

Capital Call Facilities – LPA and side letter review

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Introduction

"Capital call" facilities (also known as "subscription line" facilities) are facilities made available to funds (often on a revolving credit basis and for general working capital purposes) which are secured against the uncalled capital commitments of the investors in the fund including: (i) the right to make capital calls on investors in respect of their uncalled capital commitments, together with rights to enforce payments of them; and (ii) the right to receive the proceeds of such capital calls. It will generally also include security over the bank account into which investors are required to deposit their capital contributions. The Cayman Islands exempted limited partnership (**ELP**) is a common vehicle used for structuring private equity funds and, where so structured, the security over the right to make capital calls and the right to receive proceeds of capital contributions will be granted by way of an assignment by the fund (acting through its general partner, referred to herein as its **GP**) of those rights as they arise under the fund's Cayman Islands law governed limited partnership agreement (**LPA**) and any applicable investor subscription documents. In this note, where we refer to a "fund" this is a reference to an investment fund established as an ELP. Where we refer to a "limited partner" or an "investor", this is a reference to a limited partner in such a fund.

In addition to the security package outlined above, another key feature of capital call facilities is the "borrowing base". Broadly, this caps the amount that may be outstanding under the facility at any time (together with hedging exposure and non-cash backed letters of credit) to the lesser of (a) the available commitments under the facility and (b) the aggregate of the uncalled capital commitments of each eligible investor as multiplied by a specified advance rate which is attributed to that investor, based on its credit quality. Only "eligible" investors to which the lender attributes a certain credit score will be included in the borrowing base calculations, with other investors in the fund being "excluded" investors whose capital commitments do not form part of the borrowing base or only being included (and then at a lower advance rate) if they meet certain additional information and due diligence requirements.

Therefore, prior to entering into a capital call facility, a lender should focus its due diligence on two main elements. The first is an assessment of the identity and credit quality of each investor in the fund, to establish which investors will be included in the borrowing base calculation and then set the borrowing base at the appropriate level. The second is a documentary review of the fund's and its GP's main constitutional and corporate documents, most notably the LPA, investor subscription documents and any side letters entered into between the fund and an investor in relation to the terms of the LPA. In this article, we examine some of the key documentary due diligence points a lender and its counsel should consider when reviewing the LPA, investor subscription documents and related side letters.

At the outset, the fund structure should also be reviewed to establish whether there are any feeder fund or alternative investment fund entities or any intermediate GPs. If so, they will need to be considered in the context of the financing structure. If there is any investment advisor or investment manager, the advisory/management agreement will need to be checked to ensure the GP has not delegated its power to call capital to the advisor or manager.

Ogier's highly experienced fund finance specialists regularly act for banks, financial institutions, funds and sponsors on a wide range of fund finance transactions and many of our lawyers have been actively involved in drafting key legislation that underpins the fund structures in the jurisdictions that we operate. We have been advising on fund finance since the inception of the funds industry. The diverse nature of our practice provides us with a valuable insight and understanding of the funds market and the legal and commercial issues relevant to lenders and borrowers alike.

Key documentary due diligence points – LPA

1 - Is borrowing/indebtedness permitted?

The LPA should specifically permit the fund to incur indebtedness (be that borrowing or guaranteeing obligations of an affiliate fund or portfolio company, should the financing structure require) and any limitations on the amount or term of such indebtedness should be noted.

2 - What are the mechanics for capital call notices?

The provisions setting out how capital can be called (including the notice provisions and time frame for payment by limited partners) and also the purpose for which the GP (on behalf of the fund) is permitted to issue capital call notices to the limited partners need to be understood. Specifically whether the LPA permits capital call notices to be issued in order to repay principal debt, interest accrued thereon and costs related thereto is a relevant consideration, as is whether the LPA makes it clear how the total amount specified in a capital call notice issued in order to fund the repayment of indebtedness would be allocated among the investors.

3 - Is the fund permitted to grant security over the limited partners' uncalled capital commitments, the right to make capital calls and its assets generally?

Section 16(1) of the Cayman Islands Exempted Limited Partnership Act (Revised) (ELP Act) makes it clear that any right to make capital calls and receive the proceeds thereof is an asset of the fund. It should be checked that under the LPA, the fund is permitted to grant security over these assets. If the LPA (or any side letter (see below)) designates any investor as a confidential investor, whose identity cannot be disclosed or in relation to whom capital call rights cannot be assigned, these investors will likely be excluded from the borrowing base.

The LPA should also be checked to establish whether the LPA permits (or at least does not prohibit and permits by way of the general powers) the limited partners paying capital contributions into a specific bank account over which the lender under the credit agreement takes a security interest.

4 - What is the term of the fund?

This should be considered in light of the proposed maturity date of the capital call facility.

5 - In what circumstances may the fund be terminated and dissolved prior to the end of the term?

Pursuant to section 36(2) of the ELP Act, the fund will be dissolved upon the filing of a notice of dissolution with the Cayman Islands Registrar of Exempted Limited Partnerships. Section 36(1) of the ELP Act states that, unless otherwise specified in the LPA, the fund will be wound up upon the passing of a resolution of all the GPs and a two-thirds majority of the limited partners. The LPA may modify this position and will usually also set out other early termination events. The LPA will typically provide a contractual waterfall for distribution of the fund's assets upon its liquidation and it should be established whether creditors of the fund are at the top of this waterfall.

6 - What is the investment/commitment period and in what circumstances may it be suspended or terminated?

The right of the GP to call capital from investors will likely be restricted upon expiry or suspension of the investment/commitment period. Examples of potential termination/suspension events are: expiry of the investment/commitment period, occurrence of a key person event and removal of the GP for cause. It should be established whether, notwithstanding such restrictions, capital may still be called from limited partners after termination or suspension of the investment period/commitment period in order to fund repayment of the principal outstanding under the capital call facility and related accrued interest and costs.

7 - Are there overcall provisions in the LPA for any defaulting limited partner or excused limited partner?

These are provisions that mean if a limited partner has defaulted or is excused from making a capital contribution to fund certain investments, the fund is permitted to call capital from the non-defaulting/non-excused limited partners up to the amount of such non-defaulting/non-excused limited partners' unfunded capital commitments. Often the overcall obligations of other limited partners are capped under the LPA. For example, they may be limited to the lesser of the relevant limited partner's unfunded capital commitments and a certain percentage of its total capital contribution. Any such limitation should be noted. It is usual for any defaulting limited partners to be excluded from the borrowing base.

The excuse provisions in the LPA should be checked to understand whether the capital commitment of a limited partner that is excused or opts-out from making a capital contribution to fund a certain investment would remain unaffected (and so available) for the purposes of repayment of the principal outstanding under the capital call facility and related accrued interest and costs.

8 - Recallable distributions

It should be ascertained whether, under the LPA, the GP has the ability to "recall" distributions that have been made to limited partners and, if it does, what the limitations and terms of the recall are. The relevant considerations for lenders are likely to be whether these distributed and recallable amounts increase the amount of the unused capital commitment of the relevant limited partner and whether these distributed and recallable amounts will be available for recall to allow the fund to repay principal, accrued interest and other costs in respect of the capital call facility (including where the investment/commitment period has been suspended or terminated). If such distributed and recallable amounts are not so available, lenders may consider excluding these amounts from the borrowing base.

9 - Transfer provisions – limited partners and GP

The transfer provisions in the LPA should be reviewed to understand in what circumstances a limited partner may transfer its interest in the fund, grant security over its interest in the fund or withdraw as a limited partner in the fund and, for example, whether prior consent of the GP is required. As noted above, the identity of the investors in the fund will be an important consideration for lenders in their credit evaluation and in setting the borrowing base level.

The circumstances in which a GP may transfer its GP interest in the fund (and whether this needs a certain percentage of limited partners to give prior consent) or in which the GP may be removed or replaced (with or without cause) should also be checked. The identity of the GP will also likely be important to the lenders and any change is likely to trigger a repayment event under the capital call facility.

Where these events will cause the investment/commitment period to be suspended or terminated, as mentioned above, it should be established whether capital calls may still be made to repay principal, accrued interest and costs of the capital call facility during such suspension or after such termination (as the case may be).

10 - Are there any key person events under the LPA?

The LPA may name certain key persons who must dedicate a certain amount of their time to the fund during the investment period and/or term of the fund. If any such specified key persons fail to do so, this may be a key person event under the LPA. The occurrence of a key person event may cause the investment/commitment period to be suspended or terminated. If this is the case, it should be checked whether capital calls may still be made to repay principal, accrued interest and costs of the capital call facility during such suspension or after such termination (as the case may be).

Key documentary due diligence points – side letters

These are letters entered into between the fund and a limited partner which supplement the terms of the LPA as they apply to that limited partner. The terms of any side letters should be reviewed to confirm the absence of provisions that adversely affect any of the findings arising from the LPA due diligence review or factors that otherwise adversely affect or may potentially prejudice the security created or the lenders' right to repayment of the facility. We have seen a number of examples where side letters have expressly prohibited the fund from granting a security interest over a particular investor's uncalled capital commitment.

Some points to be considered when reviewing side letters are:-

- Note any most favoured nation (**MFN**) provisions. These provisions give a limited partner (**subject limited partner**) the right to select that it will get the benefit of provisions that another limited partner has the benefit of and that are better terms than the terms that would otherwise apply to the subject limited partner. There are sometimes parameters to the exercise by the subject limited partner of its MFN right. For example, it may need to exercise its MFN right within a certain time period or the subject limited partner's MFN right may require it to accept a group of provisions that another limited partner has the benefit of relating to a certain issue and prevent the subject limited partner from "cherry-picking" only certain of those provisions.
- Note any provisions which modify the transfer provisions in the LPA.
- Note any confidentiality/confidential investor provisions.
- Note any sovereign immunity provisions. It is not unusual for institutional investors to be connected to the state, for example public body pension funds and sovereign wealth funds may make up part of the investor base in a fund. These entities may have sovereign immunity

protection by nature of their connection with the state under certain jurisdictions. The relevant investor may wish to reserve these sovereign immunity protections in a side letter, in line with its internal investment policy or other considerations. The impact of any sovereign immunity on the requirement for the relevant investor to comply with capital calls should be considered.

Conclusion

Along with the growth and maturity of the fund finance market, funds and their counsel have become increasingly familiar with lenders' LPA requirements. Therefore newer LPAs often include the provisions lenders would require in order to provide financing under a capital call facility. However, it should be noted that the above is not an exhaustive list of all points to be considered or all the issues that could arise on review of an LPA. There are also exceptions, especially where funds continue to use an older form of LPA, where the relevant provisions are not found in the LPA or, where issues of interpretation arise. Lenders and funds should seek the advice of their legal counsel on the relevant fund documentation on a deal by deal basis to ensure the relevant issues are sufficiently addressed in the fund documents at the outset of any proposed transaction.

This note focuses on traditional "capital call" facilities, as described above. Our fund finance teams in the Cayman Islands, Guernsey, Jersey and Luxembourg have seen the financing products made available to funds in the European and North America markets broadening to include net asset value/"NAV" facilities and "hybrid" facilities, which allow funds continuing access to leverage later in the fund cycle when most or all of the investor capital commitments have been contributed to the fund. Discourse of these products has begun in Asia and our Hong Kong fund finance team is also well placed to advise on these.

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