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LPAs 101 – Back to Basics

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As we enter back-to-school season and look forward to FFA U this fall, we thought a back-to-basics primer on the limited partnership agreement (the "LPA"), which is the legal and credit cornerstone of our product, would be fitting.

This article follows and is inspired by my colleague Fiona Cheng's "**Fund Finance 101 – Back to Basics**," which proved to be an extremely popular article in *Fund Finance Friday*. Here we will focus on a key area with respect to subscription credit facilities and the LPA, with perhaps future articles to build on Fiona's example for other areas of fund finance.

What Is the LPA and Why Is It So Important?

The LPA is the foundation for underwriting for any lender. It is also, along with the LPAs of parallel funds and feeder funds, the basis for the deal's structure. At its most basic definition, the LPA is the contract governing the relationship between the fund and its investors. From a banker's perspective, that is the relationship between your customer (the fund) and your collateral (the investor's subscriptions). It is hard to overstate the importance of this document from a credit perspective. Mastery of the LPA is essential to the career of any banker or lawyer on either side of a transaction.

The jurisdictions we see in fund finance – most commonly in Delaware, Cayman Islands, Ireland and Luxembourg – have corporate laws that allow parties to contract freely and to choose the terms by which the corporate entity may govern itself. (In our case, and to use the typical Delaware terminology, this corporate entity is a limited partnership with a general partner, and we will refer to it as such, but note this can be a Cayman-exempted limited partnership, a Delaware limited liability company, Irish ICAV, Luxembourg AIF … etc., but the features remain the same). This is why we can describe the LPA as a contract, freely chosen, between the general partner and the limited partners.

Market practice allows us to have expectations on what should be in the LPA for it to be "bankable." An LPA is bankable if it is able to support a subscription credit facility that is based ultimately on the payment of capital contributions by the investors to the fund, which are signatories to the LPA and bound by its provisions. The legal obligations of the investors to fund their uncalled capital commitment, and the various qualifications and incentives that may accompany that obligation to fund, are the focus of a credit analysis of the LPA from a financing perspective.

How to Read the LPA

Given the 101 scope of this article, we won't give an exhaustive legal guide on how to analyze the LPA. We should, however, have a clear idea of the bare minimum on what to look for and expect:

- First and foremost, we look for the general partner's power to "borrow and raise money" or similar such phrasing, which will likely be in the enumerated powers of the general partner or equivalent managing entity. The LPA may even specifically reference the ability to borrow money under subscription credit facilities, which is helpful.
- Once it is clear the general partner can borrow, we want to know if the LPA explicitly authorizes the general partner to pledge its rights to the capital commitments (*e.g.*, calling capital, enforcement rights, etc.). This authorization to pledge will be the legal basis for the security agreements that secure the debt of the facility.

- We want to know if the LPA specifically contemplates the fund setting up a subscription credit facility. LPAs have come a long way over the last decade: whereas in the past the market relied on investor letters, most sophisticated funds have specific subscription facility sections with enumerated lender protections. (We still sometimes require investor letters for single investor deals or where there is a credit-linkage issue or a fault in the LPA that needs to be corrected.)
- We always read the entire borrowing section and, if applicable, its discussion of subscription credit facilities; this is where some troublesome provisions can hide, such as leverage limitations and overcall limitations (more on this below).
- We must understand the nature of the investor's commitment to fund and if such commitment is without qualification. The canonical phrasing is, "do the investors agree to fund without setoff, counterclaim or defense?" (Rarely, this language will be buried in a subscription agreement, so if this is not in the LPA, don't panic until you have checked the subscription agreement to see if it's hiding there.)
- Some LPAs will contemplate debt and equity commitments, especially if the investors are in a rated note feeder fund. If this is the case, please escalate internally at both the business and legal level, as debt commitments require a special analysis due to their treatment in bankruptcy.
- Don't ignore my overcall. Is there an express right to call on non-defaulting/excused investors to make up funding shortfalls created by defaulting/excused investors? This is fundamental to the lender. That being said, we have previously reported that 38% of LPAs have some form of overcall limitation. See our prior article, **(Over) Call Me, Maybe**. The presence of an overcall limitation would likewise need to be elevated legally, as there may be ways of solving or addressing for such limitations in the loan documents (although not always).
- What is an overcall, you ask? We're looking for the general partner's ability to call on other investors to provide additional capital beyond what was initially called from that investor in order to make up for any shortfalls, including those caused by the failure of other investors to fund their commitment. We like this to be very explicit (unless an SMA deal, in which case there can never be an overcall given it's a fund of one).
- An overcall limitation is thus any limit on the general partner's ability to call for additional capital from investors once they have already funded their commitment (*i.e.*, it may be that the general partner can only overcall for a certain percentage in the event of LP default/excuse).
- Sometimes, even if there are overcall limitations, would debt repayment under the facility be carved out from the general limitation? (This carve out is sometimes via use of the defined term "Partnership Expenses" where repayment of principal and interest under a credit facility are referenced or even better a dedicated defined term tailored for a subscription credit facility debt.)
- Most LPAs will have explicit leverage limitations. The bank and the fund should understand these and make sure the credit agreement is expected to live within those limits and any other permitted fund level debt is within the bank's underwriting guidelines. The limitations themselves will be incorporated by reference via a negative covenant in the credit agreement.
- We will also want to ensure that the general partner has traditional powers against a defaulting investor. The greater and more draconian the general partner's powers, the more likely the investors are (that is, the more it is in the investor's interest) to fund their capital commitments so as to avoid the default consequences of the general partner's powers (loss of capital account, interest charges, sale at a discount significantly below par, etc.). Such powers are also pledged to the lender, who can expect to use them in an enforcement event upon "stepping into the shoes" of the general partner by way of the collateral documents and remedies section of the credit agreement.
- There are several other LPA considerations that are beyond the scope of a 101 article, including most favored nations clauses, key person events, cessation events, fund rights in an investor default including subordination to lenders, and the ability to call capital after investment period/dissolution, to name just a few. Even a "quick look" at an LPA to see if it's bankable requires the due diligence by a seasoned legal team who sees a broad base of the LPAs in the market.

Beyond the LPA: Side Letters

The LPA itself is not the last word on the subject. Institutional investors will often negotiate side letters that affect the terms of the LPA as it relates to that investor. The careful diligence of side letters is therefore a key aspect of underwriting the LPA's governing relationship. You can think of side letters as annotations to the LPA that say "except me," "but not this" and "only if that." You need to be careful and to read the LPA and side letters as a whole. The overcall limitation you made absolutely sure wasn't in the LPA? Well, it can be in a side letter (either at the first closing

or in a subsequent closing when the credit facility is already in place!) and that side letter provision may spread to other investors via a most favored nations provision in the LPA. The LPA and side letters need to be fully vetted and any material issues addressed in order to finalize the borrowing base for the credit facility and assure that, to the bank's satisfaction, the fund documents adequately support repayment from the investors in an enforcement scenario under the facility.

Conclusion

There probably isn't a more important document in the deal than the LPA (including the credit agreement itself). Senior practitioners in the market, having learned the basics above, never stop reading and thinking about LPAs, since they are so fundamental to our transactions. While this article is a brief and a basic overview, the diligence of the LPA is a fantastic opportunity for the lawyers and business teams to discuss the fundamentals of the transaction at its earliest stage. A baseline understanding of LPAs is critical to the structuring and execution of a facility.