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Keep Calm… and Investigate Rumors – LP Default Risk and Fund Finance – 2.0

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During the Great Recession, fund finance professionals spent a lot of time analyzing and speculating about the impact of the financial crisis on fundraising, the potential for the failure of limited partners to honor their capital contribution obligations to funds, and the strength of facility structures and documentation. That makes the current scene familiar to many of us.

While the turmoil resulting from the COVID-19 pandemic is not driven by underlying fundamental financial issues, the “credit crunch” in some sectors and short-term liquidity concerns throughout financial markets invites comparison to the Great Recession. However, similar to during that crisis, despite these concerns and uncertain market conditions, many funds may now be in a strong position to take advantage of the opportunities that a down market presents.

In the past week, a *Private Funds CFO* headline announced LP defaults “already happening”, reporting, with little detail, that two European LPs had defaulted on capital calls and more were rumored. We were skeptical, because we have seen this before.

In late 2008 the *Financial Times* declared that investors might not meet commitments as stock market and hedge fund losses mounted, and the *Wall Street Journal* reported the likelihood that a number of institutional investors would not honor capital calls. Actual defaults were reported, which in most cases turned out to be false. For example, news that a governmental pension system was defaulting on nearly $1 billion in commitments was, instead, a decision by the investor not to proceed with negotiations to commit to a real estate fund – disappointing for the fund, but no deal had been executed.

Hence our caution when we saw the “LP defaults” headline. On further inquiry, it turns out that several high net worth investors may have, in fact, failed to fund a capital call, but as far as we can tell, no cascade of defaults has yet followed by other investors in that fund, and the fund apparently did not have a subscription-secured facility in place.

At the same time, we understand that the exigencies of working from home have created logistical issues leading to occasional short delays in payment of contributions, but reports are that capital calls are generally being honored. Many institutional investors hold significant liquid positions such as U.S. Treasuries, as the U.S. Federal Reserve Board and other central banks are working to ensure that financial markets remain liquid and stable.

The past does not predict the future, of course – we simply advise taking a breath when bad news is reported, especially without detail that can be corroborated. Experienced lenders and borrowers understand that subscription-secured facilities have a long track record of stability, that the documentation is strong, and that the availability of the facilities provides liquidity in times when limited partners may appreciate a pause in capital calls, while preserving the funds’ ability to nimbly take advantage of the markets.

Our industry is strong and works together remarkably well, whether we work at a financial institution, fund, law firm, or other service provider. We have already witnessed a heightening of the close attention, responsiveness, collaboration and good will that has always supported our dealings with each other, and we expect these characteristics to continue as we deal with the current crisis and, ultimately, get through it, perhaps with new lessons learned.