Default debacle

With LP defaults becoming a more common occurrence, GPs need to understand all the implications of these events for the management company, for the fund, and for the other investors

By Jennifer Harris

General partners are used to thinking of investor relations crises as situations where they have to break bad news to their limited partners. But as the recession's desiccating effects continue to be felt, GPs are finding that those tables have been turned. It is now LPs who are also sheepishly bringing the bad tidings: that many of them are facing liquidity constraints and may not be able to meet capital calls in the near future.

In the past, harshly punitive remedies contained in the limited partnership agreement were enough to keep LPs from defaulting. But in the current economic climate, there are some LPs who simply can't honour their commitments, no matter how big a stick the GP wields.

No one wants to be forced to exercise default remedies against their LPs. There are some steps that GPs can take to help avoid this outcome: they can allow LPs to reduce the size of their commitments, they can agree, informally or formally, not to issue any capital calls until liquidity pressures ease, or they can facilitate the sale of the LP's interest in the fund. Critical to the success of all of these methods, of course, is a fund managers' commitment to staying in constant contact with its LPs.

If the worst case scenario does occur, and an LP has to default on a commitment, the GP should think carefully about which default remedies to impose, how exactly to impose them, and most importantly – how to get the deal done without the defaulting LP's commitment. Again, it's best to work with the defaulting LPs as much as possible. An antagonistic approach – such as private equity fund CapGen's choosing to sue its LPs – rarely helps anyone.

Staving off default

"The smart fund sponsors are reaching out to their limited partners to talk to them about what they're doing, just to hear from them and understand their position," says Sherri Caplan, a partner in the funds formation group at law firm Debevoise & Plimpton.

Right now LPs are essentially arranging all of their fund commitments in a matrix, ranging from new funds to fully funded ones, funds that are performing well to funds that aren't. Obviously the poor performers will be among the first those LPs default on, if they find themselves short on cash. GPs with newer funds that haven't drawn down much capital yet should also worry – LPs have less to lose by defaulting. Knowing where your fund falls in those matrices, and therefore which of your LPs are on the fence, is critical in planning your next move.

Once an LP has indicated that it might default, a GP should determine whether it is defaulting because it actually doesn't have enough money (a "can't") or because they want to allocate their money elsewhere (a "won't"). A "can't" might be on the verge of bankruptcy, in which case punitive measures are likely to be ineffective. A "won't", on the other hand, might still be convinced to honour their commitment.

The politics of this period between the LP's indication that it might default and the actual default notice can be difficult to navigate, Caplan says, because until the LP actually defaults the GP still owes it a fiduciary duty.

"If the LP can still vote and the LP is on the advisory committee, it could make it quite awkward in the event that the GP would like to go to the advisory committee to discuss the resolution of the issue of the potential default," Caplan says. "How do you not include the potentially defaulting LP in those meetings if they are not actually in default yet? Few fund partnership agreements permit the GP to exclude an LP that has not yet been designated as in default."

Typically the days leading up to a default look like this: a GP issues a drawdown notice to its LPs, and they have a limited period of time, typically 10 days, to honour it. If they don't wire funds in by the end of those 10 days, the GP sends a follow-up notice. Ten days after that, the GP sends a notice of default, and ten days after that the GP decides which remedies to exercise.

"Practically what happens on all of those days is everyone is on the phone, discussing what the problem is, trying to find a way around it, seeing if other LPs will pick up the difference, deciding whether or not that LP who can't make the capital call needs to get bought out by someone else," says Carl de Brito, a partner at law firm Dechert.

Second chances

GPs can defer capital calls at the request of their LPs, but the best way to stave off a default is to facilitate the sale of the LP's stake in the fund to a third party, or to other existing investors in the fund, says Francois Roux of Roux Capital, a private equity secondary advisor in Paris.

In a straightforward secondary transaction, the new investor acquires the exiting LP's stake in all of the fund's existing investments as well as their remaining capital commitments. There are two other variations of the secondary transaction that can serve GPs well: in a stapled secondary transaction the new LP acquires not just an interest in the existing investments in one fund, but also the right to invest a certain amount of money in the GP's next fund. In a top-up secondary transaction, a new LP invests fresh money, which can be a significant portion of the already committed capital, and extends the life of a mature fund. This latter method is particularly helpful for GPs who find that a large portion of a fund's LPs are unable to continue to fund capital calls, says Roux.

"The existing LPs are given a chance to limit their capital calls without defaulting or clashing with the GP, and the GP is not forced to postpone reinvestment or equity refinancing of overleveraged buyouts," he says. "The GP is not blocked by defaulting or recalcitrant LPs, and can expand the depth and length of its fund. This has a cost to existing LPs, however, and requires their approval, as the secondary investor will ask for a preferential return, up until 1.5x its money, and pari passu afterwards."

Of course completing a secondary sale is currently somewhat difficult due to a persistent gap between the pricing expectations of buyers and sellers. Roux expects that it will take another quarter or two and another large drop in valuations to convince LPs to lower their expectations. It would also help for buyers to see reduced volatility in the market in the months ahead to give them a bit more confidence in the product they're buying.

Time to restructure?

If enough of your LPs are in danger of defaulting, it makes sense to consider a broad restructuring of the fund. One way to do this is simply to cut the size of your fund. For GPs that are noticing a slowdown in deal flow and therefore no longer need as large a fund as they originally raised, this is a useful solution. Last year UK firm Permira gave its limited partners the option to cap at 60 percent their original commitments to the firm's fourth buyout fund, and US firm TPG allowed its LPs to reduce their commitments to TPG Partners IV by up to ten percent, to its financial services focused fund by up to 25 percent, and TPG Asia V by up to 10 percent.

But the tricky thing about this type of action is that under Delaware law it usually requires the consent of 100 percent of the LPs, Caplan points out. If half of your LPs want out and half of them think now is a great time to invest, then it will be difficult for everyone to agree on a course of action.

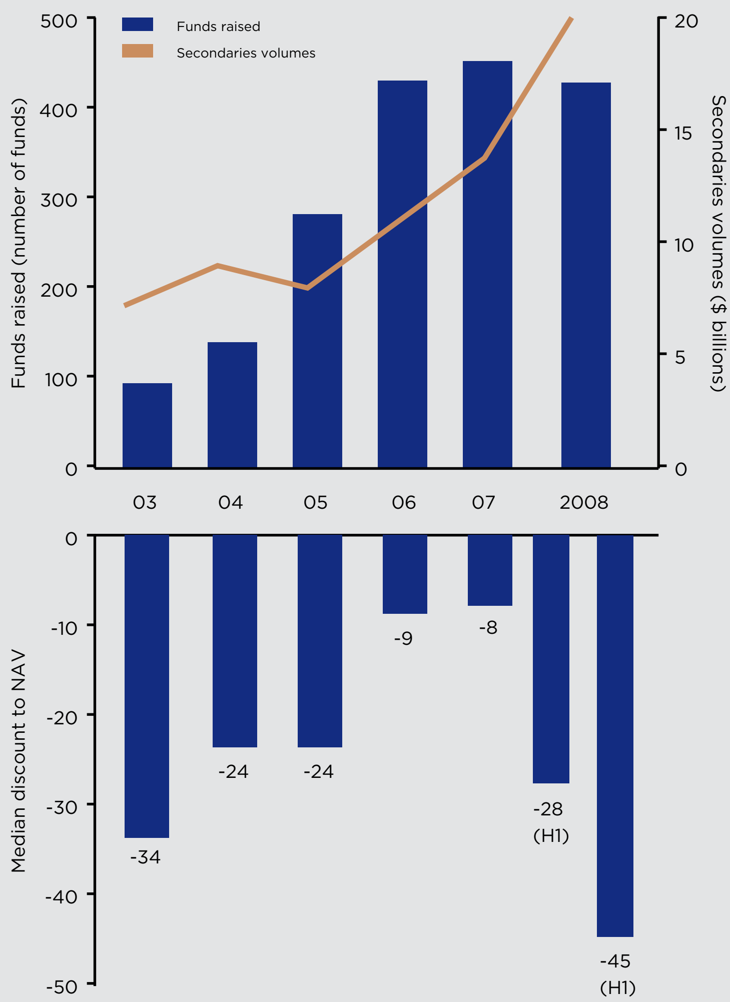
"There can be a tension between what the various limited partners want, and anytime you need to make an amendment that requires 100 percent consent you can have one limited partner literally hold the fund hostage, whether they disagree with the amendment, or they're using that leverage to strike some other bargain," she says. "The general partner has a fiduciary duty to all the partners, so it can't just favour one group of partners over the other, and so these situations can become quite difficult to maneuver."

Making the punishment fit the crime

Once a default occurs, a GP is bound to stick to the remedies laid out in the limited partnership agreement. Even if the GP might

Secondaries: poised to pounce

Even as worldwide secondary fundraising slowed in 2008, transaction volumes are taking off, and are expected to exceed $20 billion per year in the next two to three years. Pricing, however, has fallen apart: while discounts had virtually disappeared by 2007, discounts increased sharply to a median of -45 percent by the second half of 2008.



Source: Cogent Partners, Capital Dynamics. 2008

De Brito: stay in touch with shaky LPs

Caplan: know the ancillary effects of a default

Roux: consider a secondary sale

want to let the LP off the hook, it has a fiduciary duty to the non-defaulting LPs to do what is best for the fund. Some of the typical remedies GPs write into these contracts include a reduction in the limited partner's capital account, typically by 50 percent or more, the forfeiture of the right to vote on limited partnership matters going forward, offsetting any future upside the LP might receive against the amount of the default, the imposition of interest on the defaulted capital at a very high rate, or the forced sale of the defaulting LP's interest in the partnership at a discount, de Brito says. The GP has some flexibility about which of these it can impose.

"Some GPs are a little concerned that by telling their other investors about the default it could effectively cause a run on the bank – once one partner defaults, the rest feel free to do it as well, particularly if you've got a fund where the portfolio is distressed"

If the LP has filed or is likely to file for bankruptcy protection, a GP needs to take that into account when choosing which remedies to impose. It's unlikely a GP will be able to claim any money from the LP's capital account if there are more senior creditors in line ahead of it. Caplan also brings up another interesting effect of an LP bankruptcy: it may be that a GP is legally barred from issuing a drawdown notice to its entire LP group if one of those LPs is in bankruptcy. It's relatively easy to obtain a relief from that stay, but it's still something GPs need to be aware of.

Furthermore, Caplan says, many limited partnership agreements allow for the GP to call back distributions from LPs to cover certain indemnifiable events. If there are other creditors in line ahead of the GP, the GP won't be able to call back that money from the bankrupt LP.

After the default

There are a number of other implications that a GP will need to think about once a default has occurred, Caplan says. If the default is a large enough portion of the fund, a GP could find itself inadvertently breaching the diversification rules in the LPA. If those rules say that no one deal can be more than 20 percent of the fund, and an LP who previously made up 50 percent of the fund drops out, the GP could find itself working with a much smaller fund in which the existing deals are now more than 20 percent of the total capital.

A GP also has to notify its lenders if an LP defaults, and if the default is large enough it may reduce the amount the GP is entitled to borrow. Having a defaulted limited partner may also impact your insurance renewals. In terms of a private equity firm's directors and officers insurance, it is a reportable event. Caplan says she is not aware of any instances where a defaulting LP has impacted an underwriting decision, although it's possible that it could impact the pricing.

Finally, a GP needs to review its reporting obligations to determine whether it is obligated to report the default event in its financial statements, or perhaps notify the other LPs in a side letter.

"Some GPs are a little concerned that by telling their other investors about the default it could effectively cause a run on the bank – once one partner defaults, the rest feel free to do it as well, particularly if you've got a fund where the portfolio is distressed," Caplan says. "But certainly it is important information and at some point it's going to become an important disclosure item for the limited partners to know that there has been a default."

Get the deal done

The number one concern for GPs where a default occurs is of course getting the deal done regardless of the shortfall. There are a number of ways to do this. One is to call on a short-term revolving credit line while you sort out the default and round up more capital. Another method is to call down more capital than you need to complete the deal. If you draw down $120 million for a $100 million deal, and one LP who was meant to contribute $5 million to the deal defaults, you still have more than enough to close. A GP could also call down the capital commitment early if it's worried about an LP default, giving it more time to find more cash if a default occurs. There are usually contractual limits to how long a GP can hold capital before investing it though, and holding investors' capital longer than necessary hurts your IRRs.

No matter which of these you choose, it's important to have a backup plan ready – until you have the cash in hand, nothing is certain. ■