CADWALADER

Total Recall

July 9, 2021 | Issue No. 134

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Getting It Right: Recallable Capital Provisions

July 9, 2021 | Issue No. 134

By Chad Stackhouse
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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.

LIBOR Transition Update: SOFR Spotted in the Wild

July 9, 2021 | Issue No. 134

By Leah Edelboim
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We have been talking about the LIBOR transition a lot lately, whether **here** in *FFF,* amending deals to contemplate the benchmark transition or working with our clients to determine the best way to address the move away from LIBOR in their credit documents.

As you may recall, the Alternative Reference Rates Committee (the “ARRC”), a group of private-market participants convened by the U.S. Federal Reserve and the New York Fed to help ensure a successful transition to a new reference rate, recommended a move to the Secured Overnight Financing Rate (“SOFR”). The ARRC has also recommended that parties stop originating LIBOR-based loans by the end of June 2021. Giving parties a bit more time, U.S. banking regulators have advised that lenders should stop originating USD LIBOR loans at the end of 2021. Nonetheless, the transition has been slow, and it seems the market has taken some comfort in the fact that one-month, three-month, and six-month LIBOR are all expected to be around until the end of June 2023.

So the end of June 2021 has come and gone, and both here in the fund finance space and in the broader loan market, lenders continue to originate LIBOR-based loans. These agreements, in accordance with ARRC recommendations, do tend to include fallback language indicating which benchmark the parties would look to when LIBOR ceases to be available. In general, this fallback language contemplates a SOFR-based rate as the replacement benchmark rate.

As we crack into the second half of 2021, this may all be changing. Just over a week ago, the first U.S.-based broadly syndicated multi-billion dollar deal tied directly to SOFR was announced. Ford Motor Company plans to refinance all of its credit facilities, and it plans to use SOFR as the benchmark. The credit facilities in question come to an aggregate amount of about $15.4 billion. While there have been a number of bilateral SOFR-based loans, this will be the first loan of this caliber to come out of the gate tied to SOFR.

The LSTA has indicated that this may indeed be the beginning of a trend. In commenting on the Ford deal announcement, LSTA said that this development was not surprising and that we may see many more broadly syndicated loans that are not based on LIBOR still to come this year.

The bottom line: SOFR is really here, and it may not be *too* much longer before we start seeing fund finance deals pegged to SOFR.

FFA Statement on Diversity and Inclusion

July 9, 2021 | Issue No. 134

The FFA's Board of Directors this week issued a statement on the FFA's commitment to diversity and inclusion. Special thanks to Natasha Puri for her guidance to the Board in the preparation of this statement, which is available **here**.

New Fund Fanatics Episode

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Scott Aleali and Jeff Maier of First Republic Bank put out another episode of “Fund Fanatics” on LinkedIn this week, this time with guest Lori Gleeman, Founder and CEO of Soul Equity Solutions, to discuss the surge of activity in the market along with the development of ESG mandates. To watch the clip, click **here**.

Joint Morgan Stanley, Oliver Wyman Report Points to Further Private Market Growth

July 9, 2021 | Issue No. 134

High net worth investors may allocate an additional 5% of their portfolios to private markets by 2025 to drive $1.5 trillion in additional AUM growth for the industry, according to a **joint report** by Morgan Stanley and Oliver Wyman. Other key drivers for private market growth in front of wealth and asset managers include ESG, crypto, and technological innovations that will permit scalable customization in private sector investment strategies.

As we've previously highlighted, the relative attractiveness of the generic 8% preferred return in a private fund is at historic highs compared against Treasury yields, investment-grade debt and high-yield bonds. The Morgan Stanley/Oliver Wyman report affirms the view that private market allocations are likely to increase across the board for all investor types.

High net worth investors, including aggregation vehicles, are routinely included in subscription facility borrowing bases, subject to eligibility criteria. Inclusion of these investors, however, is limited by individual and aggregate concentration limits. Over time, greater high net worth participation may test lenders' willingness to be more accommodative to such investors.

Pension Fund PE Allocations Under Criticism

July 9, 2021 | Issue No. 134

PitchBook **recently detailed** the criticisms of private fund allocations and realized performance that have been leveled at Pennsylvania Public School Employees' Retirement System and at the State Teachers Retirement System of Ohio. The two pension funds face separate issues, but for pensions generally, fees paid to private fund managers tend to come under scrutiny when investment performance lags broader markets. Unfortunately, such scrutiny doesn't always consider risk-adjusted returns or overall portfolio diversification.

Cadwalader Shortlisted for The Drawdown Awards 2021

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Cadwalader's Fund Finance Team has been shortlisted for The Drawdown Awards 2021, named as a finalist in the "Fund Financing: Advisory Services" category. The winners will be announced at an awards ceremony on September 23 in London.

The awards recognize excellence and innovation within private capital fund operations, including service providers that have demonstrated expertise and provided standout client service to the private equity funds community.

In 2020, Cadwalader received The Drawdown's "Advisory/Consultancy Fund Finance Award."

The GP category finalists will be announced next week. The full list of service provider finalists is available **here**.

The Drawdown, which is part of Real Deals Media, provides insight and analysis for operational professionals in private equity and venture capital.

Fund Finance Hiring

July 9, 2021 | Issue No. 134

Fund Finance Hiring

The Goldman Sachs Asset Management team in New York is hiring an analyst to join its Alternative Capital Markets & Strategy (ACMS) Fund Finance team. For more details or to apply, please check out the GS careers **site**.

Morgan Stanley Private Bank is hiring for a Vice President - Wealth Management Risk - Credit Underwriter in its Capital Call Subscription Financing group. For more information, click **here**.