Morgan Lewis

VENTURE CAPITAL & PRIVATE EQUITY FUNDS
DESKBOOK SERIES

Capital Calls

Some venture capital and private equity funds require a portion of an investor's subscription amount to be contributed at their initial closing. Many funds, however, do not have such requirements and instead hold "dry closings," meaning that no capital contribution is required at the first closing. Regardless of the requirements on or before the first closing, nearly all venture capital and private equity funds call capital as it is needed thereafter. In other words, it is exceedingly rare for a venture capital or private equity fund to require an investor to contribute the full amount of such investor's subscription at the first closing. To avoid unpleasant logistical issues, at a minimum fund managers should consider the following capital call issues as part of their overall fund management strategy: (i) when to make capital calls, (ii) whether or not to use short-term borrowing in anticipation of capital calls, (iii) what information to include in capital call notices, and (iv) how much capital to call at any given time. This article addresses each of these key issues.

When to Make a Capital Call

The question of when to make a capital call is straightforward from a technical perspective, but can be difficult from a logistical perspective. Technically, the limited partnership agreement or other governing document of a venture capital or private equity fund will specify the number of days of notice that is required in connection with making a capital call. For many venture capital and private equity funds, the notice period is 10 business days. Funds-of-funds, of course, must have shorter capital call notice requirements in order to meet the due dates required by underlying funds. In fact, because underlying funds may have a capital call period of only 10 days (rather than 10 business days), it is advisable for a fund-of-funds to have a capital call notice period of not more than seven days. The logistical difficulties of timing capital calls are discussed below under "Short-Term Borrowing in Anticipation of Capital Calls."

Short-Term Borrowing in Anticipation of Capital Calls

As noted above, there are certain logistical difficulties in determining when to make a capital call. Such difficulties are best explained through examples: Consider a venture capital fund that is pursuing an investment in a portfolio company. The deal is hanging on by a thread as negotiations ebb and flow, and it is not clear if a final deal will be consummated. A critical point is reached where the deal must close as soon as possible and all parties are in agreement. No fund manager wants to get to the end of such a process only to have to wait an additional 10 business days to receive the capital it needs to close the investment, which is what is likely to be required by the limited partnership agreement or other governing document of the venture capital or private equity fund. Alternatively, no fund manager wants to send out capital call notices to its limited partners earlier in the process, before it knows whether the deal is actually going to close. Fund managers find themselves wishing there were a way to wait until they were certain that a deal is closing and then access capital on a same-day or nearly same-day basis, but limited partners will not agree to such terms under the governing documents. If only another source of capital existed to bridge the temporal disconnect between the needs of the fund manager and the requirements of the limited partners. Alas! Short-term borrowing is frequently permitted by the governing documents of venture capital and private equity funds. Such short-term borrowing is a handy solution to the timing concerns discussed above. Funds frequently will establish credit facilities or other similar arrangements under which they are able to draw down capital on very short notice (sometimes the same day). Thus, in our scenario above, the fund manager would wait until it actually needed the capital and then draw the necessary amount from the fund's credit facility to close the investment, while simultaneously making a capital call on the limited partners. When the capital arrives from the limited partners, the credit facility is paid down. Note that the use of credit facilities and other borrowing arrangements may also help to improve the internal rate of return achieved by a fund's investors.

Information to Include in Capital Calls

The information to be provided in a capital call notice varies considerably from fund to fund. Such variables as the size of the fund, the type of fund, and the presence of significant lead investors all impact the scope and detail of the information to be provided in capital call notices. For example, venture capital funds with a close, friendly group of limited partners may provide only the information as set forth on Exhibit A, while large private equity funds with a variety of institutional limited partners may demand that capital call notices include the information set forth on Exhibit B. There is no limit to the specific information that could be included in capital call notices, but fund managers and limited partners should consider the cost-benefit analysis of burdening the fund manager with excessive information requirements in capital call notices.

How Much Capital to Call

Many funds operate in a just-in-time fashion, calling only amounts needed for immediate investment or fund expenses, although they usually do have some reserve on hand for near-term expenses. Funds that have a large number of individual investors, however, sometimes require that a significant percentage, often 25%, of such investors' capital commitments be contributed at the initial closing of the fund and will thereafter make capital calls in similarly large chunks from time to time or in accordance with a predetermined schedule. The tradeoff that fund managers are sometimes asked to make in exchange for demanding the ability to call capital in large chunks is that the limited partners may put a cap on the amount of capital that may be called during any given period (e.g., no more than X% per year). Another tradeoff for fund managers to recognize is that although calling capital in chunks reduces the risks of default by individual investors, it also creates a drag on the internal rates of return for such investors.

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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.

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EXHIBIT A

[INSERT FUND LETTERHEAD]

ATTENTION – CAPITAL CALL NOTICE – ACTION REQUIRED

[Date]

[Name of Limited Partner]
[Affiliation]
[Address]
[City, State and Zip Code]

Capital Call Notice of ________________, L.P. (the "Fund")

Dear **[**insert name of investor**]**:

We are writing to notify you that pursuant to Section [__] of the Amended and Restated Limited Partnership Agreement of the Fund, dated __________, the Fund is calling capital from you in the amount of [insert amount] (the Capital Contribution), which represents [__%] of your unfunded Capital Commitment. Such Capital Contribution is **due on or before [____________________]** and must be wired in immediately available funds to the Fund's account as specified below. The wire instructions are as follows:

[Name of Bank]

SWIFT Code:
Account:
A/C #:
Sub-account:
Sub A/C #:

Please instruct the financial institution handling the wire transfer to include your name, as a Limited Partner of the Fund, on the wire transfer.

If you should have any questions regarding this information, please feel free to contact _________ at _____________.

Sincerely,

EXHIBIT B

[INSERT FUND LETTERHEAD]

ATTENTION – CAPITAL CALL NOTICE – ACTION REQUIRED

[Date]

[Name of Limited Partner]
[Affiliation]
[Address]
[City, State and Zip Code]

Capital Call Notice of ________________, L.P. (the Fund)

Call No.__________

Dear **[**insert name of investor**]**:

We are writing to notify you that pursuant to Section [__] of the Amended and Restated Limited Partnership Agreement of the Fund, dated __________ (the Partnership Agreement), the Fund is calling capital from you in the amount of [insert amount] (the Capital Contribution), which represents [__%] of your unfunded Capital Commitment. Such Capital Contribution is **due on or before [____________________]** and must be wired in immediately available funds to the Fund's account as specified below.

All capitalized terms used in this letter shall have the meanings given such terms in the Partnership Agreement unless the context otherwise requires.

This letter constitutes a Drawdown Notice pursuant to Section [____] of the Partnership Agreement.

The wire instructions are as follows:

[Name of Bank]

SWIFT Code:
Account:
A/C #:
Sub-account:
Sub A/C #:

Please instruct the financial institution handling the wire transfer to include your name, as a Limited Partner of the Fund, on the wire transfer.

The purpose(s) of the Capital Contribution required above is (are) as follows:

[1. to be applied toward a US$[ ] investment by the Partnership in an enterprise by the name of [ ] in the [ ] sector in [*country*], and the principle business of such enterprise is [*insert general description*]. This investment by the Partnership [has been approved by the [Manager's] investment committee] [is in the process of being approved by the [Manager's] investment committee and the Manager envisages that final approval shall be obtained on or before [ ]].]

1. [to be applied toward fees and expenses as follows:-

   [Breakdown of fees and expenses, including the period to which Management Fee payments relate, and schedule of dates they are scheduled to be paid].]

2. [other specified purposes, e.g., to fund indemnification obligations].

As of the date of this letter:

(i) Total Commitments are US$[ ];

(ii) your Commitment is US$[ ];

(iii) your unpaid Capital Commitment before the Capital Contribution referred to above is paid is US$[ ] and after the Capital Contribution referred to above is paid will be US$[ ];

(iv) the aggregate of amounts referred to in Sections [__________] of the Partnership Agreement that have been reinvested, which would otherwise be distributable to you is US$[ ];

(v) the amounts that have been distributed to you and are subject to recall (i.e., have increased your unpaid Capital Commitment amount) is US$[_____________]; and

(vi) the total amount of distributions which you may be required to contribute to the Partnership pursuant to Section [_____] [LP Clawback] of the Partnership Agreement from time to time is US$[ ].

If you should have any questions regarding this information, please feel free to contact _________ at _____________.

Sincerely,