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Contents

Delaware Enforces Full Waiver of Fiduciary Duties

By James Washburn

Limited liability companies ("LLCs") in Delaware and most other states have the option to specify in their operating agreements that their managers owe no fiduciary duties to other members or the company. But even when LLCs take advantage of that flexibility and adopt such a provision, the expectation of many is that there are still *some* duties that managers will owe to members in running the company. Indeed, all LLC agreements in Delaware and most other states contain an implied covenant of good faith and fair dealing. A recent Delaware decision (*Miller v. HCP & Co.*, 2018 WL 656378 (Del. Ct. Ch. Feb. 1, 2018)), however, clarifies that courts in that state will enforce an LLC's exclusion of fiduciary duties even in the face of allegations that the managers undertook to enrich themselves directly at the expense of other members. Applying traditional tools of contract interpretation, the court established that the members plainly intended to restrict the application of fiduciary duties and that any other result would be inconsistent with the members' intent. Members who claimed to be harmed were left with no remedy.

The original owners of Trumpet Search, LLC ("Trumpet") founded the company to provide clinical services to persons with autism and other developmental disabilities. In late 2014, HCP & Co., a Chicago-based private equity firm, formed entities to purchase an interest in the company and became Trumpet's largest member. As part of its investment, HCP gained the right to appoint the majority of Trumpet's board. In May 2016, in need of additional cash, Trumpet's members entered into a revised operating agreement that created new ownership units, and the operating agreement set out a distribution waterfall for returns on capital investment in the event of a sale. The operating agreement stated that the new units would be entitled to a first-in-line, first-priority return of 200% of their capital contribution before any other members received any return. HCP purchased more than 80% of the new units.

The agreement also provided that if a majority of the board approved a sale of all of Trumpet's ownership units to an independent third party, each member was obligated to consent. (If a member refused to consent, the agreement provided that the board would be appointed attorney-in-fact so that the board had authority to sign on the objecting member's behalf any documentation necessary for the sale.) The revised operating agreement also explicitly waived all fiduciary duties that might otherwise be owed by Trumpet's members and board. Like all contracts in Delaware, though, the operating agreement subjected Trumpet's members to an implied covenant of good faith and fair dealing.

In December 2016, seven months after the new operating agreement was signed, Trumpet's board met to consider an offer from MTS Health Partners, L.P. ("MTS"), for the sale of Trumpet, which HCP, through its majority interest on the board, was planning to accept. Though Delaware generally imposes a duty on boards and managers to take affirmative steps to determine whether a proposed sales price adequately reflects a company's market value, HCP had not undertaken any market evaluation process to determine whether the offer reflected Trumpet's market value. The non-HCP-appointed board members objected and claimed the offer substantially undervalued the company. HCP agreed to allow these board members to contact other possible purchasers, but under narrow time restrictions. In February 2017, another potential purchaser, FFL Partners LLC ("FFL"), sent a letter of interest in purchasing Trumpet for a price that was $15M to $25M higher than MTS's offer. Significantly, while accepting MTS's offer would yield benefit almost exclusively for HCP's units, the FFL letter of interest offered the prospect of substantial return for all of Trumpet's members. The minority of Trumpet's board urged HCP's appointed board members to explore FFL's interest before selling.

HCP's board majority, however, elected to proceed with the firm offer from MTS. Minority members immediately sued to attempt to block the transaction, claiming HCP had breached its obligation to act in good faith by not pursuing the FFL opportunity or otherwise assessing Trumpet's value in the market. The Delaware Court of Chancery rejected the members' argument. The court noted that the members had agreed in their amended operating agreement to waive fiduciary duties. The court also determined that the operating agreement expressly addressed the possible sale of the company, vesting the board with "sole discretion" to decide how to manage a sales process. The operating agreement also included restrictions on how the board would be permitted to act in response to conflict-of-interest offers. Considering these provisions, the court then held that the operating agreement's implied covenant of good faith and fair dealing, while still in place, should not be used by courts to contravene what it perceives to be the intentions of the parties. "When an LP [or LLC] agreement eliminates fiduciary duties as part of a detailed contractual governance scheme, Delaware courts should be all the more hesitant to resort to the implied covenant."

As the court went on to explain, "The Court does not derive implied obligations from its own notions of justice or fairness. Instead, it asks what the parties themselves would have agreed to had they considered the issue in their original bargaining positions at the time of contracting." The court determined that the parties had expressed their intentions plainly, and they did so in a manner to permit the majority to strike the deal without concern for minority interests. Doing so would effectuate a bargain different from what was struck when the LLC agreement was signed, amended presumably to attract the additional capital. When the majority acts in a manner permitted by the LLC agreement, Delaware courts will not step in to protect minority owners:

> [I]f the Plaintiffs had wanted protection from self-interested conduct by the Defendants, they could easily have drafted language requiring the Board to implement a sales process designed to achieve the highest value reasonably available for all of Trumpet's members. The Plaintiffs also could have sought other protections, such as a minimum sales price, a majority-of-the-minority sales provision, or a period during which sales were prohibited. Such a contract would, of course, have been less attractive to investors. Instead, the Plaintiffs struck an investor-friendly bargain with which they are now dissatisfied. But "[p]arties have a right to enter into good and bad contracts[;] the law enforces both."

The Delaware Supreme Court recently affirmed the Court of Chancery's decision, though in doing so it adopted a more expansive interpretation of the implied covenant. While Trumpet's board had "sole discretion" to manage the sales process, the operating agreement "did not relieve the board of its obligation to use that discretion consistently with the implied covenant of good faith and fair dealing." Nevertheless, the Supreme Court concluded that the implied covenant would not supplant an express waiver of fiduciary duties and require the board to comply with fiduciary requirements to "market-check" sales offers. (*Miller v. HCP Trumpet Investments, LLC*, 2018 WL 4600818 (Del. Sept. 20, 2018)).

The message of the Delaware courts in this case is clear: If LLC members elect to permit their company's managers to operate without owing fiduciary duties, those members should not expect courts to rely on inherent notions of fairness and implied duties applicable to all contracts to overturn self-interested conduct, even if that conduct is potentially egregious. LLC members must use the LLC agreement itself to establish the managers' duties to provide protection for their interests and rights.

Litigation Funding – Opportunities Abound for Private Equity Firms Looking to Diversify

By Larry Cerutti and Matthew Hrutkay

Most of us have a general understanding of what "litigation financing" means. Maybe we see an ethically hazy framework in which countless investors are able to inject themselves into valuable, fast-paced litigations as an investment vehicle. Or perhaps we see the overwhelming legal costs faced by a small start-up trying to seek justice for theft of its patents and other intellectual property. Regardless of context, it is clear that litigation financing (aka litigation funding) has emerged from its class action roots and is here to stay. This has caused and will continue to cause significant disruption in the legal arena for the foreseeable future – disruption from which private equity firms are well placed to benefit.

Under a traditional litigation funding arrangement, an outside investor provides a plaintiff with funds to pay legal costs and fees, in return for that investor's right to a set portion of any recovery (typically around 50%). The benefit of this arrangement for the litigant is that there is no downside risk to pursuing litigation (an investor is footing the bill), and the benefit to the investor is the incredible potential upside of the investment, which is not necessarily dependent on typical market conditions. For example, in one case (commonly known as *Tienver v. Argentina*), the litigation funding company invested $12.8 million in an action seeking compensation from the Argentine government for its expropriation of two airlines. Following a positive arbitration award of $324 million in plaintiffs' favor, the funder sold its interest in the litigation for $107 million. This represents a 736% return on invested capital, demonstrating that these investments can provide firms with significant monetary windfalls.

According to Buford Capital, one of the three largest litigation financing companies in the world, only 7% of U.S. law firms used litigation funding to prosecute litigations in 2013. That number grew dramatically to 36% in 2017, an increase of 414% in four years.

As additional creative uses of litigation funding are developed and the strategic advantages of funding become more well known, this number is likely to grow even further. How can private equity firms take advantage of this rapidly changing environment and obtain value from litigation?

Private equity firms can benefit from litigation funding in four ways. First, firms may invest in litigation financing companies such as Buford Capital, IMF Bentham, and Longford (currently the three largest participants), or make direct investments in specific litigations through one of these companies, as in the *Tienver v. Argentina* case noted above. Second, a PE firm can use litigation funding to help a company in its portfolio prosecute a claim. Third, firms can purchase interests in individual litigations or "shares" of a litigation through secondary markets. Fourth, and finally, firms can use litigation funding when acquiring a target, to reduce the cash purchase price and obtain investment without giving up valuable voting and governance rights. This creative use of litigation funding, designed specifically for private equity firms and hedge funds, takes advantage of the value underlying a target company's portfolio of litigation.

Here is a brief example of how this type of transaction works: PE Capital wants to buy XYZ Co. for a total price of $150 million but wants to front only $130 million of that cost. Traditionally, a firm would seek an additional investor, who would then have some voting rights associated with that investment. Rather than seeking a direct investor, litigation finance allows PE Capital to offer ABC Co. a percentage interest of any recovery from XYZ Co.'s litigations, for a fixed sum—here, the $20 million gap between the $150 million price of XYZ and the $130 million that PE Capital is willing to invest. In return for that $20 million investment, ABC Co. obtains a portion (typically around 50%) of any recovery from actions in XYZ Co.'s litigation portfolio, which is valued at $200 million.

While these creative investments offer plenty of upside potential, lingering ethical considerations unique to litigation merit additional scrutiny. These tend to focus on three key considerations: (1) issues relating to attorney-client privilege; (2) control of the litigation and settlement strategy decisions; and (3) ethical rules forbidding non-lawyer investments in law firms and fee-sharing arrangements with non-lawyers.

The first two issues are easily addressed. The benefit to the litigant from litigation funding is directly tied to the fact that funders ultimately have no say in directing or controlling the litigation, and have no right to obtain privileged communications or otherwise actively participate in the litigation. And while the third concern exists for some litigation funding arrangements (primarily those relating to direct investments in law firms), they do not currently implicate other "litigation portfolio" funding scenarios where the private equity firm invests in a target company's pending litigation rather than in a particular firm's litigation portfolio.

For example, in Formal Opinion 2018-5, the New York City Bar Association recently opined that Rule 5.4 of the New York Rules of Professional Conduct (which prohibits fee-sharing agreements between lawyers and non-lawyers) prohibits a financing agreement between a lawyer (or law firm) and a litigation funder "under which the lawyer's future payments to the funder are contingent on receipt of legal fees or on the amount of legal fees received in one or more matters." Although this rule is implicated only where there is a fee-sharing agreement between a firm (rather than the client) and a funder, it nonetheless demonstrates that the various state bar ethical authorities are keeping a close eye on funding issues and any potential impact on the attorney-client relationship.

Ultimately, while this quickly changing landscape can make it difficult to assess all potential risks related to litigation funding, it is apparent that PE firms can take advantage of the numerous benefits of litigation funding and can now tap into new and diversified investment vehicles that leverage litigation as an asset rather than a contingent liability.

Accounting for a Headache: Impact of New Lease Accounting Standards on Credit Agreements

By Lizzie Garner and Justin Wood

The implementation period for changes in lease accounting standards under United States generally accepted accounting principles ("GAAP") will soon be upon us. For measurement periods beginning after December 15, 2018, GAAP will require public companies to record their operating leases as assets and their payment obligations thereunder as liabilities, while privately held companies must begin adopting these changes after December 15, 2019. Although these changes have been long-anticipated in the market, their impact will no doubt lead to unintended consequences for sponsors and their portfolio companies under their credit agreements. This article discusses potential headaches that these changes may cause for borrowers, as well as certain steps borrowers and their lenders can take to mitigate such headaches.

I. A Summary of FASB Accounting Standards Update No. 2016-02

On February 25, 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update No. 2016-02 to Leases (Topic 842),[1] which, when implemented, is intended to improve and clarify financial reporting standards with respect to all types of leasing transactions and thereby nullify one of the most widespread existing forms of off-balance sheet accounting. The changes will affect all companies and other organizations that lease any type of asset (including real estate), as well as investors and others who rely on financial statements to understand an entity's financial health, including sponsors and lenders.

Under current GAAP standards (which are established by the FASB), only the assets and liabilities relating to the rights and obligations created by capital leases (leases that function like rent-to-own structures, whereby a lessor essentially finances a lessee's purchase of an asset that the lessee will own at the end of the term) must be reported on a lessee's balance sheet. However, once the FASB's updates are effective, assets and liabilities relating to both a lessee's capital *and* operating leases must be recognized on an entity's balance sheet (as long as any such lease has a term of more than 12 months). The reportable assets will be the lessee's right to use the assets, and the liabilities will be the lease payments owed by the lessee on such assets (measured as the present value of the lease payments).

As noted above, implementation of this change will be staggered: (1) for public companies, the new rules will apply beginning after December 15, 2018; (2) for privately held and not-for-profit entities, the new rules will apply for fiscal year measurement periods beginning after December 15, 2019 (but not for other measurement periods); and (3) for any other measurement period for privately held and not-for-profit entities, the new rules apply for periods beginning after December 15, 2020. Any entity is permitted to begin applying these standards prior to these deadlines.[2]

II. Potential Issues under Credit Agreements

Analyzing the potential impact of these new standards on a borrower's credit agreement begins with determining whether the

[1] FASB. (February 2016). Accounting Standards Update No. 2016-02. *Accounting standards codification.*

[2] *Id.* at 7.

operative definition of "indebtedness" or "debt" in the agreement would include lease obligation liabilities. Definitions of debt in credit agreements (particularly in the middle market) range from a narrow formulation of debt for borrowed money and related debt-like obligations to a broad inclusion of all liabilities under GAAP. To the extent that operating lease obligations constitute "debt" under a credit agreement, such obligations would likely impact the borrower's financial covenants by making borrowers appear more highly leveraged, as the calculation of many common covenants includes a debt component (including the leverage ratio, the debt service coverage ratio and the fixed charge coverage ratio, which frequently appear in leveraged loans). Additionally, any "debt" constituting lease obligations would need to be permitted under the agreement's negative covenant restricting debt: Left untouched, the accounting changes could potentially trigger an inadvertent event of default or result in unintended utilization of the negotiated debt covenant baskets. This impact could result in a diminished ability of the borrower to incur additional debt under its covenants.

III. Potential Solutions

Shortly after the FASB signaled its intention to update the lease accounting standards, market participants began trying to address its impact under credit agreements. The most common "fixes" include:

> (1) Explicitly providing that lease accounting standards in effect as of the date of the agreement will apply (even if GAAP changes), using language similar to the following:
>
> "the accounting for any lease (and whether such lease shall be treated as a capitalized lease) shall be based on GAAP as in effect on the closing date and without giving effect to any subsequent changes in GAAP (or required implementation of any previously promulgated changes in GAAP) relating to the treatment of a lease as an operating lease or capitalized lease."

The scope of this "frozen GAAP" provision with respect to leases varies, with some agreements stating that these lease rules apply "for all purposes" and others limited to purposes of financial covenants only. Borrowers should analyze the scope of any such provision and determine whether it is broad enough to cover both financial covenants and negative covenants.

Additionally, relying on such a frozen GAAP provision to mitigate the impact of the lease accounting changes could result in a mismatch of the borrower's audited financial statements required under the credit agreement to be prepared in accordance with GAAP and the use of non-GAAP financial information to calculate the financial covenants. Moreover, if a frozen GAAP provision retains the prior lease accounting standards "for all purposes," the required financial statements would thus also apply the frozen GAAP standard and would not be prepared in accordance with GAAP as in effect at the time. This mismatch would likely result in a qualification by the auditor. Lenders may instead request a second set of financials excluding leases as liabilities to align with calculation of the financial covenants.

> (2) Including an agreement to amend the agreement following any change in GAAP to preserve the intent of the agreement. In some instances, this language is limited to changes that impact financial covenant calculations.

While the new lease accounting standard may cause many borrowers to avail themselves of this language, it necessitates an amendment to the agreement, which requires time and expense and often results in frustration. However, if this "fix" is adopted, the parties should ensure that any such amendment also addresses the impact under definitions of debt, financial covenants and negative covenants, and the potential financial statement mismatch discussed above.

IV. Conclusion

Fortunately, with proper attention, these headaches should be a short-term problem for most borrowers. Looking ahead, the best way for borrowers to address the new accounting standards in their credit agreements would be to either (i) include a broad frozen GAAP provision that applies the existing standards for all purposes other than the financial statements, or (ii) address their impact under debt definitions, financial covenants, negative covenants and required financial statements during the initial drafting process or the next amendment. Borrowers should carefully analyze the impact of the lease accounting changes under their credit agreements in advance of implementation to avoid inadvertent defaults or other unintended consequences, and they should discuss how to best address such impact with their lenders and accountants.

Corporate Compliance and Regulatory Update: The U.S. Government Provides Guidance on How Companies Doing Transactions Involving China and Russia (and Certain Other Countries) May Avoid Violating the U.S. Sanctions Against North Korea

By Sharie Brown

I. The U.S. Government Issues Advisory with a Warning for Companies

Companies that do business with supply chain links to China, Russia and certain other countries are at risk of unintentionally violating the various U.S. and United Nations sanctions against North Korea due to the deceptive practices employed by North Korea that disguise transactions involving trade with North Korea and the use of North Korean labor. As discussed below, a July 23, 2018, jointly issued advisory from the U.S. Department of State, the U.S. Department of Treasury's Office of Foreign Assets Control ("OFAC") and the U.S. Department of Homeland Security ("DHS"), Risks for Businesses With Supply Chain Links to North Korea,[1] provides a warning and detailed guidance for companies with supply chain links in China and other listed countries that seek to remain in compliance with U.S. laws and restrictions on dealings with North Korea.

According to the advisory, there are two primary areas of concern for North Korea-related trade risks: i) inadvertent sourcing of goods, services or technology from North Korea; and ii) the presence of North Korean citizens or nationals working in a company's supply chain, whose labor generates revenue for the North Korean government. The U.S. government seeks to disrupt the North Korean government's ability to generate hundreds of millions of U.S. dollars in revenue from the export of North Korean labor (largely from salaries paid directly to the North Korean government by certain foreign employers). Companies should be aware of the below-described risks involving goods, services and technology.

II. Increased Risk for and Potential Indicators of Goods, Services and Technology with a North Korean Connection

The advisory provided examples of five types of trade transactions that have heightened risks for an unlawful North Korean connection or nexus:

- **Subcontracting/Consignment Firms:** A Chinese or third-country factory subcontracts with a North Korean firm to provide materials or components for a product ordered from the Chinese or third-country factory.
- **Mislabeled Goods/Services/Technology:** A North Korean exporter may attempt to hide the origin of goods produced in North Korea by falsely labeling an item as "Made in China" when, in fact, the item was made in North Korea.
- **Joint Ventures:** North Korean exporters have formed (nonpublic) partnerships with firms from China and other countries in the areas of

[1] A copy of the advisory is available at this website address: https://www.state.gov/documents/organization/284481.pdf.

- o apparel, construction, small electronics, hospitality
- o minerals, precious metals, seafood and textiles.[2]

- **Raw Materials or Goods Provided with Artificially Low Prices:** Since North Korean exporters sell goods and raw materials at substantially below-market prices to intermediates and third parties, businesses should view pricing that is well below market as a possible "red flag" that North Korea is involved as a supplier.
- **Information Technology ("IT") Services:** Since North Korean firms disguise their country of origin footprint by using front companies, aliases and third-country nationals who act as facilitators, companies should be aware that North Korea provides IT services such as website and app development, security software, and biometric identification software and take appropriate precautions to avoid the North Korean service providers.

III. Increased Risks for and Potential Indicators of North Korean Overseas Labor

A. Country Risks

The advisory identified China and Russia as the two countries that host more North Korean laborers than 39 other countries combined. The advisory provides a full list of countries hosting North Korean labor in 2017-2018 as follows:

Algeria	Nepal
Angola	Nigeria
Bangladesh	Oman
Belarus	Peru
Cambodia	Poland
China	Qatar
Democratic Republic of the Congo	Uganda
Equatorial Guinea	Republic of Congo
Ethiopia	Russia
Ghana	Rwanda
Guinea	Senegal
Indonesia	Singapore
Kuwait	Tanzania
Kyrgyzstan	Taiwan
Laos	Thailand
Libya	United Arab Emirates
Malaysia	Uruguay
Mali	Vietnam
Mongolia	Zambia
Mozambique	Zimbabwe
Namibia	

B. Industry Risks

The advisory warned that large numbers of North Korean laborers are exported to perform a huge single contract involving the following (and other) industries: apparel, construction, footwear manufacturing, hospitality, IT services, logging, medical, pharmaceuticals, restaurant, seafood processing, textiles and shipbuilding.

C. Red Flags Indicating Possible North Korean Overseas Labor

Wage Practices: The employer withholds wages; makes large, unreasonable pay deductions; pays wages late; or makes payment to workers in-kind, among other practices.

Contract Terms: North Korean laborers are generally hired on long-term two-to-five-year

[2] The advisory includes a list of known North Korean joint ventures in Annex 2.

contracts that also require a large upfront payment to the North Korean government. The upfront payment could be as high as 30% of the total contract amount.

Poor Housing: Laborers live in unreasonably inexpensive/cheap employer-provided housing that is unsafe and unsanitary; North Korean laborers are often isolated from laborers of other nationalities.

Labor Controls: North Korean laborers typically have no access to or control over their bank accounts, passports or visas (which are controlled or held by the employer). The laborers may have little to no time off work and attend mandatory self-criticism sessions, among other controlling practices.

No Transparency: The ultimate beneficiary of the contract or financial transaction is difficult to ascertain due to contract structuring designed to hide key parties and beneficiaries. Worksite inspections are prohibited by the North Korean government and laborers cannot be interviewed without a "minder" (observer) present.

IV. Risk-Based Due Diligence Required

The advisory recommends that companies review their supply chains for possible North Korean laborers, goods, services and technology. Companies must also take into account whether their activities involve any of the above high-risk industries or countries. Companies should then implement risk-based due diligence procedures and controls commensurate with their assessed risks with respect to possible North Korean links or connections.[3]

V. Possible Penalties

Failure to conduct appropriate risk-based due diligence and/or engaging in or facilitating a prohibited activity could result in civil penalties of two times the value of the underlying transaction or $295,141 per violation as well as a referral for criminal prosecution, or both. OFAC can also designate a U.S. person and impose sanctions against the U.S. person for misconduct involving North Korea. Secondary sanctions could also be imposed against foreign financial institutions that knowingly conduct or facilitate significant trade with North Korea or that knowingly conduct or facilitate a significant transaction on behalf of a designated person.

VI. Conclusion

According to the advisory, companies with dealings in China, Russia and other high-risk countries in high-risk industries have a heightened exposure for a violation of U.S. and other sanctions and restrictions against North Korea. We recommend that such companies, and the investing firms that fund those companies, ensure that a risk assessment is performed and compliance reviews are conducted to determine the required due diligence actions, controls and internal procedures necessary to detect and avoid any sanctionable North Korean connections, and to prevent a violation of the sanctions against North Korea.

[3] For more details on the recommended due diligence standards, the advisory recommends reviewing DHS Q&As (specifically question 8), and OFAC's Economic Sanctions Enforcement Guidelines, 31 C.F. R. Part 501, Appendix A.

Drafting Tips for Limited Partnership Agreements or Operating Agreements for Companies Seeking Financing

By Kris Henman, W. Peter Beardsley, and Opeyemi Akinbamidele

Private equity and venture capital investment funds ("Funds") are increasingly interested in entering into credit facilities to provide these Funds with short-term liquidity. These credit facilities will typically be structured as a capital call credit facility or a subscription credit facility in which the lender will agree to make loans available to the Fund based on some percentage of the Fund's remaining uncalled capital (i.e., the amount of capital the Fund can call from its investors). Although some of these facilities may be unsecured, most of them are usually secured either by a blanket lien or a limited lien on the proceeds of the Fund's capital calls, the right of the Fund and its general partner or manager ("Managing Entity") to call capital, and the Fund's investments.

One challenge that frequently arises when lenders and Funds are structuring a capital call facility is whether the Fund's limited partnership or operating agreement (the "Fund Document") is drafted in a way to satisfy the lender's diligence requirements such that the lender has adequate assurance that (1) the Fund is able to incur and repay indebtedness, (2) the Fund and its Managing Entity can grant security interests to the lender in the applicable collateral, and (3) the Fund can call capital from its investors with limited restrictions. If the lender is not satisfied with the provisions in the Fund Document, the lender may require the Fund to amend its Fund Document, which requires the Fund to approach its investors, often leading to delays in obtaining financing and increased costs for the Fund. Therefore, it is recommended that Funds incorporate certain provisions into their Fund Documents that will satisfy lenders' requirements for such a credit facility.

Below are provisions that lenders will look for in a Fund Document when evaluating whether to extend credit to a Fund, as well as some examples of clauses that are typically flagged by lender counsel, along with alternate suggested language that is usually more amenable to lenders in these credit facilities:

1) Allow for the Fund to incur indebtedness. Although many Fund Documents authorize a Fund to incur indebtedness, they may also put certain restrictions on the type or amount of indebtedness the Fund may incur. For example, a Fund may be prohibited from incurring any indebtedness which exceeds a certain percentage of capital commitments or without the approval of a certain advisory committee or other key person. A Fund should consider specifically carving out these capital call or subscription facilities from such restrictions in order to maximize the amount of indebtedness it may incur and streamline the process needed to obtain a credit facility.

2) Allow for the Fund to secure its borrowings with a pledge of capital commitments. Some Fund Documents are silent on whether the Fund's indebtedness can be secured, and other Fund Documents state that the Fund can borrow but cannot secure its borrowings with a pledge of capital commitments. Lenders are cautious in the absence of clear language that capital commitments may be pledged to secure loan obligations. A Fund should consider adding clear language to its Fund Document, such as the following: "The Partnership and the General Partner may secure any of the Partnership's indebtedness for borrowed money with a pledge or assignment of all or any part of the Partnership's and the General Partner's (i) interest in the Partners' capital contribution proceeds and (ii) right to call and receive capital contributions."

3) Allow for the Managing Entity to pledge to the lender the Managing Entity's right to call capital. Many Fund Documents do not have language adequate to authorize the Managing Entity to grant the liens necessary for these facilities. For example, a Fund Document may authorize the Fund to grant a lien but does not explicitly authorize the Managing Entity to do so. Others may prohibit the Managing Entity from pledging its "interest" or "rights" in the Fund, which presumably would include the right to call capital. And others may permit the Managing Entity to pledge its "interest," but restrict the Managing Entity from pledging its "managerial" or "economic" interest without any indication of whether the right to call capital is included as such an interest. A best practice is to state clearly that both the Fund and the Managing Entity have the authority to grant a lien on the capital contribution proceeds and the right to call capital.

4) Have each investor acknowledges and agrees to fund any capital calls made by a lender or to repay indebtedness. Some Fund Documents do not address whether an investor would be committed to fund capital calls by third parties. Lenders prefer to see a provision in the Fund Document that commits the investors to fund any capital call required to satisfy the Fund's obligations to lenders or to repay indebtedness of the Fund.

5) Draft the "No Third-Party Beneficiary" provision expressly names lenders as third-party beneficiaries. Many Fund Documents include a blanket statement that the Fund Document shall not be deemed to construe any rights to any third party and that no third parties will be entitled to enforce any provision of the Fund Document. Such language decreases lenders' confidence that they will be able to enforce their right to call capital. Instead, Funds should consider adding a provision such as the following: "Except with regard to the rights of a secured creditor in connection with a subscription facility, the provisions of this Partnership Agreement are not intended to be for the benefit of or enforceable by any third party."

6) Limit conditions to investors' commitment to fund capital calls. Lenders prefer to see provisions in a Fund Document that commit a Fund's investors to fund capital calls without restriction except for certain mechanical conditions. The more provisions that excuse investors from funding a capital call, the less likely it is that a lender will agree to provide such a facility. In some cases, the lender may exclude investors from the loan facility's borrowing base if the excuse provisions are too broad; in other cases, a lender may require a reduced advance rate for the borrowing base. Funds should consider the potential impact of any excuse provisions an investor may want to incorporate into the Fund Document or side letters before they agree to include such provisions.

7) Make recallable capital "lender friendly." Funds often have the ability to recall distributions from their investors in certain situations. To the extent the Funds intend to include such recallable capital in their capital commitments, they should consider subjecting recallable capital to as few limitations as possible. Lenders may give Funds credit in the borrowing base for recallable capital, but only if the lender is certain that the Fund or Managing Entity will be able to recall such capital to repay indebtedness. For example, a Fund should avoid limitations on the period of time during which the Fund may recall capital or on the use of the proceeds of such recallable capital.

8) Commit investors to fund capital calls after the investment period. Although a Fund's primary investment activity will end after the termination of the commitment period or investment period, the Fund continues to make follow-on investments and manage ongoing investments and may need to continue to borrow. If the investors are not committed to making capital contributions after an investment period, then a lender may make the termination of the investment period a default or it may terminate any commitment to lend to the Fund once the investment period expires. To ensure continued access to liquidity, Funds should add language to their Fund Documents to expressly obligate their investors to fund capital calls made after the investment period in order to repay any indebtedness.

Funds should consider the above issues when drafting their Fund Documents. Funds often need financing quickly to be able to make investments, so they should consult with counsel to review their Fund Documents well in advance of pursuing a credit facility. A properly drafted Fund Document will help expedite the closing of the debt facility and reduce transaction costs.