

Defaulting Limited Partners in Investment Limited Partnerships

INTRODUCTION

The Irish investment limited partnership (the “**ILP**”), now re-shaped as a flexible fund investment vehicle following amendments made to the existing Investment Limited Partnership Act, 1994 (the “**ILP Act**”), is expected to become the fund structure of choice for many international investment managers, particularly those in the private equity and real assets sectors.

In this key features document, we briefly consider the consequences for limited partners (“**LPs**”) who fail to uphold the obligations imposed on them under the terms of the Limited Partnership Agreement (the “**LPA**”). The LPA itself will typically include provisions which are considered to be “industry standard” in relation to defaults by LPs which can be availed of by the GPs. A more detailed analysis of the ILP is available [here](#).

KEY POINTS

- Defaults by LPs in an ILP can have a significant impact on the ILP itself and on the non-defaulting LPs;
- The LPA contains provisions relating to the consequences for default by LPs of their obligations;
- LPs should be interested in ensuring the GP has strong remedial powers under the LPA for defaults by an LP;
- Under the ILP Act, the penal nature of default remedies available to a GP will not mean they are unenforceable or inapplicable;
- “Cure” periods for breach of LP obligations are permitted at the discretion of the GP;
- Any “cure” periods permitted must be exercised taking into account the interests of non-defaulting LPs;
- Comprehensive remedies are available to GPs for defaults by LPs including forfeiture;
- GPs may utilise multiple remedies against defaulting LPs.

What constitutes an LP default?

The most common form of default in respect of an LP in an ILP will arise in circumstances where the relevant LP fails to meet a capital call or drawdown notice issued by the GP. However, given the contractual nature of an ILP there may be certain other terms or requirements specified in the LPA which impose obligations on LPs. If an LP fails to fulfil one of its obligations, that may constitute a breach of the LPA provisions and potentially a default. In keeping with provisions seen in limited partnership structures in other jurisdictions, the ILP Act provides that the remedies or consequences available to the GP under the LPA will not be unenforceable or rendered inapplicable solely because they are penal in nature.

Are LPs given any chance to remedy a breach before it becomes a “default”?

Notwithstanding the general ability of the GP to rely on the default provisions of the LPA, many LPAs will provide the GP a degree of flexibility to provide an LP with additional time to remedy any breach of obligation (sometimes subject to payment of additional interest). These “cure” arrangements are very important for GPs and LPs alike given the significant consequences for the LP arising from a breach of obligations imposed under the LPA. In circumstances where a breach is continuing, a formal notice may be issued by the GP to the defaulting LP, requiring the outstanding payment by a specified date and outlining that failure to meet the terms of the notice will result in a formal default.

There are no statutory timeframes within which a GP must declare an investor in default. Accordingly, the flexibility and ability of GPs to permit “cure” periods can be set out in the LPA. While a well-constructed LPA will build in flexibility in relation to “cure” periods, a GP does have a fiduciary obligation to the non-defaulting LPs and the ILP. Therefore, in exercising any discretion or flexibility permitted by the LPA, the GP must ensure that the interests of the ILP or the non-defaulting LPs are not prejudiced.

What are the consequences of a default for the defaulting LP?

If the cure period permitted by the LPA as exercised by the GP elapses and the default continues, the GP will be obliged to declare the relevant investor to be in default. Outlined below are some industry standard provisions which the GP may avail of in the context of a default and can be included in an LPA:

- (a) **Damages and/or Specific Performance:** This allows for the right to collect damages caused by the consequences arising from the missed payment, often with a penalty rate;
- (b) **Transfer of interest:** This allows the GP to designate a third party (typically another existing LP) as a transferee of the defaulting LP’s interest in exchange for agreeing to make-up any shortfall in outstanding capital payments of the defaulting LP and also agreeing to

meet future capital calls that would have otherwise been required of the defaulting LP;

- (c) **Sales waterfall/pre-emption rights:** These provisions allow for a right of first refusal to the existing LPs in the partnership to receive a percentage of the defaulting LP's capital account balance in exchange for proportionate contribution of the un-funded capital call, as well as agreeing to meet any future calls;
- (d) **Reduction in rights:** This reduces the rights of the defaulting LP, allowing the GP to declare that it is no longer an LP and has no voting rights, nor any rights to gain from allocations into its capital account until such time as the capital account is reduced to a zero balance;
- (e) **Forfeiture:** This allows for the forfeiture of the defaulting LPs capital account balance and the forfeiture of any right to future profit allocations. Forfeited amounts are typically re-distributed proportionately among the remaining non-defaulting LPs;
- (f) **Withholding distributions:** The LPA will typically allow for a GP to refuse to distribute cash to the defaulting LP and to apply the proceeds to discharge outstanding capital calls and expenses (including any interest accrued); and
- (g) **Liability for costs:** Under the terms of the LPA, the GP will likely have the power to require that the defaulting LP bears all out-of-pocket expenses incurred by or on behalf of the ILP with respect to the default, including the costs of arranging any bridge financing.

As the provisions outlined above are not mutually exclusive, the GP may avail of any one or more options in instances where an LP is in default.

What are the consequences of a default for the non-defaulting LPs, the ILP and the GP?

Remaining Investors

The principal burden falling on non-defaulting LPs is the potential requirement to meet any shortfall in capital commitments. Therefore, it is common for LPs to seek strong enforcement powers for the GP to be included in the LPA so as to ensure appropriate remedial powers are in place and in the hope that it might act as a deterrent for potential defaults.

LPs may also focus on "give-back" provisions in LPAs. "Give-back" provisions require a defaulting LP to repay distribution proceeds to the extent that there is a subsequent warranty or indemnity claim by a third party purchaser of a portfolio company.

Partnership

Depending on the size of a defaulting LP's capital commitment in proportion to the overall ILP, there may be significant consequences for the ILP itself, including an inadvertent breach of diversification rules (if any), impact on liquidity and consequently an impact on the ILP's ability to achieve the portfolio's objective. A significant investor who defaults on its

commitments to an ILP may call into the question the viability of the ILP as a whole.

The General Partner

Aside from the obvious risk to both management fees and reputation, in cases of a significant default GPs are likely to be required to notify any lenders appointed to the ILP of a default and in certain circumstances that may reduce the capacity of the ILP to borrow as part of the investment strategy of the partnership.

As GPs will naturally want to retain the size of the ILP, the preferred option therefore is likely to facilitate a transfer of the defaulting LP's interest to non-defaulting LPs, as described above. However, the remaining non-defaulting LPs will likely seek specific parameters specifying the conditions upon which such a transfer will occur.

In this respect, it is important to have appropriate "cure periods" in place in the LPA to provide the GP with sufficient flexibility to engage with the defaulting LP in an effort to avoid a formal default.



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