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Key LPA Provisions During Market Downturns

*In Law360, **Matt Posthuma** examines key LP provisions during market downturns.*

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The U.S. and world economies are experiencing an economic slowdown, perhaps the beginning of a recession.

Of course, fund managers should focus on the commercial aspects of their investments in times like these. However, it is also important for sponsors to examine their funds' limited partnership agreements for items that may be affected by a downturn, and assess whether modifications may be appropriate.

Particular provisions to review are as follows:

Expiring Time Periods

During market downturns, transactions may not happen as quickly. This may result in a fund not meeting its targets in scheduled time frames. Managers should examine their fund agreements to determine whether the fund is approaching, or has passed, any of these deadlines, and if extensions are needed.

Marketing Period

A closed-end fund has a limited amount of time after its initial closing, usually 12-24 months, to bring new investors into the fund. After that time, investors generally expect the manager of the fund to be focused on making investments, rather than raising capital.

In times of economic uncertainty, when investors have not had their existing investments returned to them, they may be less willing to make commitments to new funds.

As a result, funds may not reach their fundraising targets by the end of the marketing period. Fund sponsors may want additional time to raise capital, so that they have more dry powder to invest in assets at depressed prices as a downturn continues.

Investment Period

A closed-end fund has a specified amount of time, called the investment period or commitment period, to make new investments without limitation.

This period is often three-to-five years after the first closing or final closing. The investment period is limited because investors do not want to have unlimited obligations to fund capital indefinitely.

In the early stages of a recession, where values are still decreasing, interest rates are high and credit is not readily available, fund managers may be reluctant to use their unfunded commitments to make new investments.

If so, funds may find with themselves large unused capital commitments at the end of the investment period. General partners may want additional time to make investments when values are lower, and it becomes easier to obtain financing.

Management fees during the investment period are often based on capital commitments, whether called or uncalled. The rationale is to pay the manager while it is sourcing investments for the fund.

After the investment period, management fees are typically charged only on invested capital, i.e., capital contributions that have been called and not yet returned to investors. So the fee base after the investment period will almost certainly be lower than it was during the investment period.

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It is possible that investors may ask for management fees to step down at the scheduled time, even if the investment period is extended. Managers could counter that they will be doing the same amount of work during the extended investment period as they were before.

Capital calls after the investment period for closing of transactions signed before the end of the period, for completion of development projects and for follow-on investments, often have time limits as well.

In addition to extending the investment period generally, fund managers may seek waivers of these time limits, most likely with respect to particular transactions.

Term

A closed-end fund has a fixed term.

After the expiration of the term, the fund enters dissolution and is required to liquidate all its assets and resolve all its liabilities. In an environment where values are depressed and transaction volume is down, a fund manager may not want to sell assets into a down market.

Consequently, it becomes more likely that asset sales will be delayed and that not all the assets of the fund will have been sold by the end of the term.

Technically, Delaware law does not require a partnership to sell all its assets by the end of the term. Rather, the partnership must cease conducting business and focus its efforts on disposing of its assets. Delaware law also does not require the assets to be sold within a certain period of time after dissolution if that would not be in the best interests of the fund.

Nonetheless, there is at least the perception among some investors that the assets should have been sold by the end of the term. Given that Delaware law does not technically require the assets to have been sold, the general partner must consider whether it is worth it to ask for an extension of the term.

Sometimes the management fee steps down or goes away at the end of the term, which might warrant getting the extension. On the other hand, investors might ask for a fee reduction as a condition to the granting of an extension.

Sometimes a partnership agreement will have a provision that requires the fund complete the liquidation and winding-up process within a certain time after the end of the term. If the fund is not able to sell its assets within that time, an extension of the liquidation period would be needed.

If a fund is reaching the scheduled end of one of these periods, the general partner is often permitted at least one unilateral extension. After that, additional extensions may be permitted with the consent of either the limited partner advisory committee or a majority in interest — or higher percentage — of the investors.

Even if extensions are not expressly contemplated, the general partner can always amend the partnership agreement, with investor consent, for the desired period. During general economic downturns, which are not specifically related to the sponsor, investors may be more willing to grant these extensions.

Decreased Values

A second category of provisions that can be affected by a market downturn are those based on the values of assets of the fund.

Generally speaking, asset values tend to decrease during an economic slowdown. Furthermore, particularly at the beginning of the cycle, there is often a disconnect between buyers and sellers as to how much assets are worth, and fewer transactions are consummated.

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This leads to fewer market comps that can be used when valuing a fund's assets, and less certainty of valuations. Assets in open-end funds tend to receive full appraisals annually, with desktop appraisals for the other three quarters.

Closed-end funds are less likely to get appraisals, and often rely on the manager's own valuations when reporting values to investors. Because of the robustness and third-party validation of appraisals, open-end funds are more likely to use references to values than closed-end funds.

Closed-end funds are more likely to express dollar amounts in terms of capital commitments, which are fixed. However, some closed-end vehicles do use values in their calculations, particularly after the investment period.

Management Fees and Performance Compensation

Management fees in virtually all open-end funds are calculated as a percentage of net asset value — assets minus debt and other liabilities. Some closed-end funds also use gross or net asset value when calculating management fees. Decreased valuations of assets directly reduce these management fees payable to fund sponsors.

Many open-end funds also measure performance using net asset value. If increases in net asset value, plus distributions, exceed a hurdle — usually a percentage or a market index — during a particular period, e.g., 1-3 years, the general partner can receive a performance fee or a carried interest distribution equal to a percentage of the amount by which the hurdle is exceeded.

If values of assets are going down, it is very unlikely that cash flow will be enough to put the fund's performance above the hurdle. The fund's higher, earlier value may create a high-water mark, which must be exceeded before further performance compensation may be earned. The newly decreased value may also trigger a clawback of performance compensation paid with respect to an earlier period.

As mentioned above, appraisers and other valuers of assets may be reluctant to lower values when there are not a lot of comparable transactions. Because higher values result in higher compensation to managers, investors may put pressure on funds to lower valuations.

Valuation of open-end funds tends to be supervised by a handful of institutional valuation agents, who tend to be consistent in the amounts of their increases and decreases across the various funds they handle. The conflict of interest is higher when the general partner, not a third party, performs its own valuations.

Contributions and Redemptions

Open-end funds accept new investors, and redeem existing investors, based on net asset value. Obviously, newer investors would prefer to contribute their capital at lower prices.

In situations where values are falling, investors may prefer to wait before making new capital commitments to open-end funds. Delays in fundraising may prevent a fund from raising the capital it needs to take advantage of the market opportunities presented by reduced values.

Market downturns may lead more investors to request redemptions. However, increased redemption requests, and fewer new capital commitments, as mentioned above, may cause the general partner of an open-end fund to not satisfy all outstanding redemption requests right away, and to set up a redemption queue.

However, redemptions are typically made based on the value of the fund upon redemption, not when the redemption request was originally submitted. As values decrease, investors in redemption queues may end up receiving lower redemption proceeds than they originally requested.

With closed-end funds, subsequent close investors tend to buy into the fund using a fixed interest rate, such as the preferred return hurdle. Partnership agreements often have a provision that permits the general partner to use a different price if the value of the assets is materially different from cost plus interest.

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In practice, this provision is rarely used. However, it is possible that a later investor could request using a lower valuation in a down market.

Closed-end funds also provide for redemption of regulated investors at market value in certain scenarios, e.g., an Employee Retirement Income Security Act plan asset event. These redemption scenarios are quite rare and not related to market conditions.

Leverage

Fund documents typically limit the amount of indebtedness the fund can incur.

Leverage covenants, particularly in open-end funds, are often based on gross asset value, e.g., indebtedness cannot exceed X% of the fund's gross asset value.

While the values of a fund's assets fluctuate over time, the principal amount of a fund's indebtedness does not change unless it is paid. If the value of the fund's portfolio drops, these leverage limitations could be exceeded.

Fund partnership agreements usually have an exception for refinancings of existing indebtedness. This allows the fund to refinance existing indebtedness, at a lower interest rate or upon maturity, as long as the amount being borrowed does not increase.

However, the fund may not be able to incur indebtedness for a new asset, or obtain additional financing for a capital-constrained asset, at a time when new fundraising may be difficult.

Sponsors who want to borrow in these circumstances will probably need to seek a one-time waiver, rather than raising the entire leverage limit. Depending on the fund, these waivers can be obtained from the limited partner advisory committee or by consent of the fund investors.

Fund agreements sometimes allow leverage limits to be exceeded temporarily. This can be problematic if the manager is not sure when values are going to increase again to previously higher levels.

Closed-end funds typically calculate their leverage using capital commitments, rather than value, but some closed-end funds do refer to value in their leverage restrictions, especially after the investment period.

Investment Criteria

A fund's investment criteria may limit investments in certain types of assets, so that the fund is appropriately diversified and not overconcentrated in a particular asset class. As with leverage, these limitations, especially in open-end funds, are often based on gross asset value, e.g., investments in hotels cannot exceed Y% of gross asset value.

If values of certain asset classes decrease by a greater percentage than those of other assets classes, e.g., office buildings decrease in value more than industrial warehouses do, it could cause the limitation for the higher valued asset class to be exceeded.

This could prevent the fund from investing in assets that are performing better in a tough market. Like leverage, managers would probably come to investors with a specific asset to acquire, instead of increasing the general limitation. A provision permitting the fund to temporarily exceed a cap could make sense when the manager has other, uncapped investments in the pipeline.

Similar to leverage, closed-end funds usually base their investment criteria on commitments instead of value.

Clawbacks

We discussed above the potential for clawbacks of performance compensation in open-end funds.

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In closed-end funds, carried interest — also known as promoted interest — is paid to the general partner after investors receive a return of their capital contributions, plus a preferred return.

There is often a clawback upon the final liquidation of the fund if the general partner has received more carried interest than it should have received. This might occur if earlier assets were sold at a gain, while subsequent assets were sold at a loss.

Recently, investors in closed-end funds have begun to request interim clawbacks. There, a clawback could be triggered at a certain point in the life of the fund, e.g., the end of the investment period, if the general partner has received more carry than it should have, assuming that the remaining portfolio was sold at its current net asset value.

This can be problematic in scenarios where the fund sold some of its assets at the top of the market, and prices of the remaining assets subsequently fell. Managers may argue with investors that interim clawbacks based on unrealized values are not appropriate. Once an interim clawback has been agreed in the fund partnership agreement, sponsors may have a hard time getting around it.

Economic downturns require sponsors to spend extra time on their portfolios. However, fund managers and their counsel also need to pay special attention to their partnership agreements. As funds approach scheduled deadlines, and asset values decrease, general partners should maintain active dialogues with their investors, so that they can navigate any impending obstacles in their fund documents.

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