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Fund Finance
Friday

Total Recall

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Recallable capital is a hot topic these days in both subscription financing and NAV financing transactions, both at industry events and in the press. There has been a good deal of attention to this concept in the NAV market in particular over the past few weeks. I recently attended an event for women in the private equity secondaries market and while making small talk over some (excellent) wine I happened to mention that I am a fund finance lawyer. Immediately, a number of people wanted to talk about recallable NAV loans – there was some urgency to the conversation and a bit of indignance.

As I will explain below, there are certain features of the current economic environment which have increased the focus on the rights of a general partner to recall distributions and the provisions in a limited partnership agreement that give rise to these rights. Although there has been some excitement over these provisions, it is the current environment that has brought these provisions – which are contained in nearly every limited partnership agreement ("LPA") – into focus, rather than anything particular to subscription or NAV financing arrangements generally.

Background

First, the basics. Under the terms of a fund's LPA, the general partner can call for and collect uncalled capital from investors. When funds invest and subsequently return distributions from those investments to investors, under the terms of the LPA, the general partner typically has discretion to earmark the distributions as amounts that replenish an investor's uncalled capital and are thus subject to recall by the general partner. These amounts are referred to as recallable capital. Another form of recallable capital (though not the main focus of this article) are returned capital contributions that are subject to recall. These are capital contributions made to the fund by investors that the fund ultimately decides to return to investors rather than deploy itself and under the terms of the LPA, may also be subject recall at a later date. Recallable capital gives a fund optionality in managing its business and serves as a way to increase the amount of uncalled capital available to be deployed for investments and other activities of the fund, such as repayment of debt.

As a base line, most LPAs provide for some amount of recallable capital. However, not all distributions to investors are automatically subject to recall. There are limits in terms of amount and time frame during which distributions may be recalled. This gives investors a degree of comfort as to how much and for how long distributions are subject to recall. This information gives investors the ability to either keep amounts in reserve or otherwise plan for a recall, as well as the ability to deploy resources when they have certainty that a distribution (or portion thereof) is no longer subject to recall.

On the lender side, for subscription finance lenders, when determining whether to give borrowing base credit to recallable capital, lenders also need to understand whether any limitations or restrictions exist on the general partner's right to issue a capital call for recallable capital in order to make a payment to the lender. You can read more in-depth coverage on this concept **here**. Common limitations in an LPA include (i) that the general partner may only recall an amount equal to a certain percentage of the investor's overall commitment amount (generally in the range of 20-25%), (ii) that recallable capital cannot in the aggregate exceed 100% of distributions made to the investor, (iii) a sunset provision where the general partner only has a right to recall distributions within 18-24 months of the distribution or the

end of the investment period, *etc*. (although we do see exceptions here, especially for the repayment of debt) and (iv) limitations as to the uses of the proceeds of recallable capital.

Now, some context and background. The last time I saw this much focus on recallable capital was during the first half of 2020 during the early COVID days. At that time, fund sponsors were thinking on their feet as they navigated the unprecedented pandemic, and that thinking resulted in many LPA amendments. One type of amendment that was popular at that time were amendments to increase the percentage of investor commitments that may be subject to recall or to extend the time periods by which returned capital may be subject to recall by the general partner. Even if sponsors did not directly access this additional capital from investors, this additional uncalled capital (*i.e.*, in the form or recallable capital) would potentially increase sponsors' borrowing capacity under the subscription facilities. As stated above, this gave funds additional flexibility in managing their investment activities and other businesses of the fund (as sponsors looked for access to liquidity to support distressed investments).

Recallable Capital in Fund Finance Deals Now

So how is recallable capital being accessed and leveraged today? The answer, unsurprisingly given the innovative minds in the fund finance industry, is in some interesting ways.

Recallable NAV loans is a term being used in the market to describe a transaction where a fund borrows under its NAV facility in order to make a distribution to investors. In the current market, many funds are holding onto assets longer, particularly real estate and buyout funds. As funds hold on to assets longer, that means that investors are waiting longer to receive distributions. If a fund borrows under its NAV line it has the ability to make distributions to its investors sooner. Some investors have been outspoken about the fact that some of these distributions may be recallable in some instances.

In the first instance, these transactions are just an example of a fund borrower utilizing its NAV facility to meet its liquidity needs within the constraints of the terms of the LPA investors signed up to. Investor notice and consent are not required with this approach. Generally speaking, distributions to investors will be accompanied by a distribution notice, which will inform each investor of the amount of the distribution that is deemed recallable, and the resulting uncalled capital of such investor. Some investors have expressed concern that where a distribution is recallable, the investor may need to set this amount aside or in some other way reserve those funds just in case they are recalled. Ultimately, the LPA is the road map here. As stated above, in order for any distribution to be recallable, it has to meet certain parameters. Generally, the general partner's right to recall recallable capital is more restricted than general rights to call uncalled capital.

Recallable capital is also featuring prominently in our subscription deals. We are seeing a number of amendments to credit agreements that are responsive to the current environment where funds are sticking around longer as they hold on to investments longer. Many subscription facilities have been in place for quite some time and the amount of uncalled capital is at a level where the availability under the subline is not meeting the liquidity needs of the fund. Generally speaking, where a fund is farther along in its life cycle and more fully invested, that is where we see funds utilize their investments for access financing using NAV and hybrid financing products.

While we are seeing a number of fund borrowers transition from subscription to hybrid or NAV deals, leaning on recallable capital has also been a way for a fund to increase borrowing availability – either with or without an additional financing product. In many instances we are amending credit agreements to give additional borrowing base credit to recallable capital. Doing this allows the fund to keep its subline otherwise largely undisturbed while also giving it additional availability under the line. In an example of the "best of both worlds" we have seen hybrid structures where fund borrowers have additional availability on the subline side of the house thanks to recallable capital while also looking to its NAV for further incremental availability.

Issues for Lenders to Consider

When a subline lender gives borrowing base credit to recallable capital, it should make sure that the credit documents in the deal contain certain recallable capital provisions and lender protections. To that end, generally speaking, borrowing base credit is only given to recallable amounts if (i) the borrower provides the lender with copies of the distribution notices sent to investors, which notices should inform each investor of the amount of the distribution that is deemed recallable, and the resulting uncalled capital of such investor, and (ii) the general partner certifies to the lender as to the amounts distributed, how much is deemed recallable and the resulting impact on uncalled capital. There will also be confirmation that such actions have been taken in accordance with the terms of the LPA. The notice to investors is critical to prevent any investor from claiming that its uncalled capital was unknowingly increased or that

they did not know the amounts could be subject to recall, and the certification as to compliance with the fund documents also helps to ensure that investors have no defense to the requirement to fund in response to a capital call for recallable amounts.

We are seeing a number of funds that have a subline in place after the investment period has expired. In these cases it is critical to confirm that the general partner has the right to recall distributions from investors after the end of the investment period in order to repay the subline.

Lenders are being cautious and making sure to get things right. We have even seen instances where lenders have requested and borrowers have obtained comfort letters from the investors affirming their obligation to repay recallable distributions if needed to repay a subline, despite the fact that LPA generally covered these rights and obligations.

Conclusion

It's always interesting when something picks up excitement and momentum the way that discussions regarding recallable NAV have recently. While on its face the recallable concept may seem surprising, when you break it down, it is just another example of fund managers balancing the competing forces of the economic environment and investor demands, using the financing products available to them to do it and doing so within the bounds of their fund documents. More than anything else, this shows the value and importance of investors – particularly the most sophisticated ones – really understanding the LPA they are subscribing to and the importance of open communication between sponsors and investors.