PRIVATE EQUITY FUNDS: SHOULD YOU BE THINKING ABOUT LIMITED PARTNER DEFAULTS?

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To Our Clients and Friends:

Given current market conditions, it is no surprise that private equity fund managers have been thinking seriously about liquidity concerns affecting the ability of their Limited Partners to make capital contributions -- an issue that less than a year ago was considered by most as only a theoretical possibility. And while the number of publicly reported significant defaults (or threatened defaults) by Limited Partners in major private equity funds has been limited to date, there is reason to believe that liquidity concerns will continue to challenge fund managers for at least the near future.

Even General Partners not experiencing funding issues may want to give some thought as to what actions can be taken in the event of a Limited Partner default or potential default. Of course, default terms for each fund partnership agreement are different, and each situation will likely involve unique and complex factual issues, so fund counsel should be consulted immediately in the event of a potential or actual default or any other funding-related issue.[1]

WHAT SHOULD THE GENERAL PARTNER DO IF A LIMITED PARTNER DOES NOT FUND (OR INDICATES THAT IT PLANS NOT TO FUND) AN OBLIGATION?

The three most important things to think about are: (*1*) how to cover the missed contribution to close a pending portfolio investment, (*2*) how to treat the Limited Partner and (*3*) how (and whether) to replace the Limited Partner's unfunded commitment.

Covering the Missed Contribution to Close the Portfolio Investment

Most partnership agreements permit the defaulted amount to be called from the other Limited Partners, although it is possible that the replacement amounts may not be funded before the scheduled closing. In addition, some funds impose caps on the replacement amounts that can be called from the non-defaulting Limited Partners; if the amount required would exceed the cap, it will be necessary to raise capital, perhaps either by seeking a waiver to the cap or identifying a co-investor to fund the acquisition.

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[1] *In preparing this memorandum, we have generally focused on Delaware limited partnerships, noting where English law takes a slightly different approach. As a general matter, Cayman Islands, which has limited case law in this area, would likely follow an English law approach.*

- Draw Down Early. It may be desirable to set drawdown dates sufficiently far in advance of a closing to avoid the risk of shortfalls due to a default. This will provide the extra time to issue a new capital call to fund the defaulted amount.

- Draw Down More than Required. Some General Partners routinely overcall to cover unforeseen contingencies at closing, including late Limited Partner contributions. The overcalled amounts are then returned or otherwise used if there is no default. This approach may not work if more than one Limited Partner defaults or the defaulting Limited Partner represents a large proportion of the fund's capital.

- Borrow the Defaulted Amount. Some fund partnership agreements permit short-term borrowing to cover the defaulted amount, whether from a third party or a General Partner affiliate. While timing considerations may make borrowing from a third party lender impractical, funds may be able to use existing subscription backed credit facilities to bridge the defaulted amount. Any amounts borrowed would then typically be repaid by a subsequent drawdown from the non-defaulting Limited Partners.

- Late-Funding Limited Partners. In some cases a Limited Partner may indicate that it plans to fund, but that it is unable to do so by the drawdown date. It may be possible to apply overcalled amounts from the other Limited Partners to cover the late contribution. Depending on the length of delay, it may be appropriate to require the late-funding Limited Partner to pay interest on its contribution (similar to investors admitted to a fund after the initial closing). If the delay persists, the General Partner may have to take more drastic action.

- Offset Distributable Amounts. If the fund is set to distribute amounts related to other investments, it may be possible to offset amounts distributable to cover the defaulted amount. The amounts would be treated as distributed, then recontributed to cover the unfunded amount.

Declaring the Limited Partner in Default

Most fund partnership agreements provide the General Partner with a wide range of remedies in the event a Limited Partner is in default, with the General Partner usually permitted to select among and apply any or all of them in its sole discretion. These rights typically include a forfeiture by the defaulting Limited Partner of 25% to 50% or more of its interests in the fund.

- Work Through Alternatives. It may not be necessary to declare the Limited Partner in default if the Limited Partner is cooperating with the General Partner to resolve a

liquidity issue or the Limited Partner is trying to identify a third party or an existing Limited Partner to assume its interest in the fund.

- Declare the Limited Partner in Default. In many cases, default is not automatic; the General Partner must deliver a default notice before it can declare the Limited Partner in default. Until the notice has been delivered and the Limited Partner given a chance to cure, a Limited Partner would typically not be considered in default. It is possible, however, that undue delay in issuing a default notice may foreclose the General Partner from declaring the Limited Partner in default. This may be true even if the fund partnership agreement expressly provides that failure to take action in these circumstances does not constitute a waiver of contractual rights.

- Reduce the Unfunded Commitment. In certain cases, Limited Partners have recently asked to have their commitments reduced. Generally, the General Partner does not have a unilateral right to compromise the Limited Partner's obligations and would have to obtain Limited Partner consent (100% unless the partnership agreement otherwise provides) to reduce an unfunded commitment. Any such undertaking would generally require the offer to be extended to all Limited Partners.

- Court Enforced Contributions. In theory, the General Partner may be able to convince a court to require a Limited Partner to honor its capital contribution obligations. Barring that, the General Partner should be able to sue for damages. However, General Partners have traditionally been reluctant to sue their investors, concerned primarily about the effects any such action might have on future fund raising. It is possible that under certain circumstances a General Partner may conclude that its duty to the other Limited Partners requires it to take action to enforce the terms of the partnership agreement.

- Enforceability of Default Remedies. Neither Delaware nor English law is entirely clear as to the enforceability of default remedies. As a matter of general principle, both Delaware and English courts are reluctant to interfere with the freedom to contract and will not strike out provisions agreed to by sophisticated parties. However, default provisions -- which in the closed-end fund arena provide the primary leverage against default -- are subject to particular scrutiny in many jurisdictions. In determining whether to apply the remedies in the fund partnership agreement, the General Partner should consult with counsel concerning applicable case law in the relevant jurisdictions.

Replacing the Unfunded Commitment

If a Limited Partner defaults, the size of the fund may be reduced by the amount of the defaulting Limited Partner's unfunded commitment. The reduction may impact the number

of investments the fund is ultimately able to complete, as well as reduce the management fee. (The other Limited Partners are in almost all cases not required to fund the defaulting Limited Partner's management fee; the defaulting Limited Partner might still be required to pay the management fee out of any forfeited portion of its interest, which would likely delay payment until the fund has distributable income.) If permitted under the fund partnership agreement, the General Partner may want to pursue replacing the unfunded commitment.

- Offer the Interest to Other Limited Partners. One possible source to replace the unfunded commitment is to offer it to the other Limited Partners. The fund partnership agreement generally governs whether it must be offered to all on a pro rata basis or can be offered only to certain Limited Partners. In some cases, liquidity-constrained Limited Partners who do not want to be declared in default have offered to sweeten the transfer by agreeing to pay additional amounts to the purchasers; if offered to the other Limited Partners, any such benefit should generally be offered to all on a *pro rata* basis.

- Offer the Interest to a Third Party. Most fund partnership agreements permit the General Partner to offer the interest to a new investor, in some cases instead of offering it to the other Limited Partners, in other cases only after the Limited Partners have declined the offer. Some General Partners have begun to establish relationships with one or more secondary funds who would have done their due diligence and be positioned to acquire interests in the event of a default.

WHAT ADDITIONAL CONSIDERATIONS MUST BE EXAMINED IN THE EXERCISE OF DEFAULT REMEDIES?

In the event of a default, the General Partner should also consider the following:

- Fiduciary Duties of the General Partner. The general partner of a Delaware limited partnership owes duties of loyalty and care. Although these duties may be limited contractually in the partnership agreement, at a minimum the general partner must act in good faith and deal fairly with the fund. The standard is somewhat higher under English and Cayman Island laws, which require the general partner to act in utmost good faith towards its limited partners. These standards may require the General Partner to consider a number of factors, including whether it is in the fund's best interest to declare the default, whether the non-defaulting Limited Partners have an interest in any amounts forfeited by the defaulting Limited Partner, whether defaulting Limited Partners must be treated equally, and so forth.

- Impact of Precedent. The General Partner must consider that any course of action it takes against the first defaulting Limited Partner may limit its ability to take a different course of action against similarly situated later defaulting Limited Partners. This can be particularly tricky when, as is often the case, the fund consists of multiple parallel vehicles in different jurisdictions with different legal standards and actions taken in one parallel vehicle might affect the remedies available in other jurisdictions. Also, "most favored nations" rights might limit the extent to which defaulting Limited Partners may be treated differently. In addition, any disclosure or other communications with the Limited Partners on this issue may restrict future courses of action; for example, if the General Partner has indicated that it will take a hard line on defaults, it may be difficult to later apply a more flexible approach.

- Treating Defaulting Limited Partners Differently. It may be possible to distinguish, for example, between a Limited Partner that defaults because it is on the verge of bankruptcy and a Limited Partner that threatens to default because it is triaging its various private equity fund investments. In the absence of some clearly delineated difference, however, in most circumstances it will usually be best to treat all defaulting Limited Partners consistently. It is also important to consider the anti-fraud provisions of the Investment Advisers Act.

WHAT ARE THE OTHER IMPLICATIONS OF A DEFAULT?

A default by a Limited Partner can also have an affect on other aspects of fund management, for example:

- Existing Credit Facilities. A failure to fund by a Limited Partner usually requires notice to the lender. This may be true even if the General Partner does not declare the Limited Partner in default. In addition, the default by a certain specified percentage of Limited Partners may trigger the acceleration of outstanding loans or the termination of the facility. In addition, the General Partner may be required to obtain the lender's consent for certain transfers of Limited Partner interests.

- Insurance Company Renewals. Most D&O insurance policies are renewed annually and will require the fund to identify any Limited Partner defaults. It is possible that a default may affect underwriting decisions, including pricing.

- Audited Financials/Other Reporting Obligations. The fund may be required to report the default of a Limited Partner (and the reduction in total fund commitments) on its

financial statements. The fund partnership agreement or side letters may also require material changes to be reported.

- Diversification Limitations. If the defaulting Limited Partner's unfunded commitment is not replaced, the reduced total commitments of the fund may affect the size of future investments.

- ERISA Considerations. If the fund limits benefit plan investors to less than 25% to satisfy ERISA, a Limited Partner default may require a recalculation to confirm that the fund is still in compliance.

- Voting and Representation on Advisory Committee. In almost all cases, a Limited Partner that defaults is no longer entitled to vote on fund matters and can be removed from the Advisory Committee.

- Limitations in the Event a Limited Partner Declares Bankruptcy. It is possible that the fund's remedies may be constrained in the event a Limited Partner declares, or is about to declare, bankruptcy.

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This memorandum addresses only some of the issues that should be considered in the event of a default or potential default of a Limited Partner in a private equity fund. Each situation will likely have its own unique facts and all actions should be carefully considered with the advice of fund counsel.

Please feel free to contact us with any questions.

New York

Sherri G. Caplan
+1 212 909 6994
sgcaplan@debevoise.com

London

Anthony McWhirter
+44 20 7786 9009
amcwhirter@debevoise.com

Hong Kong

Andrew M. Ostrognai
+852 2160 9852
amostrognai@debevoise.com