Not All Commitments Are Treated Equal

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In recent weeks, a number of transactions have come across our desks involving levered feeders set up as an investment vehicle for insurance-related investors. For regulatory reasons, these vehicles are established such that each such investor's commitment is comprised of both a loan commitment (the "Debt Commitment") and an equity commitment (the "Equity Commitment"). This structure presents a challenge for lenders trying to balance the requested borrowing base treatment for investor commitments of this type against the potential bankruptcy implications that this structure poses.

The private equity fund (a "Fund") will almost certainly seek inclusion of the entire investor commitment (*i.e.,* the Debt Commitment and Equity Commitment portions) in the borrowing base. However, the decision of whether to honor that request is by no means simple. A common issue of this structure is evaluating how to address a circumstance where an investor funds some, but not all, of a capital call. Is the funded portion allocated entirely to the Equity Commitment, or is the funded portion allocated *pro rata* between the Equity Commitment and the Debt Commitment? Many limited partnership agreements are silent on this point and thereby leave the lender with more questions than answers as to the ultimate outcome.

Despite the questions related to allocation of funding a capital call, the issue at the forefront of a lender's concern is the bankruptcy risk. The risk centers around the lack of precedent concerning the enforceability of Debt Commitments should a Fund commence bankruptcy proceedings. 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. The Code does not define what constitutes an "executory contract." However, most experts define an executory contract to be one in which both parties have material, unperformed obligations.

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) of the Code). Therefore, if a Fund commences bankruptcy proceedings in the United States, an investor with a Debt Commitment may argue that the document governing its obligation to fund a Debt Commitment (such agreement whether the limited partnership agreement or a separate side letter, a "Debt Agreement") constitutes an "executory contract" under Section 365(c)(2) of the Code.

In contrast to Debt Commitments, lenders have legal precedent supporting the enforceability of Equity Commitments in a bankruptcy proceeding. In *Chase Manhattan Bank v. Iridium Africa Corp.*, 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 were not "new" obligations and had 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*."

Iridium gives lenders comfort that Equity Commitments can escape an investor's executory contract argument, but the outcome is not as clear for a Debt Commitment. We could see an argument that an investor might make to distinguish the holding in *Iridium* where a Debt Commitment is involved on the basis that the Debt Agreement is an executory contract that is intended to be protected under Section 365(c)(2) of the Code and thereby unenforceable. Against this backdrop, lenders are faced with the challenge of evaluating whether such a distinction can be made. Clearly, inclusion of language in a limited partnership agreement whereby an investor agrees to fund its commitment without setoff, counterclaim or defense and waives any defense under Section 365(c) of the Code is favorable. But the case law is unsettled as to whether this is enough to avoid a Debt Commitment/executory contract argument.

Another mitigant that seems common is a suggestion of an investor letter whereby the investor explicitly agrees that, in the event of a bankruptcy proceeding, 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. Some experts have proposed that this approach may undo the tax and other regulatory advantages that the structure intends to provide. Others have questioned whether an investor letter can actually affect the rights of the bankruptcy trustee in a Debt Commitment scenario, as the bankruptcy trustee is not a party to the investor letter and may view the investor letter as an ancillary component of an executory contract.

It is difficult to determine whether instances of a bifurcated investor commitment between a Debt Commitment and an Equity Commitment are isolated or if this is a growing trend. If the latter, lenders will be faced with the challenges of evaluating the risks and exploring possible solutions with reoccurring frequency.

(Note that the above analysis applies only to funds in the United States and therefore may differ in Europe and other jurisdictions.)

Subscription Finance Loan Agreement Series, Part 18: Conditions Precedent

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Perhaps a strange place to finish this series, and more to do with the order in which an LMA-based Subscription/Capital Call Facility is set out than the actual timing, but in this last article in our Subscription Finance Loan Agreement Series we look at the documentary and other conditions that lenders will need to see completed before any utilisations under facilities can be made. As with the other articles, the focus is very much on those items in the conditions precedent that are unique to subscription/capital call facilities or where there is a particular "twist" to think about in relation to these facilities.

We start with the constitutional documents of the fund and any other fund-related parties to the facility agreement. It is worth noting here that these documents should include all relevant documents that go to form part of the fund's powers to operate (so they should include, for example, any side letters from investors as well as the subscription agreements of those investors, in addition to the relevant limited partnership agreement and any prospectus or equivalent). As we have stressed in previous articles in this series, all of these documents can in one way or another impact the relevant powers of the fund and its related parties in respect of the transaction. In contrast to corporate transactions, lenders will have limited or no protection if there has been a breach of those powers, so it is important that all documents are provided and reviewed. Depending on the relevant jurisdictions involved, there may be requirements for additional documents (for example, documents registered on public registries) also to be provided.

Next come approvals for the transaction and the transaction documents. These will generally be approvals provided by the general partner or manager of the fund (acting on behalf of the fund), but it is also important to include approvals from these entities in their own right. As with other loan facilities, there should also be a requirement for a certification that no borrowing or other limits in the constitutional documents will be breached by the transaction. As we have noted, this is particularly important in a fund context (and should form a specific part of the due diligence) as, in contrast to a corporate loan, there are generally no overriding legal protections which might save a lender if these restrictions are breached. We would also expect to see conditions precedent requiring specimen signatures and certification of constitutional and other documents (in common with similar conditions in most other loan agreements).

Then come the finance documents making up the transaction – so, including the facility agreement, any security and any other related items. We have covered this in previous articles in this series, but particularly important here is to ensure that any notices of security are completed and that delivery of these notices to investors (and to any account bank) is included as a condition if not to signing the facility agreement at least to any utilisation under it. As also discussed previously, acknowledgments of such notices, while always desirable, are usually not required from investors, although where there is only one or a small group of investors, acknowledgments should also be considered.

After that, we would expect to see legal opinions covering the transaction. These will be a mix of enforceability opinions and capacity opinions. In the UK and Europe, it is market practice for the lender counsel to provide enforceability opinions but for fund counsel to provide any capacity opinions. Because of the nature of a fund, it is almost impossible for a lender's counsel to have sufficient information to provide a capacity opinion, which is why this important condition is almost always left for fund counsel to provide.

Finally, at least in respect of documents specific to conditions for subscription/capital call facilities, we would expect to see relevant documentation and information on the investors and the investors' commitments. This may take the form of an opening "borrowing base" certificate or something less "formal" but should always be required. Alongside this, consideration should be given to requiring some reassurance or certification to the effect that these documents are valid, binding and enforceable, or at the very least that there are no disputes with investors ongoing as to the liability of the investors to satisfy commitments. Depending on the circumstances, lenders may also consider whether to extend this to cover information on disputes in other related (or even unrelated) funds with the general partner or manager.

As said at the beginning of this article, the above is not intended to cover every condition required but just those where there is a particular issue with (or which are particularly relevant to) subscription/capital call facilities. Repeating an overarching theme of all of these articles, getting the conditions precedent right, and ensuring that all relevant documentary and other angles are covered, is, of course, important in any finance transaction. However, given the nature of funds and the limited protections available to lenders where there are "gaps" or "breaches," it is particularly vital to have all angles covered in a subscription/capital call facility context, and it is hoped that this final article in the series will help parties to achieve this.

Samantha Hutchinson Listed Among ‘Most Daring, Innovative and Creative Lawyers’

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We’re proud to see Samantha Hutchinson recognized on *The Lawyer* **Hot 100** list of innovative lawyers shaping the legal profession. The publication highlighted Sam's accomplishments over the past year, during which she advised on more than 50 new fund financings exceeding £15 billion in value. We’re excited to see the energy and growth in our London practice recognized beyond the fund finance industry.

Promissory Notes in Fund Finance

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When a promissory note is lost, the obligation to repay a loan continues, and the lender may “re-establish” the note so long as it has not sold or transferred the note, writes our colleague Susan Vuernick in "**Don’t Lose It over a Lost Promissory Note**" in Cadwalader's *REF News and Views*. She goes on to review recent case law on lost notes arising in the context of real estate foreclosures. The article provides a helpful guide to the significance of a lost note and potential curative steps.

Of course, in the fund finance context, as with syndicated commercial credit facilities more broadly, there is no strict legal requirement for a note, and the primary benefit – a note’s usefulness as a negotiable instrument that a holder in due course can take free and clear of certain claims and defenses – is not available when the note does not contain all essential terms of the repayment and an unconditional promise to repay. Not surprisingly, a number of lenders have concluded that the additional administrative burden associated with notes outweighs the potential benefits.

FFA Sends Survey Request

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The Fund Finance Association this week sent two e-mail blasts in preparation for the 10th Annual Fund Finance Symposium. The first email invites registrants to complete a brief survey on industry topics. The results will be aggregated and shared at the Symposium. To complete the survey, click **here**. The second asks attendees for advance questions they would like to have considered for Former Secretary of State Hillary Rodham Clinton or Earvin "Magic" Johnson during their sessions. To submit a question, click **here**.

ARRC Consults on Spread Adjustment

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Much of the thought in the LIBOR phase-out process has been on drafting contract terms that identify an agreed-upon replacement benchmark and then effecting the transition. One aspect that has received less attention is the necessary margin adjustment that should accompany a change in the benchmark. Because LIBOR is an unsecured interbank lending rate and SOFR, as the name suggests, is based on secured transactions, there inevitably exists a LIBOR-SOFR basis. Without an accompanying margin adjustment, the transition to SOFR would, under normal circumstances, result in a reduced interest rate on a loan.

The Federal Reserve's Alternative Reference Rates Committee (ARRC) is tackling the topic in its recently published ***ARRC Consultation on Spread Adjustment Methodologies for Fallbacks in Cash Products Referencing USD LIBOR***. The publication provides an opportunity for market participants to comment on the appropriate methodology for determining the spread adjustment. Our colleagues at the *Cadwalader Cabinet* summarized the consultation **here**.

#girldad

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By Michael Mascia
FFA Board Member

This has been a sad week. Kobe and his daughter Gianna passing has hit me hard, like it has for most all of us. I've several times found myself in public with moist eyes simply from seeing the Facebook post with Kobe's arm around Gianna at a Lakers game. **This clip from Elle Duncan** on SportsCenter about how Kobe loved being a father was the most impactful for me. Jeff Johnston sent it to me because he knows how much I've always reveled in having daughters. I wouldn't suggest watching it on a trading floor.

I also received awful news that Keith Connolly of SMBC passed away unexpectedly on Tuesday. Keith was one of the early leaders of the fund finance industry and helped lay the foundation for SMBC's business. I did not know Keith extremely well; he had largely matured out of actual deal work and into senior management as I was getting involved in the market. But he was always warm and friendly to me; always asking how he could be helpful. As I understand it, Keith leaves behind two young daughters. Best wishes and thoughts for Keith's family, friends and co-workers. I hope we can find a moment to recognize and honor him at the FFA Symposium in Miami.

Clayton Christensen, the Kim B. Clark Professor of Business Administration at Harvard Business School and widely regarded researcher and author on innovation, also passed last weekend. Weeks like this are such a clear reminder not to take anything for granted. Dr. Christensen's article, "**How Will You Measure Your Life?**," is a great read to finish out a week like this one. Let's all spend a little extra time with our families and friends. I'm going home to be a girl dad.

Fund Finance Hiring

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Fund Finance Hiring

Commonwealth Bank of Australia is seeking a seasoned Fund Finance banker as a Director in its Financial Institutions Group in New York. For more information, click **here**.

Fund Finance Calendar
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