

## Feature

### KEY POINTS

- Typically a lender will take security by way of assignment (technically a form of mortgage over a chose in action).
- The parties may need to engage with the general partner of the limited partnership to address any consent requirements under a limited partnership agreement.
- There are numerous issues for lenders to take into account when looking to realise their collateral through the sale of a limited partner interest.

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# Enforcing security over limited partner interests in English limited partnerships

In this article the authors look to analyse and explore some of the key issues for lenders when taking and enforcing security over a limited partner interest in an English limited partnership, limiting their analysis to matters arising under English law.

## INTRODUCTION

Although many types of financings involve the securing of limited partner (LP) interests by way of collateral for a loan facility, the proliferation of NAV facilities in the fund finance industry in recent years has seen the use of this form of collateral rapidly expand as lenders seek to take security over portfolios and investments which are often held via one or more limited partnership vehicles. There are numerous reasons for this, including:

- the continued growth and maturity of the secondary market for private equity and related asset classes means that credit providers are now more confident that there is a liquid market for the sale of these interests if necessary;
- in the context of a secondary financing or multiple investments held via a limited partnership vehicle, a diversified underlying portfolio asset offers reduced concentration risk for credit providers; and
- historically there has been a very low risk of default and/or enforcement of this type of security – in fact, to our knowledge, there are no examples of enforcement over collateral consisting of an LP Interest in the context of a European fund finance transaction.

However, the absence of practical examples of an enforcement of this type of collateral means that there is very little literature on how an enforcement is achieved and the practical legal and commercial considerations that this involves. Whilst the issues highlighted may be relevant in multiple

jurisdictions, this article is limited to matters arising under English law which apply to LPs in English limited partnerships governed by the Limited Partnership Act 1907 (the Act).

## WHAT IS AN LP INTEREST?

An English limited partnership's partners are split into two categories: limited partners and the general partner (GP). A GP is responsible for managing the business and operations of the limited partnership and has unlimited liability for the debts and obligations of the limited partnership. An LP, on the other hand, is essentially a passive investor in the fund which has limited liability up to the level of its capital commitments provided it does not play an active role in the operation and management of the limited partnership. Each limited partnership will be governed by its limited partnership agreement (LPA) and each LP which is or becomes a party to this agreement will be recorded in the register of limited partners maintained by the GP and hold a limited partner interest in the limited partnership (the LP Interest). The limited partnership also has the benefit of being fiscally transparent. For UK tax purposes, this means that the limited partnership is disregarded (sometimes referred to as being "looked through") and is not treated as an entity that is separate and distinct from its partners.

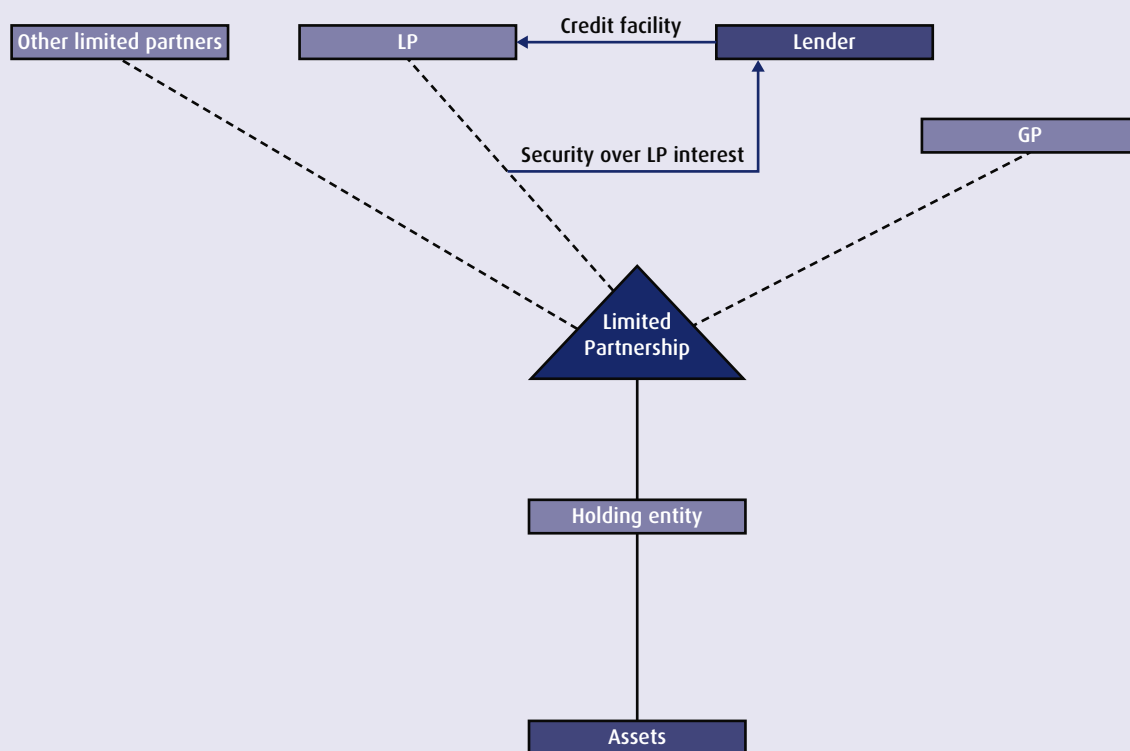
The rights attached to the LP Interest will be set out in the LPA. Broadly speaking, these rights will be similar to those granted to a shareholder in a limited company: an entitlement to distributions, voting rights (albeit limited only to certain key matters) and the ability to transfer and sell that

interest in accordance with the terms of the LPA. The LP has corresponding obligations towards the limited partnership including the obligations to advance all or part of its commitment provided that the various conditions to funding in the LPA (and any side letter entered into between the LP and the limited partnership/GP) have been met.

## HOW TO TAKE SECURITY OVER AN LP INTEREST

A lender will typically take security either by way of a charge or an assignment over the LP Interest, together with all ancillary rights (including the right to receive any distributions payable to the holder of the LP Interest). Typically a lender will take security by way of assignment (technically a form of mortgage over a chose in action). Note that, unless the security is taken by way of novation, the lender will only be able to take security over the LP's rights under the LPA – the LP's liabilities under the LPA are not assignable. Taking an assignment may be preferable to taking security by way of charge as the enforcement of security by way of an assignment involves a transfer of title to the lender. If the lender is able to take a legal assignment of the LP's rights under the LPA the lender will be entitled to sue the limited partnership in its own name. This would not be the case where the lender takes a charge over the LP Interest, as it would only have the right to appropriate the moneys raised from the LP Interest towards repayment of the debt secured. Equally, certain statutory rights applicable to mortgages will not apply where the security is taken by way of charge. However, practically speaking, the differences between these forms of security may be of limited significance where the various enforcement rights are contractually agreed in the security documentation.

DIAGRAM 1:



It is important that the parties check the terms of the LPA in order to determine whether the LP is contractually entitled to grant security over its LP Interest. If this is not permitted under the terms of the LPA, or if the consent of the GP is required, there may well be adverse consequences arising under the LPA as a result of the LP breaching the terms of the LPA including, for example, restrictions on the right to receive distributions. It is common for the LPA to require the GP to consent to any “Transfer” of an LP’s LP Interest and, depending on the drafting in the LPA, a “Transfer” may be defined so as to cover a sale, assignment or transfer as well as any “pledge, hypothecation or other disposition or encumbrance”. Clearly, this language will mean the consent of the GP is required to the creation (and enforcement) of the security and the parties will need to obtain this as part of the conditionality to the financing.

Whilst obtaining consent to the creation of the security is, typically, relatively straightforward, obtaining consent to the

enforcement of the security can be more challenging. A GP has a fiduciary duty to act in the best interests of all of its LPs and will need to be comfortable that any transfer resulting from an enforcement does not result in any adverse legal, tax or regulatory consequences for the limited partnership and its LPs. To the extent that the LP has unfunded commitments at the time of any transfer, the GP will want to be comfortable with the creditworthiness of the transferee LP. In addition, a GP may be subject to other contractual restrictions, for example, existing LPs may have a right of first refusal to acquire any LP Interest before it can be sold to a third party. Equally, if the limited partnership has a “subscription line” or “capital call facility” in place, this may impose restrictions on the GP’s ability to approve LP transfers without the prior consent of the lenders under that facility.

As a result, we often see a compromise position whereby:

- the GP confirms that, in an enforcement scenario, it will not unreasonably withhold or delay its consent to a

transfer provided that such transfer will not result in the GP breaching the terms of the LPA; or/and

- a pre-approved “white list” of potential purchasers is agreed in respect of which the GP agrees it will not withhold its consent. This list might include, for example, the lender and its affiliates or investors that have previously invested with the GP or which might be a source of primary capital in relation to future fundraisings.

### ENFORCEMENT STRATEGIES

Generally, an enforcing lender may be entitled to take any of the following actions:

- appoint a receiver (provided it has a statutory right to do so or a contractual right under the terms of the security documents);
- exercise its right to take possession of the LP Interest by assuming the benefit of the LP’s rights under the LPA (in particular, its rights to distributions); or
- exercise its power of sale and sell the LP Interest.

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A receiver will generally have the right to take possession of, deal with and sell the LP Interest as well as exercise any of the LP's rights in respect of the LP Interest. The security document will typically set out the order in which the receiver must apply all monies received by it.

Where the security is taken by way of assignment or charge, the enforcing lender will only take security over the rights, and not the obligations, of the LP. As such, the lender will typically want the security to provide that it has certain "step-in" or cure rights which entitle it to "step into the shoes" of the LP and cure any payment default which might exist under the LPA. If the LP is still liable to the limited partnership in respect of its uncalled commitments or recallable distributions, the lender may want to ensure that the LP meets those obligations so it is not treated as a "Defaulting Limited Partner" under the LPA. The GP will typically have a range of contractual remedies which it can exercise against an LP which fails to meet its payment obligations under the LPA, including restricting its rights to distributions.

It should be noted that the LP will generally have an equitable right of redemption meaning that either:

- it will be entitled to be re-assigned its rights to the LP Interest where the lender (or receiver) has taken possession of the LP Interest and the secured liabilities have been discharged; or
- if the lender (or receiver) has exercised its power of sale, the LP will be entitled to any surplus arising from the sale proceeds once the secured liabilities are discharged (assuming there are no prior ranking creditors with an interest in the asset).

The enforcement strategy contemplated by the enforcing lender(s) will be driven by the nature of the financing and the number of LP Interests secured. On enforcement, the lender(s) enforcing their security may look to "cherry pick" certain LP Interests that are particularly valuable and/or considered more liquid and sell these individually. Alternatively, the enforcing lender(s) may prefer to sell the entire portfolio of LP Interests.

### HOW TO SELL AN LP INTEREST

Whilst there have been, to our knowledge, no examples of LP Interests being sold as a direct result of an enforcement process in the context of a fund finance transaction, any such sale would most likely be effected in the same way as a typical "LP led" sale in the secondaries market through an auction process. This is not only market practice but would likely assist an enforcing lender (or receiver acting on its behalf) in demonstrating that the enforcing lender has discharged the following common law duties which arise when exercising the power of sale:

- to act in good faith;
- to take reasonable steps to obtain a price for the asset;
- to obtain the best price reasonably obtainable;
- to act with reasonable care and skill; and
- to act fairly towards the LP borrower.

Although security documents typically attempt to remove the application of these duties, the effectiveness of those exclusions of liability is questionable (*Bishop v Bonham* [1988] 1 WLR 742) and a prudent lender will need to consider such duties carefully when exercising a power of sale.

The specific details of an LP-led auction process are beyond the scope of this article but the fundamental steps involved are, generally, as follows:

- **GP consent and preparation:** Obtaining GP consent and disclosing information packs to prospective purchasers (once they have signed an NDA).
- **Auction process:** Prospective purchasers will be invited to make initial indicative offers for the LP Interest(s). A shortlist of potential bidders is selected and provided with further confidential information so as to enable them to properly due diligence the underlying limited partnership(s). The draft sale and purchase agreement (SPA) is circulated to prospective purchasers for comment alongside details of their final bids.
- **Selection of winning buyer:** Buyer and seller exchange the SPA. Note that if existing investors in the limited partnership have a right of first refusal to

acquire the LP Interest before any third-party purchaser, the GP will need to run that process and allow for any potential transfers to those existing investors before the SPA can be executed.

- **Transfer documentation:** The lender, GP and purchaser will negotiate and agree the relevant documentation needed to effect the transfer of the LP Interest to the buyer. This may take the form of a transfer agreement or deed of adherence pursuant to which the purchaser will agree to be bound by the terms of the LPA.

There are numerous issues for lenders to take into account when looking to realise their collateral through a sale of an LP Interest in a third-party managed limited partnership. Some of the key points to note are as follows:

- **Confidential information:** In addition to obtaining the GP's consent to the transfer itself, the enforcing lender may need to obtain the GP's consent to disclose certain confidential information relating to the limited partnership to prospective purchasers, including financial statements, LPA, any private placement memorandum, capital account information and information relating to the calculation of the net asset value of the limited partnership. A prospective purchaser may also want the opportunity to speak to the GP directly as part of its due diligence process. Alongside the commercial terms of any sale, the outcome of the due diligence process is essential in determining what a prospective purchaser will pay for the LP Interest and how they value that asset. In light of this, when taking security over an LP Interest, lenders may also seek assurances from the GP that it will be entitled to disclose this information to prospective purchasers provided that they have entered into a confidentiality agreement on terms acceptable to the GP.
- **Valuation:** There will be various factors which influence the sale price, including market conditions at the time of sale, the value of the assets, as well as the

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quality of the GP managing the limited partnership. Generally, case law suggests that it does not matter that the time of the sale may not be the most optimum (*Tse Kwong Lam v Wong Chit Sen* [1983] 1 WLR 1349). Equally, if the enforcing lender were to sell the asset to an entity in respect of which it holds an equity interest, it would need to show that the sale was made in good faith and that reasonable precautions were taken to obtain the best price reasonably obtainable at the time of the sale (*Den Norske Bank ASA v Acemex Management Co Ltd* [2003] EWCA Civ 1559).

- **Allocation of liabilities (other than tax):** When determining the sale price, the liabilities owed by the LP borrower to the limited partnership will be taken into consideration as part of the sale and purchase negotiations and the expectation will be that the purchaser will assume all of the unfunded commitments of the transferring LP borrower.

**TAX**

The UK taxation treatment of the enforcement of security by a lender is a complex area. Any tax treatment will be specific to the facts of each transaction. As stated above, a lender may appoint a receiver to effect a sale of the LP Interest to another LP or to a third party purchaser, or may exercise its right to take possession of the LP Interest. In the former scenario, the beneficial ownership of the LP Interest will not transfer to the lender, but the lender will benefit from the proceeds of such transfer. In the latter scenario, as a limited partnership is treated as transparent for tax purposes, where a lender wants to take possession of the LP Interest on an enforcement, the tax treatment of the lender, as purchaser of the LP Interests, will depend primarily on the type of assets comprising the LP Interests, as the lender will be treated as if it is acquiring those assets directly. We have broadly considered the tax issues arising on such enforcement scenarios below.

- **Shares in underlying holding or portfolio companies (or other marketable securities):** For all tax purposes, the key tax exposure for a

lender on a purchase of an LP Interest consisting of shares or marketable securities will be stamp duty at 0.5% on the sale price of the shares. In the current context, while the legal ownership of the shares would remain with the limited partnership, the beneficial ownership of the shares would have transferred from the selling LP to the lender. As a consequence, a stamp duty charge will be triggered on the document transferring the beneficial ownership. Where the LP Interests comprise of shares in non-UK underlying holding and portfolio companies, it may be possible to structure the transfer of the LP Interest to the lender so that it is outside the scope of UK stamp duty if the lender enforces security through a non-UK entity in its group and the share registers of those holding and portfolio companies are maintained outside of the UK. However, this will need to be considered on a commercial and practical basis in each case, as the cost of the stamp duty may not be high enough to justify such a transactional arrangement.

- **Other assets:** If the LP Interests consist of other, capital, assets (such as rights in underlying partnership funds or directly held interests in real estate), the lender will need to consider the tax treatment of the transfer of each asset in turn, with a particular attention to property-based stamp duties and stamp taxation, and VAT.
- **Sale price:** Structuring the sale price for the LP Interests will also require consideration from the tax perspective of both the purchasing lender and the selling LP. Where the sale price relates to an LP Interest comprising shares or other marketable securities which would attract stamp duty on transfer, the inclusion of elements of the sale price that are contingent on future events can affect the amount of stamp duty payable. In addition, tax liabilities of underlying portfolio companies can affect the value of shares in such companies, which in turn can affect the value of the LP Interest subject to the purchase by the

lender; any specific tax liabilities of the underlying portfolio companies relating to the period of ownership by the LP and that are known about at the time of the transfer (other than stamp duties on transfer of real estate LP Interests, which would be borne by the purchasing lender) may be priced into the upfront sale price. Equally, the limited partnership seller may want value for any tax credits that are due to the underlying portfolio company. Where the LP Interest is being sold to another LP or a third-party purchaser, it will be important to consider the position of the lender who will be receiving the proceeds of the sale in satisfaction of its outstanding loan. This may result in a loan relationship credit or debit for the lender.

- **Limited partnership's sharing ratios:** For any transfer of the LP Interest to the lender, another LP or a third party, the application of Statement of Practice D12 (SP D12) will need to be considered in detail. Where applicable SP D12 supplements the UK legislation on the taxation of capital gains and allowable capital losses, and the determination of base cost attributable to any LP purchasing the transferred LP interest.
- **Allocation of tax liabilities:** Where the LP Interest includes shares of underlying portfolio companies, an additional tax consideration is the allocation of tax risks and tax liabilities between the selling LP and the purchasing lender. A lender will not want to inherit historic tax risks and liabilities of the underlying holding and portfolio companies. Tax concerns are most likely to relate to tax risks and contingencies for the period of ownership of the shares of the underlying companies by the limited partnership, as full tax protection is likely to have been obtained by the limited partnership on prior acquisitions from previous owners. The purchasing lender would expect to be indemnified by the selling LP in respect of such tax risks and contingencies. In the event that specific tax risks relating to the LP Interests are identified in respect of which the

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purchasing lender wants additional protection (for example where the LP is in financial difficulty itself), tax insurance policies can be sought to cover such risks; lenders will have to pay a premium (and any policy excess) but policy pricing can be competitive, particularly when weighed against the costs involved in negotiating and claiming under a tax indemnity from a seller.

## REGULATORY ISSUES

Regulatory considerations on enforcement are largely driven by the nature of the underlying assets held within the limited partnership.

- **Change in control:** On an enforcement of a security interest that entails a transfer of beneficial ownership of an LP Interest that involves a controlling stake in a regulated financial services entity, consideration will need to be given as to whether a change in control application is required. Section 178 of the Financial Services and Markets Act 2000 requires any person who decides to acquire or increase control over a UK authorised person to obtain the prior consent of either the Financial Conduct Authority or the Prudential Regulation Authority, depending on which of those bodies has authorised the controller. Control generally starts at 10% and moves through bands of 20, 30 and 50% (though for certain firms such as payment services providers and consumer credit firms there is a single control band of 20%) and the regulator's approval must be obtained in advance of the acquisition of the relevant controlling stake. This means that exercising security over an LP Interest that holds a controlling stake in a regulated firm will require regulatory approval before the beneficial ownership of that LP Interest passes to the enforcing lender.
- **Acquiring publicly traded shares:** If on enforcement a transfer of beneficial ownership of a limited partnership which includes interests in publicly traded shares takes place, the enforcing

lender will need to consider whether or not that transfer has taken place while it is in possession of inside information about the issuer of those shares in order not to incur liability under Pt V of the Criminal Justice Act 1993 or the UK version of the Market Abuse Regulation (Regulation (EU) No 596/2014) for insider dealing. Additionally, and depending on the particular shareholding in question, the enforcing lender may also want to consider whether it is obliged to make disclosures under the Takeover Code or Pt 5 of the Financial Conduct Authority's Disclosure Guidance and Transparency Rules sourcebook which requires notification of major shareholdings.

- **Draft Economic Crime and Corporate Transparency Bill:** Part 2 of the Act applies disclosure obligations to limited partnerships and their LPs to the registrar of companies. While the information to be disclosed concerning LPs is basic in nature, there is nothing in the Act to suggest that an LP who has assumed their partnership interests as a result of exercising a security interest would be exempt from the requirement to make the disclosure.

## CONCLUSION

The increasing volume of loan facility collateral comprising security over LP Interests demonstrates the need for advisors, lenders and borrowers to fully understand the legal and commercial considerations surrounding the taking of such security and its enforcement. Whilst the legal form of security and its perfection is fairly straight-forward, the commercial dynamics between the parties are important drivers of what may be achievable in an enforcement scenario. Whether we will see any live examples of this in the future in the context of fund finance transactions remains to be seen. In any event, the need for understanding the intricacies surrounding this type of collateral will continue to be of growing importance to lenders. ■

## Further Reading:

- Legal conundrums: taking security from English limited partnerships (2022) 8 JIBFL 524.
- Structures, security and finance products: the increasingly sophisticated world of investment fund focussed borrowing (2021) 1 JIBFL 46.
- Lexis+® UK: Banking & Finance: Article: Taking security over fund interests: miracle cure or more of the same for borrowers.