-investor Subscription Facilities).



Reference Materials

- Please see the following Mayer Brown article:
 - “Model LPA Provisions for Subscription Credit Facilities” in *Fund Finance Market Review*, Spring 2019.

Thank You



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