CADWALADER

Getting It Right: Recallable Capital Provisions

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As a way to increase the availability of uncalled capital and deploy additional capital for new and existing investments, limited partnership agreements will typically permit the general partner to recall proceeds from investments received by a fund borrower (a "Fund Borrower") and subsequently distributed by a Fund Borrower to its limited partners ("Fund Borrower LPs"). It is important for a lender and its counsel to review the recallable capital provisions in a limited partnership agreement in connection with a prospective or existing subscription credit facility (a "Facility"). Fund Borrowers usually request that a lender include recallable capital in the lender's calculation of remaining uncalled capital, which effectively increases the borrowing base and availability to a Fund Borrower under a Facility. Careful analysis and understanding of the recallable provisions and limitations in a limited partnership agreement is a prerequisite in responding to such a request. In this article, we will touch on a few categories of recallable capital commonly found in limited partnership agreements.

Unused Capital Contributions. When a general partner calls capital and the capital contributions are not used for the intended purpose, such as to make an investment in a portfolio company, or such investment is not consummated during a defined period of time, the limited partnership agreement will typically provide that the general partner may, in its sole discretion, return to the Fund Borrower LPs all or a portion of any unused capital contributions *pro rata* in accordance with such Fund Borrower LPs' respective capital contributions. In order for the returned capital to be included in a Facility borrowing base, it must be subject to recall by the general partner and considered callable capital again. The limited partnership agreement should clearly and explicitly provide that any such returned capital shall be added back to the unfunded capital commitments of such Fund Borrower LPs and considered uncalled and thus subject to recall by the general partner pursuant to the terms of the limited partnership agreement. It is also important to note, when reviewing a limited partnership agreement, any restrictions or limitations on the return of unused capital. A common limitation that we see is that unused capital must be returned within 60-90 days following the drawdown date for such capital. To the extent that any capital is returned and added back to the unfunded capital commitments of a Fund Borrower LP, such capital should be noted in a report detailing uncalled committed capital and in the borrowing base certificate used to calculate the borrowing base for a Facility.

Recycling Distributions. When a portfolio company of a Fund Borrower experiences a liquidity event, such as a sale of the company or an initial public offering, the Fund Borrower will receive proceeds realized from such liquidity event sale or disposition of the portfolio company securities. The limited partnership will grant the general partner the authority to either distribute such proceeds to the Fund Borrower LPs or retain such proceeds for certain purposes set forth in the limited partnership agreement. If, in the former case, the general partner distributes such proceeds to the Fund Borrower LPs and the limited partnership agreement provides that such distributions are to be added to the unfunded capital commitments of the Fund Borrower LPs and thereafter available to be called by the general partner, subject to any limitations or restrictions set forth in the limited partnership agreement, such returned distributions are commonly referred to as "Recallable Capital." In order for a lender to consider Recallable Capital as unfunded Capital Commitments of the Fund Borrower LPs and otherwise eligible under a Facility borrowing base, the limited partnership agreement must explicitly provide that the distributions made to the Fund Borrower LPs may be called again by the general partner according to the provisions of the limited partnership agreement as if such amounts had not been previously called and funded. To properly document and evidence any Recallable Capital, Lenders should request that Fund Borrowers provide copies of any distribution notice sent by the general partner to the Fund Borrower LPs, which notice should set forth the amount of such distribution, the increase to such Fund Borrower LP's uncalled capital and that such distribution is subject to recall by the general partner in accordance with the limited partnership agreement. Similar to the reporting for unused capital contributions, the Fund Borrower should certify to the Lender on a borrowing base report and a compliance certificate the amounts distributed to the Fund Borrower LPs, the increase to the Fund Borrower's uncalled capital, and that such amounts are available to be recalled by the general partner. These notices and certifications provide assurances to the lender that the Fund Borrower LPs know that their unfunded capital commitments have been increased by such distributions and that such distributions are subject to recall by the general partner to be used again by the Fund Borrower for any purpose, including the repayment of a Facility, permitted under and in compliance with the limited partnership agreement. Another important aspect for a lender to consider, when deciding whether to include Recallable Capital in the borrowing base, is whether any limitations or restrictions exist on the general partner's rights to issue a capital call for Recallable Capital. A few noteworthy limitations include: (i) sunset provisions that require the general partner to recall distributions within 18-24 months from the date of such distribution, (ii) that distributions to the Fund Borrower LPs must occur during the investment period of the Fund Borrower, and (iii) the general partner may only recall distributions to make investments in portfolio companies to the extent that the aggregate cost basis of all portfolio company investments does not exceed 120% of aggregate capital commitments of the Fund Borrower LPs.

Indemnity Recallable Capital. If the assets of the Fund Borrower are insufficient to satisfy any of the obligations or liabilities of the Fund Borrower (including any indemnification obligations of the Fund Borrower), a limited partnership agreement will sometimes provide that the general partner may recall, on a prorated basis, distributions previously made to the Fund Borrower LPs solely for the purpose of satisfying such obligations or liabilities. In addition, limited partnership agreements usually provide that the amount of such Recallable Capital shall not exceed the aggregate amount of distributions previously received by the Borrower Fund LP or a certain percentage of a Fund Borrower LP's capital commitment and for sunset provisions. Recallable Capital indemnity provisions typically also provide that such provisions do not inure to the benefit of any creditor of the Fund Borrower. For these reasons, Recallable Capital used by the Fund Borrower to satisfy indemnity obligations and other liabilities of the Fund Borrower should be **excluded from the Facility borrowing base** and clearly identified on a compliance certificate and borrowing base report as being excluded. Subscription credit finance lenders do not lend against this Recallable Capital for multiple reasons, including that limited partnership agreements do not explicitly contemplate this type of Recallable Capital being pledged as collateral or authorize the call by lenders in a default scenario, and Fund Borrower LPs do not expect or plan for such distributions to be recalled in practice (because they typically are not in fact).

Retained Capital. As mentioned above, a general partner may decide to retain the proceeds of a liquidity event instead of distributing such proceeds to the Fund Borrower LPs in accordance with the limited partnership agreements. Similar to Recallable Capital, a limited partnership agreement may provide for a general partner to cause its Fund Borrower to retain any proceeds realized on the sale or disposition of securities, but instead of distributing such proceeds to the Fund Borrower LPs and subsequently recalling such distributions, a general partner will retain and reinvest such proceeds in new or existing portfolio investments. In addition, if permitted by the limited partnership agreement, a general partner may also use retained distributions to satisfy subsequent capital contribution obligations of a Fund Borrower or other payments or obligations owed by a Fund Borrower. Even though a limited partnership agreement may treat such retained amounts as if the distributions were made to the Fund Borrower LPs and subsequently contributed as capital to the Fund Borrower for the purpose of reducing unfunded capital commitments of the Fund Borrower LPs, it is important to note that retained proceeds are not distributed and thus not subject to being recalled by a general partner. Consequently, for purposes of a facility borrowing base, despite the same intended use of liquidity event proceeds by a general partner, retained proceeds would not be considered Recallable Capital since the essential element of recalling such distributions is missing. A careful examination of the limited partnership agreement is needed to understand and analyze the differences between Recallable Capital and retained capital.