

CADWALDER



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The COVID-19 pandemic brought with it a newfound concern for the financial strength of state pension plans, particularly in states that were already experiencing credit deterioration, growing debt concerns or underfunding issues. Having weathered what will hopefully be the worst of the crisis, our market has emerged unscathed in terms of no known material defaults by governmental investors, including state pensions. In fact, many state pensions have re-upped commitments with funds, and we saw the end of 2020 cap off the most robust year ever for SMA facilities with state pensions as the sole investor. But what if you had to sue to collect from a state pension investor?

That is a question we received from bank credit officers much more frequently in 2020. The good news is that, for the overwhelming vast majority of state pensions, acceptable recourse will be available.

The general rule of thumb is that any state entity is immune from suit under the legal protection afforded by the doctrine of sovereign immunity. However, many exceptions exist. For state entities that act as private individuals and enter commercial transactions via contract (such as a state pension making a capital commitment to a private fund with a subscription line), a statutory or common law waiver is very likely to apply. In other cases, express or implied waivers or equitable theories may save the day.

Statutory waivers

With respect to state governments, the Eleventh Amendment, along with U.S. Supreme Court precedent, generally shields state governments from suit in federal or state court without their consent. Thus, it is highly common (if not universal) that state pensions will frequently reserve their Eleventh Amendment rights in a side letter with the fund's general partner. Regardless of such reservation, applicable law will carry the day and a waiver will override the general shield of immunity from suit. Thus, it's important for lenders to understand applicability of local law as it relates to potential enforcement against a state pension for failure to fund its capital commitment. The interest of the fund is also aligned as the fund needs recourse and a means for enforcing the partnership agreement's default remedies if the pension investor is in default. Typically, the lender's rights are the same as the fund and derived through the assignment of contractual rights under the fund's partnership agreement and its subscription agreement and side letter with the investor.

A statute enacted by the state's governing legislature that expressly waives immunity for contractual claims in commercial transactions will control and generally permit suit against the investor for failure to honor its funding commitment under the fund documents. Thirty-seven states have waived immunity in this context via statute (including those states that have waived via state constitutions or similar legislative action). There are procedural and jurisdictional requirements, of course, such as where to bring suit (some states have special claims courts to hear cases against the state government), but the key takeaway is that there is a legal means for recovery and obtaining a judgment.

Common law waivers

Some states have not enacted a statutory waiver, but have decades or even hundreds of years of controlling case law holding that the state pension is precluded from effectively raising sovereign immunity as a defense to contractual claims in a commercial transaction. Twelve states have used this approach absent a controlling statute.

Most often, the state appellate courts, including its supreme court (or equivalent high court), have rendered decisions and a line of thinking that eliminate sovereign immunity with respect to such contractual claims. For example, the North Carolina Supreme Court, among other state high courts, has held that when the state enters into a contract, the state implicitly consents to be sued and waives its sovereign immunity to the extent of its contractual obligations. This type of case law is also relevant and supportive of a waiver in states that have statutes on point as the courts have interpreted the applicability of the statutes.

Express waivers

If a state entity consents to suit in writing, then the doctrine of sovereign immunity will not apply to the given transaction. In our case, this is often achieved by an investor expressly and unequivocally waiving its right to sovereign immunity in an investor letter or side letter that can be relied upon by the lender.

While some think the cleanest and best-case scenario for lenders is an express waiver from the investor that sovereign immunity does not apply, such a waiver, while effective, is no more effective than a statutory or common law waiver already applicable under state law. As many facilities no longer require investor letters and because side letters usually come fully baked or follow precedent with the fund, it is often commercially difficult (if not unreasonable under market conditions) to request an investor letter for this reason. Where a state law waiver exists, additional comfort is not needed for legal reasons. However, for SMA facilities that expose lenders to single investor risk of the state pension defaulting, it is quite common to receive an investor letter that addresses any material risk items presented by the partnership agreement or side letter, and this would include obtaining either an express waiver or language consistent with applicable law to establish and gain comfort on the immunity issue.

Implied waivers

With an implied waiver, the lenders are provided with an affirmative representation that the investor is subject to commercial law and that its performance under the partnership agreement, the subscription agreement and any applicable investor letter constitutes private and commercial acts, not governmental acts. While not an unequivocal written consent to being sued, this does put the investor at a severe disadvantage when distinguishing itself from a private actor in the marketplace and when attempting to argue that it should be entitled to immunity as a governmental actor. This is important because the applicability of most state law waivers turn on whether or not the state entity is acting in non-governmental capacity and entering into commercial transactions.

A slight variation of the implied waiver is what many legal practitioners refer to as “the mitigating language.” It often appears in side letters and follows as a qualification of the express reservation of immunity by the state investor. Typically in the form of a representation, the language will say that despite the investor’s sovereign immunity and its express reservation thereof, such immunity does not in any way limit the investor’s obligations to make capital contributions under the partnership agreement. Paraphrased, this language really says, “I have sovereign immunity as a state government and I am not waiving that immunity; however, under applicable law you can still sue me for default because this is a commercial contract claim and so I recognize that my immunity does not limit my obligation to fund.” This has become the most commonly accepted language in the market because it’s often difficult to ask or receive more from a state investor unless structuring an SMA facility. State law still rules the day and a statutory or common law waiver would apply even absent this qualification and where there remains a full written reservation of immunity. However, this form of implied waiver highlights the investor’s acknowledgment that exceptions to immunity exist and could be used against it as defense to the investor invoking immunity or arguing that the transaction falls outside the scope of the commercial contract situation.

Equitable theories

The reason the above waiver exceptions to immunity exist at all are simply because we as an evolving society no longer believe in the centuries-old universally applicable doctrine of “The King can do no wrong.” State legislatures and judges have recognized the inequities of such a harsh rule in the commercial context and, as a result, have pierced holes in the shield. Who would do business with a state entity if there was absolutely no recourse if the state defaulted on the contract?

That said, there are still states and even local jurisdictions within states that have uncommon limits on immunity waivers. The general rule in Texas is that the state cannot be sued for a breach of contract, even with evidence of a waiver to the contrary. At least one appellate court in Texas has attempted to reverse course, holding that there is a waiver-by-conduct exception to sovereign immunity in breach of contract cases against state entities. However, the Texas Supreme Court denied review of this holding, leaving the viability of such an exception unsettled. There are, however, municipal exceptions in Texas.

Other states have dollar limits on payment of claims without budgetary or other legislative approval. California has an archaic 1937 statute that applies to county pension plans (of which many are frequent PE investors). A plain reading of the statute has only three exceptions permitting enforcing a judgment against the pension. Sadly, subscription facilities are not one of them, as these were clearly never contemplated in 1937.

Despite these challenges, many lenders derive comfort from equitable theories coupled with the practical (the investor has never and is highly unlikely to default) and are able to give borrowing base credit. Sympathetic courts interpreting

archaic laws in modern day and equitable law theories such as unjust enrichment present strong comfort on these issues. There are also enforcement theories available that may permit certain actions in federal court and/or the use of writs of mandamus to overcome the limitations and provide for a remedy where a lawful judgment has otherwise been obtained against the investor in a commercial setting.

Hurdle concept and application

For gray-area investors such as Texas, the market has developed a risk-adjusted approach. For Texas, the norm has been to exclude its state investors from borrowing bases for years. But this obviously presents challenges in facilities where the largest or some of the most concentrated investors are Texas state entities.

The good news for many borrowers with strong Texas ties is that lenders are now more willing to employ a “hurdle concept” that permits admission to the borrowing base as soon as the investor has sufficient “skin in the game” – usually 30-50% or more of funded equity net of any returned capital that increases its unfunded commitment. Partnership agreements typically contain draconian penalties for default – such as losing half or all of a defaulting investor’s capital or having the defaulting interest assigned to a new investor at a significant discount well below par. So long as the fund is performing well and the investor has significant equity at stake, it is unlikely to default and would be motivated to remain in good standing.

Conclusion and practical considerations

Despite well-documented budget issues faced by many state governments and underfunding of some state pensions, further exacerbated by the pandemic, state pensions continue to be significant investors in new funds and with near zero default rates. Many practical reasons also exist to further mitigate the likelihood that a state pension would default on its commitment to fund capital contributions. These include the draconian default penalties found in partnership agreements, the damaging publicity such investor would likely receive, and the impactful and irreparable damage the default might cause to the investor’s credit rating and reputation in the market. Yet, we must account for the risks involved with lending against sovereign commitments and understand the means of enforcing in the unlikely event of a default. Nearly all states have either a statutory or common law waiver in place to permit suit against the investor in the context of our facility enforcement. Other states, while perhaps more murky or challenging, provide other equitable or alternative means for dispute resolution and, when coupled with comforting reps and funding track records and/or more bespoke structured approaches to limiting risk, can be quite acceptable.

In a future edition of *FFF*, we will examine these issues as they relate to foreign sovereigns, supranational or quasi-governmental entities as well as alternative modes of dispute resolution such as binding arbitration.

Fund Finance Association Updates

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Despite the virtual environment, the FFA is as busy as ever, with several upcoming programs.

European FFA University is just around the corner on February 4, starting at 9 a.m. London time. Yesterday, a terrific keynote speaker was announced: premier women's soccer player Eniola Aluko. The cost is only £175. Please consider investing in your newer team members and supporting the FFA by registering them for the program. The agenda is available [here](#). To register, click [here](#).

The deadline to sign up for the European mentor program is January 29. The program is scheduled to launch in February and is designed to help develop current and future leaders in the Fund Finance space through a safe and supportive network of individuals who are committed to exploring, growing and developing with each other. If you are interested in being either a mentor or a mentee, click [here](#) for more information.

The FFA has additionally announced the launch of Asia Pacific chapters of the NextGen network, the FFA's diversity initiative. Look out for additional announcements of new events and initiatives in the coming weeks.

For more information about any of the FFA's ongoing programs, contact [Michelle Bolingbroke](#).

Pink Book Published

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Global Legal Group published the 5th edition of the Pink Book (*Fund Finance 2021*) this week. Similar to prior years, there are 23 product- and market-oriented chapters and 16 jurisdictional updates, each submitted by a leading fund finance law firm. Mike Mascia was again the Contributing Editor, and this year included his “Year in Review” article as the Introductory chapter (available [here](#)). Our great thanks to all of the contributors and to GLG.

Brickfield Article on Legal Recruiting

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Brickfield Recruitment, the global fund finance recruitment specialist, has [recently published an article](#) focusing on how legal associates stand to benefit from an expanding fund finance market in 2021. Demand is increasing for associate-level candidates globally with one to four years of experience and looking to develop their career in fund finance, with many firms considering candidates coming from related practice areas. Readers looking to receive regular updates on talent acquisition trends in fund finance can [follow Brickfield on LinkedIn](#). Law firms, banks, funds, advisories and candidates with specific enquiries should contact Rory Smith at Brickfield Recruitment by [email](#) or by telephone on +44 7800 963 594.

The Drawdown Looks Ahead to Anticipate Opportunities for NAV Facilities for Buyout Funds

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A recent article by *The Drawdown* examines the impact of COVID-19 on the deal volume for NAV facilities by buyout funds and what can be expected in the next 12 to 18 months. In particular, the article examines the pricing differences between banks and direct and specialist lenders; alternatives to NAV facilities that buyout funds are exploring; and potential opportunities that are available. The article is available [here](#).

Cadwalader Fund Finance Team Recognized at The Drawdown's PE Service Provider Awards

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Cadwalader's Fund Finance Team was yesterday awarded "Fund Finance Advisory Team of the Year" at *The Drawdown's* Private Equity Service Provider [Awards](#), based on the views of a panel of leading private equity COOs, CFOs CCOs, GCs and CTOs. Our UK team won the award for demonstrating "impressive business growth, exceptional service and product innovation" in 2020.

Fund Finance Partner Samantha Hutchinson Recognized for Women, Influence & Power in Law UK Awards

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Law.com International/Legal Week have released their annual list of top women lawyers who have made a significant contribution to the legal profession this past year, as part of the 2021 Women, Influence & Power in Law (WIPL) UK Awards. It's absolutely no surprise to us that our own Samantha Hutchinson has been awarded in the "Thought Leadership" category, as we can certainly attest to Sam's continued ability to lead and inspire her team through one of the most challenging years. Congratulations to all who made the [list](#) (including Cadwalader capital markets partner Suzanne Bell and associates Rebecca Chambers and Cassandra Nelson-Williams) and will be recognized during an awards ceremony on March 10, as part of the WIPL UK Virtual Summit.