Capital Commitments in the Form of Investor Loans in the U.S.

December 14, 2018 | Issue No. 7

We have seen several transactions this fall where an investor's capital commitment is, at least in part, structured in the form of a "loan commitment" ("Debt Commitment") and not purely in the form of an equity capital commitment ("Equity Commitment"), as is traditionally the case. In these arrangements, investors and the fund, either in the partnership agreement or in a separate contract or side letter ("Debt Agreement"), agree that the fund may issue a traditional capital call for a capital contribution in the form of equity ("Equity Contribution") or in the form of a loan (a "Debt Contribution"). Given the recent influx of funds utilizing this arrangement, we thought it might be helpful to include a refresher in this week's *Fund Finance Friday* as to the potential risk created by Debt Commitments.

The risk centers around the lack of precedent concerning the enforceability of Debt Commitments should the fund file bankruptcy. Generally, under the United States Bankruptcy Code (the "Code"), the debtor-in-possession or bankruptcy trustee gets to decide whether to assume (thereby keeping the parties bound to) or reject (thereby effectively voiding any continuing obligations under) an executory contract. While an "executory contract" is not specifically defined in the Code, it is generally considered to be a contract where both parties have material, unperformed obligations remaining. An important consideration for our analysis is that under the Code, a debtor-in-possession or bankruptcy trustee is prohibited from assuming an executory contract if the other party's obligation is to "make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor" (Section 365(E)(2)(B)). Therefore, if a fund files bankruptcy in the United States, an investor with a Debt Commitment may argue that its Debt Agreement constitutes an "executory contract" under Section 365(c)(2) of the Code. Thus, for years, lenders have liked to see that the "no setoff, counterclaim or defense" language in a partnership agreement includes "any defense under Section 365(c) of the Code."

On the other hand, in the traditional capital commitment space, lenders have strong legal precedent supporting the enforceability of Equity Commitments in a fund bankruptcy. In fund finance's most famous case, *Chase Manhattan Bank v. Iridium Africa Corp.*, the investors argued that the limited liability company agreement was an executory contract that the Code prohibited from being assumed, and therefore, their obligation to fund their uncalled capital commitments should be void as a financial accommodation. The court rejected the argument, noting that the purpose of Section 365(c)(2) of the Code is to protect parties from extending new credit or funding, whose repayment relies on the fiscal strength of an already bankrupt debtor. The court held that the investor's uncalled capital commitments, in contrast, were not "new" obligations, instead having long since been committed by the investors ("*these purchases are, for all practical purposes, existing debt obligations.*"). Thus, the court concluded that "*the [Investors] are not within the class of creditors Congress intended to protect under Section 365(c)(2) of the Bankruptcy Code*."

But what if the capital commitments are expressly to be funded in the form of *loans* instead of as *equity* under the applicable partnership agreement? The rationale behind the *Iridium* decision would certainly be equally applicable, and we hope a court would look through the phraseology to the substance of what investor Debt Commitments actually are and differentiate appropriately. However, the "loan" language might give an investor a basis to distinguish the *Iridium* precedent and argue that the Debt Agreement is an executory contract, and thus its Debt Commitments are non-enforceable under Section 365(c)(2). And this is the risk that gives us a little pause.

To help protect a subscription finance lender and a fund against this possibility, we prefer to see explicit language in the partnership agreement or Debt Agreement (or if necessary, an investor letter) addressing the point. Ideally, the investor explicitly agrees that, in the event of a fund bankruptcy, all capital contributions will be called and funded only in the form of equity (and not as loans) and that any unfunded capital contributions made in the form of loans prior to the bankruptcy will be automatically recharacterized as Equity Contributions.

Note that the above analysis applies only to funds in the United States and therefore differs in Europe and other jurisdictions. We will address this issue in other jurisdictions in an upcoming edition, so stay tuned.

Abraaj Press Tracker

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Some incremental information on the Abraaj matter trickled out in the press this week. On December 10th, *PitchBook* published an article titled “How a private equity powerhouse went bust” that reports alleged facts leading to Abraaj’s challenges. The article also reports on potential bidders for certain Abraaj assets. The article is available **here**. On December 13th, *Bloomberg* reported that NBK Capital Partners is close to consummating a takeover of the Abraaj Global Credit Fund. The article states that the fund had raised $260 million and made three investments. No mention of any fund financing. The article is available **here**.

LIBOR Transition Moving Along

December 14, 2018 | Issue No. 7

By **Jeffrey Nagle**
Partner | Finance

The Federal Reserve Bank-sponsored **Alternative Reference Rates Committee** (ARRC) took significant steps last week with respect to four market consultations. The ARRC consultations outline draft language for new contracts that reference LIBOR so as to ensure these contracts will continue to be effective in the event that LIBOR is no longer usable.

The ARRC released the results of its consultations on U.S. dollar (USD) **Syndicated Business Loans** and **Floating Rate Notes** published earlier this fall. Next, the working groups devoted to these products will review the results of the consultations, with the goal of publishing final recommended language for inclusion in new syndicated loan and note documentation going forward.

In addition, the ARRC released consultations on USD LIBOR fallback contract language for **bilateral business loans** and **securitizations** for public feedback. Feedback to these consultations should be submitted by February 5, 2019.

Cadwalader represented the ARRC in the preparation and review of the LIBOR fallback consultations.

Carey Olsen Article on Investor Commitments

December 14, 2018 | Issue No. 7

The Cayman Islands office of offshore law firm Carey Olsen published this week a detailed thought leadership piece titled “Fund Finance and releases of investor commitments: How can lenders protect themselves?” The timely article identifies the specific causes of actions a lender could pursue against a fund, its sponsor and its investors in the event capital commitments were released in violation of the negative covenants in a credit agreement. It also provides advice for upfront diligence and transaction structuring. The article is really well done and we recommend its reading. Available **here**.

FFA Next Generation Kick-Off Event Announced

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The Fund Finance Association's young professionals initiative, Next Generation, announced its official launch and inaugural event this week. The group intends to be a forum for young professionals focused on education, networking and mentorship opportunities. The event is scheduled for January 30, 2019 in London and includes a breakfast panel titled, "What Can a Career in Fund Finance Look Like for You?" A network reception follows. Additional events are in the planning stages in both London and the United States. For more information or to RSVP for the event, visit the FFA's website at **www.fundfinanceassociation.com**.

On the Move–Fund Finance Tidbits

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On the Move

Senior attorney Amrita Maini joined Cadwalader's Fund Finance practice in London this week. Amrita joins from Dentons, where she was a counsel in the Fund Finance practice in London. At Dentons, Amrita represented banks and private markets managers in many of the largest fund finance transactions in Europe. Amrita has several years of experience in not only subscription financings but also GP/co-investment financings, asset-backed financings, hybrid and secondary acquisition financings. Prior to joining Dentons, Amrita was a senior associate in the Fund Finance practice at Reed Smith in both London and Abu Dhabi.

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Prior Editions of Fund Finance Friday

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Abraajfluenza? Not in London…
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