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Lending to Limited Partnerships against Uncalled Financial Commitments

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Introduction

This paper briefly sets out the law and practice to be considered by a lender in making facilities available to a limited partnership ("**LP**") secured against the uncalled financial contributions of the LP's limited partners, and seeking their repayment. Such a facility may also be used to bridge the portion of investments made by a fund which is to be financed eventually from capital contributions which the investors in the fund are required to make to such fund, in which case it is known as an equity bridge facility or capital call facility. The majority of this paper is from the perspective of English law. However, we touch briefly below on issues to be considered when lending to an overseas LP.

Background: What is a Limited Partnership?

A UK LP is a type of partnership set up pursuant to the Limited Partnerships Act 1907. Save in the case of an LP formed and registered in Scotland, it does not have a separate legal personality. Subject to the provisions of that Act, the provisions of the Partnership Act 1890 and general legal rules governing partnerships apply.

An LP is comprised of, at least, one general partner ("**GP**"), who has unlimited liability for the LP's debts and obligations and is responsible for the management of the LP, and one or more limited partners, who are effectively investors who benefit from limited liability but are prohibited from becoming involved in the management of the LP. If they contravene this prohibition, they will forfeit their limited liability. Unlike a limited company or an LLP formed under the Limited Liability Partnerships Act 2000, a limited partnership is not a separate legal entity, save as mentioned above. It is instead a form of partnership which, subject to compliance with certain strict conditions, affords limited liability to the limited partners. The GP is often itself a limited company.

Each limited partner is required on admission to make a contribution of capital to the LP, the amount of which must be quantified in cash and registered at the UK Companies Registry. It may also agree to make additional contributions of capital in instalments throughout the life of the LP, although these will not be registered until they are actually made. Alternatively it may agree to make future loans or advances to the LP which will not constitute part of its capital even when made and do not require to be registered. Therefore at any one time it is likely that each limited partner will have outstanding contributions which are or will be owed to the LP but which have not yet been called by the GP. These uncalled contributions are, in one sense, assets of the LP albeit that the LP's right to enforce those contributions on a true analysis belongs to the partners who include the limited partner who is so bound. It is on the security of these assets that a lender may agree to lend.

LPs are the vehicle of choice for private equity funds. This is largely due to the three main advantages (in addition of course to limited liability) of the LP, which are as follows:

a. the content of the partnership agreement which governs the relationship between the partners is only lightly regulated;
b. LPs have a high degree of flexibility as they are free from many of the legal constraints and formalities that usually apply to corporate entities; and
c. since LPs are recognised as partnerships, not corporations, under UK domestic tax law they have "fiscal transparency": the partners are treated for tax purposes as having invested directly in the underlying partnership assets, with limited or no taxation of the LP itself.

However, it is likely that an LP will be an unregulated collective investment scheme under the Financial Services & Markets Act 2000, and may accordingly require the involvement of a person authorised by the Financial Conduct Authority ("**FCA**"). Therefore in practice the GP must either be an FCA authorised entity or the LP must be managed by such an entity.

Lending to an LP

Documentation generally

As discussed above, the management of an LP must be undertaken solely by the GP (or, if more than one, the GPs together). It is therefore necessary to ensure that any loan or security documentation is executed by the GP on behalf of the LP so as to bind the limited partners (but not so as to make inroads into their limited liability). If there is more than one, it is good practice to ensure that all GPs execute the documents or at least that one GP has the requisite authority to execute the document on behalf of all, especially where deeds are involved. In practice, given that many LPs will be unregulated collective investment schemes invariably the GP will delegate management of the LP's investments to an FCA authorised manager. It is accordingly important that the role of the manager is factored into the documentation taken by the lender.

Preliminary steps

Partnership Agreement

One of the most important steps that the lender must take when lending to an LP against uncalled financial contributions, as part of its due diligence on the LP, is to review the partnership agreement. The key matters to confirm in this regard include:

a. the amount of the LP's fixed capital (i.e. the capital to be contributed by the limited partners on registration of the LP at the UK Companies Registry) and the amount by which it has been increased since registration;
b. the obligation on the limited partners to make non-capital contributions;
c. when the uncalled contributions are payable (i.e. when the GP is entitled to make calls);
d. who is entitled to make the capital calls. Normally this will be the GP but sometimes the right will be delegated to a manager in the partnership agreement;
e. the status that the uncalled contribution will have once made. If payable as an advance, the lender will need to be satisfied

that the advance will be subordinate to its loan (happily case law assists here - see below);
e. the ability of the limited partners to transfer or cancel their commitments;
f. that the GP has the power to borrow money and grant security over the right to the uncalled contributions;
g. whether the grant of security will affect the status of the contribution once made;
h. any special terms allowing a limited partner to be excluded from making a contribution;
i. the terms on which new general partners or limited partners may be admitted to the LP or retire from the LP, whether by assignment or otherwise;
j. the ability to expel a limited partner and the financial consequences of so doing;
k. the manner and terms on which the LP can be dissolved;
l. the terms of any side letters or subscription agreements.; and
m. the terms of any management agreement whereby the GP has delegated its powers to an FCA authorised manager.

In addition, in case enforcement becomes necessary, the lender may want to investigate the possibility of amending the partnership agreement such that the uncalled contribution becomes payable on a dissolution of the LP or on the occurrence of an event of default under the loan agreement. Whether or not the LP will accept such an amendment to the partnership agreement will depend largely on whether the lender is the LP's only or primary source of funding (other than the capital and other contributions of the partners). Normally a lender can expect strong resistance to any proposed amendment.

Search at the UK Companies Registry

The lender should also make a search against the LP at the UK Companies Registry to check that it is duly registered, the registered particulars of the LP (including details of the GP and the limited partners and the capital amounts contributed by the latter) and the duration of the LP.

Loan Agreement

When drafting the loan agreement, apart from reflecting the terms of the credit committee's approval/term sheet, the following points should be noted:

a. subject to any delegation by the GP to a manager, it is the GP which contracts on behalf of the LP so that the GP will accept and sign the loan agreement on behalf of the LP;
b. the lender may require financial covenants not only in respect of the LP, but possibly also in respect of the limited partners on whose contributions it will be relying;
c. the lender will wish to consider including in the events of default cross-defaults in relation to the limited partners upon whose contributions it is relying; and
d. the lender will wish to consider including additional representations and covenants taking account of the specific provisions of the partnership agreement.

The lender will wish to include prohibitions on the LP/the partners (without its prior written consent):

a. varying the terms of the LP agreement;
b. assigning a partnership share (whether by the GP or a limited partner);
c. admitting new partners and expelling existing partners;
d. incurring any indebtedness apart from under the lender facility and advances/loans by limited partners; and
e. granting any security interest over its property or assets, save for the security granted to the lender. Note that this type of negative pledge cannot be registered so that third parties would not have notice of it unless they saw a copy of the loan agreement.

Subject to the above, the loan agreement is likely to be in fairly standard form, but with various "add-on" provisions reflecting the status of the borrower as an LP. For example, mandatory prepayment or cancellation may be included to cover the risk that the commitments of limited partners do not come in, or expire, with relevant thresholds negotiated. There may also be pricing advantages if the facility is drafted on an uncommitted basis.

Security over uncalled contributions

What are uncalled contributions?

The right to uncalled contributions is technically an asset of the LP, even though it is not traditionally viewed as such. It is known in law as an intangible or a "chose in action" i.e. a personal right in law rather than a physical "thing" capable of actual possession, although the partner's corresponding obligation will usually be regarded as an attribute or incident of his share. The unusual feature here is that the right is technically owned by the partners, including the partner against whom it is exercisable. However, the right can certainly be enforced by the other partners. The position can be covered by careful drafting.

Because the capital of an LP must be registered and will not be registered until it is made, there is an issue whether uncalled capital is capital properly so called and whether such capital, if paid to the lender and not to the LP, will be registrable as such. It is preferable that contributions, the right to which is to be mortgaged or charged, be styled as either loans or advances and that the partnership agreement clearly states that the LP's right to such contributions is a partnership asset and such right and the contributions made pursuant to the partnership agreement can properly be used as security for the LP's borrowings and can be assigned to a third party for such purposes.

In most English LP's the limited partners make their contributions by way of loan so as to limit the amount of capital they have at risk. A concern of a lender might be whether or not any loan from the limited partners was subrogated to the rights of the lender if the LP were to become insolvent. Fortunately for the lender, case law provides that limited partners would be precluded from proving in competition with other creditors of the LP.

How do you create security over them?

There are two methods by which a security interest can be taken over a chose in action or an intangible. The first is by equitable mortgage by way of assignment where the lender would have beneficial title to the intangible concerned. The second is by way of charge where the lender would obtain an equitable proprietary interest in the intangible, but not beneficial title. Both are effective in the insolvency of the debtor (i.e. the LP) and both are subject to the same priority rules. In each case, the mortgage or charge can be enforced by the creditor taking over the debtor's rights to the intangible concerned.

Case law has made it clear that the key to obtaining effective fixed security (as opposed to a floating charge) is control. This means that the lender must have control of the asset and the chargor must not be free to deal with it. In the context of "choses in action" such as the right to uncalled contributions, the most effective way of ensuring the requisite control is for the lender to take an assignment by way of security of the right to the uncalled contribution from the LP and to give notice of the assignment to the LP. This means that all future calls for such contributions must be paid to the lender (into a specified, blocked account). The lender may then allow the LP to use the contribution, but it must not do so as a matter of course (as this would render the concept of "control" by the lender a sham). The use by the LP of the contribution (when called) must be at the absolute discretion of the lender.

How do you take an equitable mortgage by way of an assignment from an LP?

The GP would execute an equitable mortgage by way of an assignment on behalf of the LP, pursuant to a power conferred on it by the LP Agreement. In particular, the lender requires an assignment of the right to issue drawdown notices to the limited partners and any co-investment vehicles, and the right to exercise relevant penalties such as the forfeiture of investors' rights under LP documents. It will often also require security from the LP acting by the GP and/or any relevant manager over the accounts into which proceeds received from investors to repay a bridge loan are to be paid and a prohibition on withdrawals from the collateral account until each such loan has been repaid.

Frequently lenders not only take security from the LP (acting by the GP) over the right to make capital calls, but also from the GP itself in respect of its right to make the capital calls. It is unclear what, if any, property the GP has to assign to the lender and can be regarded as a "belt and braces" exercise. One advantage to the lender of doing this is that, if the GP is a limited liability company incorporated in the UK, it should be able to register the assignment as a charge, against the GP, at the UK Companies Registry. If, on the other hand, the GP (or possibly a manager to whom the GP has delegated its powers) is a GP or a manager of more than one limited partnership, it might refuse to have anything registered against it. In these circumstances, the lender should be adequately protected if it takes security from the LP itself (acting by its GP and/or a manager) and takes an irrevocable power of attorney from the GP and the manager (if any) to make capital calls.

How do you perfect an equitable mortgage by way of assignment?

This will be by giving notice in writing to the limited partners. This will generally convert the mortgage into what is commonly referred to as a "statutory assignment under the Law of Property Act 1925". It is essential for the lender to ensure that notice of the assignment is given to the limited partners whose obligation to make uncalled contributions form part of the security. The main reasons for this are as follows:

a. To prevent the limited partner from paying the contribution to the GP or the LP instead of the lender. Until the limited partner has notice of the lender's mortgage, he can obtain a good discharge by paying the GP or the LP.
b. Priority of the mortgage is determined by the order in which the limited partner receives notice of the mortgage. If the lender did not give notice, a subsequent encumbrancer or purchaser without notice of the lender's mortgage would obtain priority over it.
c. To prevent any equities (e.g. rights of set-off or similar rights) arising in priority to the lender. Although a lender takes his mortgage of the intangible subject to equities which the limited partner has, they cannot be increased once notice has been given to the limited partner.
d. To enable the lender to take proceedings against the limited partner in its name without joining the LP as a party.

In addition, the notice may seek to include an acknowledgment from the limited partner that:

i. he will not transfer his share in the LP without the prior written consent of the lender;
ii. he has not received notice of any security interest or assignment affecting his obligation to make uncalled contributions;
iii. he does not have any existing rights of set-off against his uncalled contributions and will not rely on any right to an account in order to reduce its obligation to make such contributions; and
iv. he will not agree to any amendment to the partnership agreement without the lender's prior written consent.

However, in practice it is unlikely that the GP will allow the lender to approach the limited partners for such an acknowledgement and lenders rarely insist on the limited partners signing an acknowledgement. Indeed, sometimes the lender will agree that the notice is not sent out until, say, the GP sends the next quarterly report to the limited partners. The risk here is that a lender could lose priority if another encumbrancer gets its notice in first and does not have notice of any prior assignment.

Registration

A mortgage or charge over uncalled capital contributions is registrable at the UK Companies Registry. However, since only limited registration requirements apply to an LP (e.g. details of names of each of the general partners and limited partners and amount of capital contributions must be delivered to the UK Companies Registrar), a charge over uncalled contributions

created by an LP cannot generally be registered at the UK Companies Registry. But, if the charge is also created by a GP (and/or a manager) which is a company or a limited liability partnership incorporated in the UK in its own name then the charge can be registered at the UK Companies Registry. As explained above, this is often resisted if the GP (or the manager) is a GP (or a manager) of more than one limited partnership. In these circumstances, a lender may instead take an irrevocable power of attorney from the GP (and the manager (if any)) which should provide adequate protection to the lender and is not registrable at the UK Companies Registry even if the GP (or the manager) is a company or a limited liability partnership incorporated in the UK.

Power of Attorney

The lender should obtain an irrevocable power of attorney from the GP by way of security. This will enable the lender to exercise the GP's rights to call for the uncalled capital in an enforcement situation. In some rare financings, the LP may resist giving any security other than by agreeing to the GP giving such a power of attorney.

If the GP has delegated its power to make capital calls to a manager then an irrevocable power of attorney should also be taken from the manager by way of security. An irrevocable power of attorney granted by the GP should then cover the rights of the GP pursuant to the partnership agreement (and/or any management agreement) to dismiss or replace the manager and to resume the power to make capital calls.

Practical steps to enforcement

Ensure that an event of default has taken place

As with any other enforcement situation, the lender should review the loan agreement to ensure that an event of default has taken place and that any applicable grace period has expired. It should be cautious about relying on an event of default in situations where its occurrence would be open to dispute by the LP, for example, it would not wish to rely solely on a "material adverse change" event.

It is assumed that a dissolution of the LP would be an event of default. The LP Agreement could provide that, in the event of a dissolution, all unpaid contributions will immediately fall due, thus enabling the lender to demand payment of those contributions. This does not, however, mean that the partners could not alter this requirement, albeit by committing a breach of the covenant not to vary the partnership agreement.

Make formal demand

The lender must make formal demand on the LP strictly in accordance with the loan agreement. It is likely that the loan agreement will require such demand to be served on the GP. The demand should state that the lender reserves its right to enforce its security.

Enforce

The rights available to the lender by way of enforcement will depend to a certain extent on the wording of the security document. However, the most likely method of enforcement will be for the lender effectively to "step into the shoes" of the GP (and/or the manager if the GP has delegated its power to make capital calls to the manager) and call in the uncalled contributions. In this regard, the lender should bear in mind the following points:

a. The lender must review the partnership agreement to ensure that the GP is entitled to call the uncalled contributions. Ideally, the partnership agreement should provide for contributions to be payable on an event of default under the loan agreement, or on the lender making demand on the LP.
b. As mentioned above, the lender should obtain an irrevocable power of attorney from the GP at the outset to enable the lender to serve notice on each limited partner on behalf of the GP calling for payment of all outstanding contributions. Often the GP (and the manager) will only wish the power of attorney to be exercisable after the occurrence of an event of default which is continuing.

Potential difficulties with enforcement

Dissolution of the LP

An LP may be dissolved in the following ways:

a. by mutual unanimous agreement of the partners;
b. by the exercise of an express power to dissolve reserved by the partnership agreement;
c. by rescission for fraud or misrepresentation;
d. on the occurrence of a determining event in the Partnership Act 1890 (e.g. the expiry of a fixed term or the completion of a specific transaction); or
e. by a court order.

A limited partner can only dissolve an LP by notice if the partnership agreement confers such a right on him.

The lender should review the partnership agreement to ascertain in what circumstances dissolution may occur. The lender should ensure that the LP is not permitted to dissolve (other than through a dissolution event outside the control of the partners) without the consent of the lender and/or that any uncalled contributions will fall to be made immediately on a dissolution and prior to any application of the partnership assets pursuant to section 44 of the UK Partnership Act 1890. If the latter provision is omitted, then there will be no obligation on the limited partners to make the contributions, since the obligation will cease on dissolution.

Insolvency of the LP

The insolvency regime applicable to LPs is broadly similar to that applicable to limited companies.

Liquidation

The current insolvency regime in respect of LPs deems an insolvent English LP to be an unregistered company. This allows the LP to be wound up under the company insolvency regime (with certain amendments and limitations).

Where the LP is wound up in this way, the lender's security remains effective (as it would on a corporate borrower's insolvency) and can be enforced in the normal way.

As mentioned above, the lender must ensure that the power of attorney given by the GP (and the manager, if applicable) is by way of security so that it survives the LP's insolvency and the insolvency of the GP and the manager (if applicable).

Administration

An administration order in respect of the LP, as with a limited company, creates a moratorium during which no proceedings may be brought against the LP or its assets, whether by way of enforcement of security or otherwise. Therefore this might prevent the lender from exercising its right to call for the uncalled contribution unless the lender obtains the consent of the administrator or the court.

Possible grounds for challenging the security on insolvency

There are aspects of the clawback regime which apply on the insolvency of the LP where concurrent petitions are also presented against the LP's members. These may result in the lender's security being challenged as follows:

Preference

A preference occurs where an insolvent entity does something which has the effect of putting a creditor in a better position than it would otherwise have been in the event of such entity going into insolvent liquidation. There are various reasons why this is unlikely to apply to the granting of security in favour of the lender:

- The insolvent entity must have been influenced by the desire to put the lender in a better position than its other creditors. However, provided the lender took the security before making the loan, a preference would not arise as against the lender.
- The preference must have been entered into within the six months prior to the commencement of the winding up unless the insolvent entity and the lender are connected.
- The liquidator must be able to show that the entity was insolvent at the time of the transaction or became insolvent as a result of it.

Transactions at an undervalue

The grant of a charge will not usually amount to a transaction at an undervalue on the basis that the charge does not itself deplete the chargor's assets but the position is not free from doubt. A transaction at an undervalue arises where the benefit conferred by the chargor on the lender in giving the security is significantly more than the benefit received by the chargor from giving such security. In these circumstances, the transaction may be set aside by court order by a liquidator or administrator if:

- the chargor was insolvent or became insolvent as a consequence of entering into the transaction; and
- the chargor entered into administration or insolvent liquidation within two years of the transaction being entered into.

Insolvency of a limited partner

If a limited partner of the LP becomes insolvent, the lender would be an unsecured creditor of that limited partner. This is because the lender's rights to the uncalled contributions from that particular limited partner are derived from the rights of the LP itself. Therefore, on the limited partner's insolvency, the LP becomes an unsecured creditor of that limited partner and the lender can be in no better position than the LP.

Lending to overseas limited partnerships

As previously mentioned, the majority of this paper is from the perspective of English law. Assuming that the documentation would be governed by English law, much of the above will remain applicable, notwithstanding the fact that the LP itself is registered in another jurisdiction.

However, there are a number of jurisdictional issues to be considered, particularly if an LP is registered outside England and Wales. These include the following:

a. the law of the LP itself (i.e. the law of the jurisdiction where it is registered);
b. the governing law of the partnership agreement;
c. the governing law of the loan agreement/security documents;
d. the law of the jurisdiction of incorporation of each limited partner; and
e. the law governing the "rights" to the intangible itself (i.e. the law governing the right to call for the uncalled contribution, which is likely to be the same as b) above).

As is always the case in such situations, a legal opinion should be sought from lawyers in the jurisdiction in which the LP is registered. This opinion should cover, amongst other things:

i. whether the LP is a separate legal person (not the case in England);
ii. the capacity of the LP (and indeed the capacity of the GP on its behalf) to enter into documentation;
iii. the execution formalities of the documentation;
iv. whether the governing law of the loan and security documentation would be recognised by the courts of that jurisdiction;
v. whether registration of the security documents is possible in that jurisdiction and whether giving notice to the limited partners with an irrevocable power of attorney from the GP is sufficient to secure priority and to perfect the security;

vi. whether the power of attorney given by the GP in favour of the lender will be effective, particularly in an insolvency situation;
vii. what the implications would be for the lender should the LP or one of its limited partners become insolvent;
viii. whether a judgment of the English courts would be recognised and enforced in that jurisdiction;
ix. whether there are any withholding tax or exchange control issues; and
x. whether there are any formal requirements or procedures which must be complied with in order for the lender to enforce its security in that jurisdiction.

In addition, a legal opinion might also be sought from the jurisdiction in which the LP has most of its assets (in case the lender might wish to enforce against those assets) and also, from lawyers in the jurisdiction of each limited partner (where the lender would need to bring proceedings if the limited partner failed to pay up on a call for a contribution).

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Contact

Andrew Evans
Partner - London

E: andrew.evans@fieldfisher.com
T: +44 (0)20 7861 4169

Philip Abbot
Partner - London

E: philip.abbot@fieldfisher.com
T: +44 (0)20 7861 4065

Aleksandra Cison
Associate - London

E: aleksandra.cison@fieldfisher.com
T: +44 (0)20 7861 4581