

Investment Funds: Monthly Digest

March 05, 2019

EXCUSE PROVISIONS IN INDIA FOCUSED PE / VC FUNDS: LEGAL CONSIDERATIONS

INTRODUCTION:

Investment funds may be structured on a blind-pool basis, a deal by deal basis or hybrids of the same. Traditional private equity ("PE") or venture capital ("VC") funds are structured on the basis of a blind-pool model. Investors ("LPs") participate in a PE / VC fund by committing their capital and relying on the skill and acumen of the investment manager ("GP"), to identify portfolio companies presenting favourable investment opportunities for the fund and causing the fund to invest in them by making drawdowns on the capital commitments of LPs. In this manner, LPs generally participate in every investment opportunity identified by the GP "blindly". However, even in such funds, LPs often negotiate an exception to such general situation through the insertion of 'excuse provisions' in the fund documents. Excuse provisions permit an LP to decide not to contribute to the Fund in respect of proposed portfolio investments in certain circumstances which meet, or fail to meet, certain specified criteria.

In India, PE / VC funds are invariably structured as alternative investment funds ("AIFs") registered with the Securities and Exchange Board of India ("SEBI") under the SEBI (Alternative Investment Funds) Regulations, 2012 ("AIF Regulations"). In spirit, it appears that SEBI's intent as expressed through the AIF Regulations is to encourage all LPs to participate in all portfolio investments in which the AIF participates¹. The exception which proves the rule, is SEBI's prescription for angel funds, requiring GPs to seek an angel LPs prior approval for consummating a portfolio investment with such LP's contributions. Another subtle exception, not enjoying such an explicit regulatory nod, and yet being quite prevalent in PE / VC fund documentation especially with increasing participation by sophisticated, institutional LPs, is the presence of 'excuse provisions'. SEBI has, on a case-to-case basis, been comfortable with excuse provisions if there are certain legal or regulatory prescriptions applicable to an LP which prevent it from participating in the portfolio investment.

In this issue of the digest, we analyse excuse provisions and their place in PE / VC fund documentation.

EXCUSE PROVISIONS:

Excuse provisions provide a right which enables an LP to opt-out from participating in a deal identified by a GP for the fund. It may arise from statutes, regulations, internal charters or even from commercial considerations (in which case, it can be expected to be more open to negotiation). An excuse right to an LP is generally backed by all or any of the following reasons:

1. regulatory or legal impairment to participate in a deal, often specific to the LP;
2. religious reasons such as excuse from "sin" investments made by the fund, such as investments in alcohol, pork, prostitution, or firearms industry²; and
3. investments against the policy of the LPs³ such as ESG⁴ policies of an LP or policies containing investment restrictions that preclude LPs to invest in certain types of assets, activities or jurisdictions⁵.

CONSIDERATIONS AND DOCUMENTS

What? - GPs should be very careful of what an LP is seeking an excuse from. Excuse provisions should ideally be specific and clear to prevent an LP from cherry-picking deals under the guise of exercising excuse rights. In some cases, GPs often seek a representation from the LP that its participation in the relevant portfolio investment would result in a breach of law, regulation, license or similar, and hence the LP should be excused from the same. In many such cases, a GP may sometimes require a legal opinion from the LP's counsel confirming that its participation would result in such breach⁶.

When? - Ethically, LPs should disclose to the GP, preferably at the stage of fund documentation, the situations in which any proposed investment of the fund may violate the LP's laws or internal policies. If such a disclosure is not made by an LP at the time of committing to the fund, then it is good practice for the GP to ask whether the LP has any such policies and if yes, the same be shared with the GP in advance. Typically, an excuse provision also allows for excuse towards deal expenses incurred by the fund towards consummation of the relevant portfolio investment.

Where? - Generally, the excuse provisions are captured in the relevant contribution agreement / subscription agreement or the related side letter, which are specific to an LP. In such case, the GP must be mindful of the MFN⁷ clauses. Although specific excuse rights may be granted under the contribution agreement or side letter, it is preferable that the general fund documents (accessible to all LPs) contain the GP's framework towards the grant of excuse rights. This helps set the boundaries for LP – GP negotiation on excuse rights.

Ultimately though, the incorporation and breadth of an excuse provision is the product of negotiation.

IMPACT OF EXCUSE PROVISIONS

Research Papers

Handbook on New Labour Codes

April 29, 2024

Compendium of Research Papers

April 11, 2024

Third-Party Funding for Dispute Resolution in India

April 02, 2024

Research Articles

Private Client Insights - Sustainable Success: How Family Constitutions can Shape Corporate Governance, Business Succession and Familial Legacy

January 25, 2024

Private Equity and M&A in India: What to Expect in 2024?

January 23, 2024

Emerging Legal Issues with use of Generative AI

October 27, 2023

Audio

Third-Party Funding: India & the World

April 27, 2024

IBC allows automatic release of ED attachments: Bombay HC reaffirms

April 15, 2024

The Midnight Clause

February 29, 2024

NDA Connect

Connect with us at events, conferences and seminars.

NDA Hotline

Click here to view Hotline archives.

Video

Q&A 2024 Protocol to the Mauritius India Tax Treaty

April 22, 2024

Boost to India's Space Potential: India Liberalizes Foreign Direct

In typical VC/PE fund structures, the GPs issue drawdown notices to the LPs and pursuant thereto the LPs are often required to contribute in proportion to their unfunded capital commitments and not their total capital commitments. This is advantageous for the fund since this avoids a potential “dry powder” situation, especially in situations of excuse. Typically, an excuse right is also accompanied with an ability for the fund to draw down further from non-excused LPs, although often LPs may seek to restrict such “extra” drawdowns.

To illustrate on the “dry powder” situation in case of excuse, assume 2 LPs committed a total of \$100 each to the fund and a drawdown notice was issued to both LPs whereby one LP contributed \$50 and the other LP by virtue of his excuse right contributed \$0 to the fund; the unfunded capital commitment of the first LP would now be \$50 whereas the unfunded capital commitment of the second LP would still be \$100. Therefore, if the GP then issues a drawdown notice for \$150, then the first LP would be required to contribute only \$50 as opposed to the second LP who would be required to contribute \$100 since the drawdown would be based on unfunded commitments. However, if the drawdown model was based on total commitments, the GP would have the right to call \$75 from the first LP and \$75 from the second LP. But since, the first LP is not liable in excess of unfunded commitments, the GP can only call \$50 from the first LP thereby leaving the fund with dry powder of \$25⁸.

In other words, if an LP is excused from participating in a deal, its unfunded capital commitment should not be reduced whereas the amount which it did not contribute should be added back to its unfunded capital commitment, thereby avoiding shrinking of the corpus of the fund. In this model, the “un-excused LPs” will always run a risk that the next investment in which an excused LP participates may yield bumper returns and the excused LP will benefit more than the other LPs; and the excused LP will always run the risk that the next investment in which the excused LP participates may be a loss-making investment thereby increasing his losses *vis-à-vis* the other LPs.

A hybrid model to combat the situation wherein the excused LP may benefit more than the other LPs is where LPs require GPs to allocate hot investment opportunities based on total commitments, rather than unfunded commitments, thereby granting the GP discretionary powers in this regard.

Impact on the Fund's ability to borrow

Under Indian law, leverage at the fund level is generally not permitted for Category I AIF and Category II AIFs⁹ (which are the categories used for PE / VC AIFs). However, globally, a closed-end fund may be permitted to avail equity-bridge facilities. In such cases since the lender's main security is over the GP's ability to drawdown LPs' unfunded commitments, it will want to ensure that the circumstances in which an LP is excused from complying with a drawdown notice are as narrow as possible¹⁰. Hence, the presence and breadth of excuse provisions can affect the ability of an offshore fund to leverage for making investments.

Parallel structures

GPs may set up a parallel fund or an alternative investment vehicle (“AIV”) for the “non-excused LPs” in the event an excused LP is unable to participate, especially when the excuse pertains to legal or regulatory restrictions upon the fund. These parallel funds or AIVs are typically deal specific or established for a group of related deals. AIVs may invest in parallel to or in lieu of the master/primary fund and have full rights to draw on LP capital commitments on substantially the same terms as the primary fund.¹¹ Though this model is out there, not too many funds are known to have followed this.

Impact on fund expenses, management fees and carried interest of the GP

Non-participation in a deal should not reduce the total commitments of the excused LPs, in the said model and the excused LP should continue to pay its entire share of the management fees if based on a commitment base. However, if the management fee is based on capital contributions (which it often is after the expiry of the commitment period), the management fee share of the LP may be reduced. An excuse provision should not affect an LP's contributions towards fund expenses except expenses relating to the portfolio investment from which the LP has been excused. The distribution waterfall of an LP should not take into account the distributions pertaining to portfolio investments from which an LP has been excused. Accordingly, the GP should not earn carried interest from such an excused LP in respect of such distributions (although, in all probability, the amount would have been accounted for in the waterfalls of non-excused LPs).

CONCLUSION

Excuse provisions are important clauses in fund documentation which facilitate LP participation in ‘blind-pool’ models. Often, in negotiations, GPs accept LP requests for excuse provisions since they are eager to have the LP commit to the fund. However, considering the impact of the exercise of an excuse right by an LP on the fund corpus, on the other LPs and ability to leverage, such provisions should be carefully incorporated in fund documentation, a point sometimes missed due to the non-immediate nature of an excuse trigger. LPs should also evaluate the pros and cons before seeking an excuse provision, especially if driven by commercial rather than legal or regulatory reasons, since it could mean that the same sort of right may be sought by other LPs (especially those with an MFN clause too). In this manner, in spite of the legal / regulatory kernel underlying excuse provisions, often the commercial positions should also be looked into in order to arrive at a viable framework for both LP and GP.

– Ramya Kumar & Srikanth Vasudevan

You can direct your queries or comments to the authors

¹ This can also be part of the diversification norms prescribed under the AIF Regulations, to ensure that no LP is disproportionately exposed to the performance of a narrow base of portfolio investments.

² Impact Investing Private Equity Fund Industry: Legal Consideration; authored by: Jennifer Bolton, Ilomai Kurik, and Rebecca Pereira of Clifford Chance.

³ Mayer Brown: Beginner's Glossary to Fund Finance; authored by Kristin M. Rylko, Zachary K. Barnett and Mark C. Dempsey.

⁴ ESG means environmental, social and governance.

⁵ RESPONSIBLE INVESTMENT IN FUNDS: WITH AGE COMES RESPONSIBILITY; authored by: James Burdett and Jon Unger of Baker McKenzie; Published in: 2017 by Thomson Reuters (Professional) UK Limited. This article first appeared in the November 2017 issue of PLC Magazine.

⁶ RESPONSIBLE INVESTMENT IN FUNDS: WITH AGE COMES RESPONSIBILITY, authored by: James Burdett and Jon Unger of Baker

McKenzie, Published in: 2017 by Thomson Reuters (Professional) UK Limited. (This article first appeared in the November 2017 issue of PLC Magazine.)

⁷ MFN means Most favoured nation.

⁸ Closed-End Private Equity Funds: A Detailed Overview of Fund Business Terms, Part I, authored by: Seth Chertok and Addison D. Braendel; Legal studies research paper, The Pennsylvania State University, The Dickinson School Of Law

⁹ As per Regulations 16(c) and 17(c) of the AIF Regulations, borrowing by a Category I or II AIF can only be for meeting temporary funding requirements for not more than 30 days, on not more than 4 occasions in a year and not more than 10% of the investable funds of such AIF.

¹⁰ Private equity funds: Equity bridge facilities; authored by: Leon Stephenson and Christopher Akinrele of Reed Smith LLP.

¹¹ Mastering Private Equity: Section IV, Fund Management and the GP-LP Relationship; authored by Claudia Zeisberger, Michael PrahI and Bowen White; first published 2017 © 2017 Claudia Zeisberger, Michael PrahI and Bowen White; Set in is 10/12pt Helvetica LT Std by Aptara, New Delhi, India Printed in Great Britain by Bell & Bain Ltd, Glasgow.

DISCLAIMER

The contents of this hotline should not be construed as legal opinion. View detailed disclaimer.

This Hotline provides general information existing at the time of preparation. The Hotline is intended as a news update and Nishith Desai Associates neither assumes nor accepts any responsibility for any loss arising to any person acting or refraining from acting as a result of any material contained in this Hotline. It is recommended that professional advice be taken based on the specific facts and circumstances. This Hotline does not substitute the need to refer to the original pronouncements.

This is not a Spam mail. You have received this mail because you have either requested for it or someone must have suggested your name. Since India has no anti-spamming law, we refer to the US directive, which states that a mail cannot be considered Spam if it contains the sender's contact information, which this mail does. In case this mail doesn't concern you, please unsubscribe from mailing list.