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Fund Finance Friday

Declaration of Sovereign Immunity: Navigating Side Letter Provisions

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We have recently been fielding a number of questions from our lender clients on the application of certain investor side letter provisions on the collateral package that secures the repayment of a subscription credit facility. A typical collateral package for subscription credit facilities consists of the fund's limited partners' unfunded capital commitments, capital contribution proceeds, and the general partner's right to call capital from the limited partners. It is common for investors to enter into side letters, which are separate written agreements with the fund which amend, supplement, and alter the terms of the investors' rights and obligations under its limited partnership agreement with the fund. These changes agreed to by the fund in a side letter may have material implications on a lender's subscription credit facility. Here we take a look at certain side letter provisions that impact a subscription credit facility, how these provisions operate, and how lenders look to mitigate the risks associated with the consequences of the side letter provisions.

Most Favored Nation (MFN) Clause

A MFN provision seeks to provide assurances to an investor that they will receive the same terms and benefits that a fund may offer to another investor in the fund. The MFN permits such investor to elect the more favorable right granted to such other investor in their side letter. MFN provisions generally appear in the investor's side letter, but it is important to also review the applicable partnership agreement closely to determine if a MFN provision is included as well. The various MFN provisions may be problematic from a lender's perspective, as one negative side letter provision, such as a defense against an unconditional funding requirement, could spread to multiple investors if the MFN provision is broadly drafted and doesn't contain limitations or carve-outs narrowing the provisions that an investor can elect into from such side letters.

MFN provisions typically contain limitations on what the investor may elect from other investors' side letters. One of the most common limitations is that an investor can only elect provisions that were granted to other investors with a capital commitment equal to or less than the investor. Investors may also often aggregate their capital commitments with affiliates for the purposes of MFN, so lenders must be mindful of this aspect when determining which provisions may be electable by other investors.

There are also substantive mitigating limitations that may be included in MFN provisions. Generally, these limitations prevent an investor from electing via MFN any side letter provision that other investors received related to (i) laws or statutes that specifically regulate the activities of the other investor and require special rights in order to comply, (ii) rights granted to other investors related to their place of organization, for tax purposes, to their ERISA status, and (iii) any reduction in management fee percentage or carried interest percentage.

Lenders must stay apprised of how the MFN is drafted when it has been determined that an investor has a non-lender-friendly side letter provision. Excluding one investor from the borrowing base isn't ideal but manageable and may still provide sufficient availability and collateral coverage to support the credit facility. However, if the investors each receive

very broad MFN provisions, the exclusion of multiple investors from the borrowing base would significantly compromise the lender's ability to extend credit and may even preclude the deal from moving forward.

Reservation of Sovereign Immunity

Certain investors, by virtue of being a governmental entity or agency, such as state governments, public pensions, and state university endowment funds, may have immunity from contractual claims and other lawsuits through a reservation of sovereign immunity included in the investor's side letter. Generally speaking, these entities and agencies may be immune from suit and liability due to the legal protection provided by the sovereign immunity doctrine pursuant to the Eleventh Amendment of the United States Constitution and even a number of state Constitutions. The reservation of sovereign immunity clause in a side letter may also include that the investor does not agree to fund without setoff, counterclaim, or defense. These provisions may create an uncertain risk for a lender if not waived or mitigated, as the sovereign immunity protections may cast doubt on the ability of a lender to successfully enforce its rights to call capital from the sovereign investor in the event of a default under a credit facility.

However, exceptions to broad sovereign immunity do exist, as many states have enacted statutes that expressly waive immunity for contractual claims in commercial transactions (*i.e.*, a sovereign investor making a capital commitment to a private fund with a subscription credit facility in place). There are also common law waivers that have been upheld by state supreme courts on the basis that when a state, including its agents and instrumentalities, enters into a commercial contract, the state consents to being sued and waives its sovereign immunity with respect to its contractual obligations.

In the event a reservation of sovereign immunity provision appears in an investor's side letter, it is critical from a lender's standpoint to confirm that the provision also includes sufficient mitigating language. While the mitigating language can come in a variety of forms, such as a full waiver, an acknowledgment that the investor remains obligated to contribute capital, etc., lender's counsel must make sure this additional language is adequately covered in the side letter. The mitigating language can be straightforward, and something similar to the below, at the end of the sovereign immunity provision, can be very beneficial from the lender's perspective:

> "The foregoing shall not be interpreted to relieve the Investor from any of its contractual obligations under the Partnership Agreement and applicable Subscription Agreement, including, without limitation, with respect to funding its Capital Contributions or returning distributions."

Another more encompassing example of sovereign immunity mitigating language is represented by the following:

> "Notwithstanding the foregoing, nothing in this foregoing paragraph shall be construed to compromise or limit the contractual obligations of the Investor under the Partnership Agreement or the Investor's subscription agreement, including without limitation the Investor's obligation to contribute capital, make payments or return distribution to the Partnership, when and as called, in accordance with the terms and conditions of the Partnership Agreement and the Investor's subscription agreement, and nothing contained herein shall reduce or modify the rights of the General Partner or the Partnership to seek to enforce such obligations of the Investor at law or in equity."

If the side letter is in final form without any mitigating language, and it is unlikely that the side letter can be amended, lenders may also request that the investor deliver a separate Investor Letter. Investor Letters can be an effective method of mitigating a reservation of sovereign immunity provision, as it puts the investor within contractual privity with the lender. An Investor Letter is an acknowledgement and agreement by an investor for the purpose and benefit of a lender extending credit to a fund in a subscription credit facility. While the Investor Letter can come in many forms, an effective Investor Letter will acknowledge (i) the credit facility, (ii) that the investor will honor its capital commitment to the fund, and (iii) that the investor will make capital contributions when called by the fund to repay outstanding fund obligations to the lender. Investor Letters may also provide an agreement by the investor to unconditionally fund capital contributions for the purpose of repaying any outstanding obligations without defense, setoff, or counterclaim.

Lenders should remain diligent of the various sovereign immunity provisions that can exist in a side letter, and the different mechanics that can be implemented and relied on in order to mitigate the applicable sovereign immunity provision.

Cease Funding/Withdrawal Rights

A cease funding right in a side letter is a provision that allows for an investor to immediately stop funding any capital contributions to the fund when called by the general partner without being declared a defaulting investor, and withdrawal from the fund. Typical cease funding rights are related to (i) placement agent disclosure provisions, (ii)

political candidate campaign contributions, and (iii) ERISA and tax purposes. These cease funding and withdrawal rights present a major concern for lenders. There is significant risk to a lender's repayment source if the fund's ability to repay the obligations under a credit facility is compromised by an investor exercising a cease funding right. The commitment by the investors to honor their capital call obligations is an important part of the lender's collateral and source of repayment, so the prevalence of cease funding rights within side letters can vastly change a lender's underwriting process.

Typically, investors with cease funding rights are excluded from the borrowing base. However, a more complicated issue arises when an investor with significant fund concentration has entered into a side letter with a cease funding right and the investor's commitment needs to be included in the borrowing base to unlock the requested availability under the credit facility. Apart from excluding the investor, there are certain representations and covenants that should be added to a credit agreement to mitigate these cease funding and withdrawal provisions. For placement agent disclosures, the representations may include disclosure compliance and covenants, and an event of default if the fund fails to comply with the side letter provisions that trigger the cease funding and withdrawal rights. An expedited clean-down period may also be added to the credit agreement in order to minimize the risk of having any loan obligations outstanding for an extended period, which would ensure that the fund is paying down the loan balance more frequently to reduce the risk of the cease funding event occurring while there are outstanding obligations.

In most cases involving cease funding rights, the practical solution for a lender is to exclude the investor from the borrowing base. However, when this solution isn't feasible or exclusion is impractical, lenders must be aware of and familiar with the other available options to help mitigate against the potential risks associated with investor's right to cease funding or withdrawal from the fund.

While we touched on only three separate side letter provisions, these three are some of the most common we see lenders ask questions about and try to navigate when setting up a new credit facility. It is always best practice to review the side letters as soon as possible during the underwriting process and, hopefully, even when the side letters are in draft form. This additional time is beneficial so that the parties can work through the above-mentioned side letter provisions and any other problematic side letter provisions in advance of a closing or funding request under a credit facility.