Morgan Lewis

VENTURE CAPITAL & PRIVATE EQUITY FUNDS
DESKBOOK SERIES

Avoiding and Handling Defaults

One major distinguishing factor between venture capital and private equity funds, on the one hand, and hedge funds, on the other, is that limited partners of hedge funds contribute all of their capital at one time, while those in venture capital and private equity funds simply make a contractual commitment to make capital contributions capped by the amount of their commitment whenever asked, usually upon 10 days' notice. This arrangement reflects the desire of venture capital and private equity fund managers to increase returns to limited partners by only calling capital when it is actually needed, either for investments or fees and expenses. The trade-off, however, is that fund managers must rely on the creditworthiness of their limited partners and their ability and willingness to timely respond to capital calls over the course of 10 years or more and are therefore faced with the prospect of limited partners, for myriad reasons, not fulfilling their capital contributions and defaulting on their commitments.

Mitigating Risks of Default

Know Your Client

Certainly, the easiest way to mitigate limited partner defaults is to only sell interests to limited partners that you know are creditworthy. This usually means that institutional investors will be favored over individuals. Institutions generally have more significant assets and have their own safeguards and systems built in to avoid defaulting on long-term commitments and to handle capital calls in a timely manner. When dealing with individual investors, it is advisable to perform additional due diligence so that you are comfortable that they will be able and willing to manage the long-term commitment required.

Build in Deterrents

Another strategy to mitigate defaults is to provide in the fund agreement for very onerous remedies in the event of a default as a deterrent. These usually include high interest charges, seizure of some or all of a limited partner's capital account, forced sale at a reduced price, and the threat of litigation. Unfortunately, due to the very nature of these funds, such terms do not carry as much weight at the beginning of a fund's life when little capital has been contributed, and so the perceived cost of walking away is low compared to the remaining commitment. For your reference, we've compiled a list of terms and remedies, available at the end of this document, that should be considered when drafting a default provision.

Handling Defaults When They Occur

Encourage Payment

The first and most obvious step will be to contact a defaulting investor and encourage payment. This process may elicit information on why the limited partner is either unable or unwilling to meet its obligations and can provide openings for resolution. Part of this process should also involve reviewing the

terms of the partnership agreement and the remedies available, and reminding the limited partner of its binding obligation and the potential consequences of defaulting.

Encourage a Secondary Market Sale

If it is clear that, for whatever reason, the limited partner will not meet its obligations, then it is recommended that, wherever possible, you encourage and even facilitate a sale of the interest in the secondary market at a negotiated price. This is generally the preferred route, as it preserves the interest and the future commitment for the fund and relieves the defaulting partner of its obligation and even provides it some needed liquidity. While it is acceptable to help locate a buyer for the interest, you should be careful not take on the role of broker, intermediary, or negotiator. The parties will need to come to an agreement on their own regarding the price to be paid for the interest, and fund managers should avoid any perception that they have set the price. Given the facts and circumstances at the time, a buyer may be difficult to find or, as is often the case, the defaulting seller may be unwilling to sell at the price being offered.

Take a Hard Line

If a sale is not possible, then it is time to take a hard line. It is at this step that a formal notice of default is often served, and consideration and implementation of available remedies begin. This step is driven by the partnership agreement and the available contractual remedies set forth therein. Ultimately, some action must be taken, otherwise you risk a stampede to the door of limited partners when times get tough.

Recognize That Litigation Is Costly and Has Risks

Where the remedies that are provided by contract in the document (e.g., forfeiture of a capital account) are not sufficient or desirable (e.g., this is a major investor, the loss of which jeopardizes the viability of the fund or very little capital has been called), consider litigation, but do so recognizing that it is costly, time consuming, and personal. Whether before an arbitrator or a judge, these cases are rarely granted summary judgment despite every fund manager's firm belief that the limited partner has no defense. You will be met with counterclaims alleging breach of fiduciary duty, breach of contract, fraud, gross negligence, and securities law violations. Then discovery will begin and defense lawyers will be combing through your offering materials, financial statements, and other confidential data. Any deviations from your initial plans set forth in a PPM or any conflict-of-interest transactions, or disparate treatment of other defaulting limited partners, will be exploited to their maximum effect. This is not to say that litigation is not a good tool in the right circumstances. Just be prepared for a battle.

Best Practices When Handling Defaults

Regardless of what steps are ultimately taken, we recommend documenting the process along the way. Communicate with the limited partner in writing. Keep notes or minutes of meetings and document decisions made and the reasons for them. Whenever possible, be consistent in your handling of defaults for different limited partners, deviating only if you have a sound business reason for the benefit of the fund in question and not for other aspects of the fund manager's business, such as preserving a business relationship for possible future funds. Such factors as the size of the interest and its current value, the availability of a market, the amount of uncalled capital, cost, and the likelihood of litigation may all be taken into consideration when determining the best course of action. The variety of these factors is why we recommend that general partners retain the discretion and flexibility to take appropriate action under the circumstances.

* * *

For more information on the issues discussed here, please contact your Morgan Lewis Private Investment Funds Practice attorney.

About Morgan Lewis's Private Investment Funds Practice
Morgan Lewis has one of the nation's largest private investment fund practices and is consistently ranked as the "#1 Most Active Law Firm" globally based on the number of funds worked on for limited partners by *Dow Jones Private Equity Analyst*.

About Morgan, Lewis & Bockius LLP
Morgan Lewis provides comprehensive transactional, litigation, labor and employment, and intellectual property legal services to clients of all sizes—from global Fortune 100 companies to just-conceived startups—across all major industries. Our regulatory and industry-focused practices help clients craft and execute strategies to successfully address legal, government, and policy challenges in today's rapidly changing economic and regulatory environment.

Founded in 1873, Morgan Lewis comprises some 4,000 professionals—attorneys, patent agents, employee benefits advisors, regulatory scientists, and other specialists—in offices across the United States, Europe, Asia, and the Middle East. The firm is unified in its long-held service philosophy that every action of our attorneys, in every representation, is driven first and foremost by the immediate and long-term concerns of each client. For more information about Morgan Lewis or its practices, please visit us online at www.morganlewis.com.

Terms and Remedies in Default Provisions

The definition of a default should cover all obligations of a limited partner in addition to its capital commitment to the fund. Such obligations include capital calls to alternative investment vehicles, interest payments, and limited partner clawbacks.

The general partner should retain discretion in how to apply remedies.

The provision may contain the following enumerated remedies and consequences:

- Charge maximum interest allowable by law for late payments.
- Withhold future distributions to cover unpaid commitments.
- Reduce all or a portion of the limited partner's capital account.
- Allocate losses and expenses at the original commitment percentage.
- Reduce commitment to amount paid.
- Limit reporting to such limited partner.
- Remove from the LP Advisory Committee any representative of the defaulting limited partner.
- Sell the interest at a reduced valuation.
- Eliminate voting rights.
- Accelerate payment on the entire commitment.

The provision should make clear that the above remedies are not the exclusive remedies and that the defaulting partner is liable in a suit for damages in law or at equity (e.g., specific performance).

It should be clear that prior delays or waivers or any course of dealing with a defaulted partner does not constitute a waiver of any of the foregoing provisions.