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Sovereign Immunity Analysis in Subscription Credit Facilities

Subscription credit facilities (a Facility) have become a popular form of financing for private equity and real estate funds (Funds). The Facility's lenders (the Lenders) are granted a security interest in the uncalled capital commitments of the Fund's limited partners (the Investors) and the Lenders rely on the Investors' obligations to fund capital contributions as the primary source of repayment. Governmental pension plans, state endowment funds, sovereign wealth funds and other instrumentalities of foreign and domestic governments are frequent Investors that may possess certain sovereign immunity rights against enforcement proceedings rooted in the common law concept that "the King can do no wrong."[1]

Sovereign immunity in its purist form could shield a governmental entity from all liability—e.g., enforcement by a Lender seeking to collect uncalled capital commitments contractually owed by the Investor to the Fund. Thus, as Lenders evaluate the creditworthiness of governmental Investors for inclusion in a Facility's borrowing base, they naturally inquire into how sovereign immunity may impact the enforceability of such Investors' capital commitments.

Governmental Investors must be evaluated on a case-by-case basis to ascertain if any sovereign rights apply and, if so, whether such Investor has effectively waived its immunity. Given the financial troubles facing many governmental Investors as a result of the ongoing economic crisis and sovereign debt concerns, Lenders are increasing their scrutiny of the credit wherewithal of such Investors and their potential ability to raise sovereign immunity as a defense in subsequent litigation. This Legal Update seeks to set forth the basic legal framework of sovereign immunity in the United States relevant to a Facility.

Basis of Immunity

At its most basic level, the doctrine of sovereign immunity states that the government cannot be sued in its own courts unless it has otherwise consented to waive its sovereign immunity. As it relates to governmental Investors organized under the laws of the United States or a political subdivision thereof (a US governmental Investor), the doctrine of sovereign immunity comes in two flavors: (i) sovereign immunity of the federal government[2] and (ii) sovereign immunity of state governments and their instrumentalities pursuant to the Eleventh Amendment of the US Constitution, and in some states, through the state's Constitution.

Sovereign immunity of the US federal government is a concept that has existed in US jurisprudence since the country's founding.[3] Through the Tucker Act,[4] however, it is well settled that the US federal government has waived sovereign immunity with respect to any express or implied contract. With respect to state governments, the Eleventh Amendment, along with US

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Supreme Court jurisprudence on the issue, provides that states generally are immune from being sued in federal or state court without their consent.[5] Recognizing the inequities of such a rule in the commercial context however, many state constitutions, legislatures and high courts have eroded the sovereign immunity of state governments to permit actions based on contractual claims.

The doctrine of sovereign immunity also protects certain foreign governments and international organizations of a quasi-governmental nature, such as the United Nations, against claims in US courts. The Foreign Sovereign Immunities Act of 1976 (the FSIA) generally shields such Investors, but provides an exclusive basis and means to bring a lawsuit against a foreign sovereign in the US for certain commercial claims.[6]

Waivers of Immunity—US Investors

There are three ways that sovereign immunity is generally waived by US governmental Investors: (i) an Investor expressly and unequivocally waiving such immunity in a writing that can be relied upon by the Lender (i.e., an "Investor Letter" delivered to the Lenders in connection with the Facility or a side letter provision running to the benefit of the Lenders), (ii) a statute enacted by the applicable governing legislature that explicitly waives immunity for contract claims in commercial transactions, such as the Tucker Act[7] in the case of the US federal government, or (iii) controlling case law, typically from a federal or the applicable state's highest court, that precludes governmental Investors from effectively raising sovereign immunity as a defense to contractual claims.

WRITTEN WAIVERS FROM INVESTORS

The best case scenario for the Lenders is an explicit waiver from the Investor or an express statement that sovereign immunity does not apply. Often in an Investor Letter, the subject Investor: (i) acknowledges and agrees that, to the extent it is entitled to sovereign immunity now or at any time in the future, it irrevocably waives such immunity to the fullest extent permitted by law and/or (ii) represents that it is not subject to, or cannot claim, immunity from suit in respect of contractual claims to enforce its obligations under the applicable partnership agreement and subscription agreement.

A second variety of waiver is an implicit waiver. With an implicit 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 the Investor Letter (if applicable), constitutes private and commercial acts, not governmental acts. While this form of waiver is not as strong as the explicit waiver, it puts 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 (note: the comfort afforded by this waiver to a Lender certainly pivots on whether applicable law has abrogated immunity for commercial transactions).

In transactions where Lenders receive Investor Letters and Investor opinions as a condition to including a particular Investor in the borrowing base, it is best practice that the Investor's counsel opine, among other things, that the Investor has effectively waived immunity or that such Investor does not enjoy sovereign immunity in connection with its obligation to fund capital contributions to the Fund.

A third variation of waiver language common in the Facility market involves neither an explicit nor an implicit waiver, but rather a statement by the governmental Investor 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. While this seemingly contradictory language is not really a waiver at all, it provides some comfort to the Lenders that the Investor has agreed to fund its capital contributions. The Facility market seems to accept this language cautiously, and then only after a careful review of the underlying law to determine whether the applicable Investor could potentially raise a successful immunity defense in the context of a Facility.

STATUTORY WAIVERS

While it is ideal for Lenders to receive a written waiver as discussed above, Investors often are unwilling to provide such a waiver, or the Facility does not permit Lenders to request and rely on Investor Letters. US governmental Investors will frequently reserve their Eleventh Amendment rights in a side letter; hence, it is very important to carefully review and vet governmental immunity provisions in side letters against applicable law. Many states, however, have waived sovereign immunity for commercial contract claims by constitution, statute or case law.

Several states, including California and New York, have passed statutes explicitly waiving sovereign immunity with respect to contractual claims.[8] In these states, a plaintiff may proceed against the state government just as if it were proceeding against a private citizen. If obtainable, Lenders should seek an explicit statement from the Investor acknowledging that the Facility qualifies under the applicable sovereign immunity waiver statute of that state. An example of such language would be: "Each of the Partnership Agreement, the Subscription Agreement and the Investor Letter constitute a contract within the meaning of [insert applicable state statute (e.g., Cal. Gov. Code Section 814, New York Court of Claims Act §8 (L. 1939, c 860), Section 12-201, State Gov. Article, Ann. Code of Maryland and ORS Section 30.320)]."

These state statutes often contain a specific set of requirements and procedures that must be complied with in order to bring suit and obtain a judgment. For example, statutes that waive sovereign immunity for contractual claims often require that a claimant show that the contract was validly authorized and entered into by the governmental Investor.[9] Additionally, it is not uncommon for such statutes to require that a claimant bring the claim within a certain period of time and in a particular venue, often a certain county or an administrative law court within the applicable state.[10]

Given the variations among statutes with respect to waivers of sovereign immunity, it is prudent for Funds, Lenders and their respective counsel to examine each individual state's statute on a case-by-case basis.

COMMON LAW WAIVERS

Some state high courts have rendered decisions eliminating sovereign immunity with respect to contractual claims. For example, the South Carolina Supreme Court 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.[11] Similarly, in 2006, the Missouri Supreme Court held that sovereign immunity does not apply to breach of contract claims against state agencies.[12] State courts are continuing to follow such decisions. In 2010, the Virginia Supreme Court reaffirmed its prior ruling that sovereign immunity is not a defense to a valid contract entered into by a duly authorized agent of the state.[13] State courts, like state legislatures, have taken varying approaches with respect to the procedures and timelines that must be followed for a claimant to bring an action based on a contractual claim.[14]

We note, however, that a minority of states have bucked the trend to waive immunity for contract and thus leave Lenders at risk of enforcement uncertainty if the state defaults. While not entirely clear, the general rule in Texas may still be that state government entities cannot be sued for a breach of contract, even with evidence of a waiver to the contrary.[15] 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.[16] However, the Texas Supreme Court denied review of this holding, leaving the viability of such an exception unsettled.

Waivers of Immunity—Non-US Investors

Foreign governments and their instrumentalities are also frequent Investors, often with sizable capital commitments. Lenders should carefully review such Investor's credit, as well as the procedural requirements for enforcement of their capital commitments, including with respect to immunities.

The general premise of the FSIA is that a foreign government has immunity and cannot be sued in the United States. There are, however, three exceptions to this rule. First, waivers where the Investor has expressly waived immunity by contract, including any such waivers that arise from language in applicable international agreements.[17] Second, implied waivers where the Investor (i) agrees in a choice of law provision to be "governed by" US law,[18] (ii) agrees to arbitration with the expectation of enforcement of an award in the United States,[19] (iii) affirmatively files a suit or responds to a pleading without raising an immunity defense[20] or (iv) has signed an international convention permitting the enforcement of an award in the United States.[21] Third, the "commercial activity" exception.[22]

Under the commercial activity exception, a claimant may sue a foreign government in a US court when the claim is based on (i) a commercial activity carried on in the United States by the foreign government, (ii) an act by a foreign government that is performed in the United States in connection with a commercial activity outside the United States or (iii) an act by a foreign government that is performed outside the United States in connection with commercial activity that occurs outside the United States, if such action "causes a direct effect" in the United States.[23]

Absent an express written waiver, a valid submission to jurisdiction in the United States or an agreement to binding arbitration,[24] non-US governmental Investors in the context of a Facility should fall into the commercial activity exception. In *Republic of Argentina v. Weltover Inc*,[25] bond holders sued the Government of Argentina for breach of contract. The US Supreme Court articulated the applicable legal standard: "[w]hen a foreign government acts, not as a regulator of a market, but in the manner of a private player within it, the foreign sovereign's actions are 'commercial' within the meaning of the FSIA."

Argentina argued that that the commercial activity exception did not apply because (i) the issuance of sovereign debt should not constitute commercial activity and (ii) the alleged breach did not have a "direct effect" on the United States. The Court disagreed on both counts. First, the Court concluded that the issuance of the bonds was of sufficient commercial character. Second, the Court rejected the argument that the FSIA required the direct effect to be "substantial" or "foreseeable," instead concluding that it need only follow "as an immediate consequence" of the sovereign's activity. Despite the fact that none of the bondholders were situated in New York, the Court held that the effect was direct because New York was the designated place for payment.[26] This is certainly helpful

precedent for Facility Lenders. For a more in-depth review of the "commercial activity" exception, please see Mayer Brown's White Paper, "Sovereign Immunity and Enforcement of Arbitral Awards: Navigating International Boundaries," available at http://www.mayerbrown.com/publications/detail.aspx?publication=5048.

Satisfaction of a Judgment Against a Sovereign Entity

While a governmental Investor may have waived sovereign immunity by one of the means identified above, enforcing a judgment against a governmental Investor merits additional discussion.

First, side letter provisions may prescribe a particular jurisdiction (other than New York or Delaware) or a means of alternative dispute resolution (e.g., binding arbitration by the International Chamber of Commerce or similar body), and such provisions will affect how a Lender should pursue the Investor.

Further, once a judgment is obtained from the proper tribunal, satisfying a judgment against a governmental Investor may differ from satisfying a judgment against a private person. Due to public policy concerns, some government entities that do not enjoy immunity from suit may nonetheless argue they are effectively exempt from monetary judgments.[27] In these cases, a Lender can initiate enforcement proceedings but may not be able to collect on a judgment. In other cases, payment of the judgment may require that a specific appropriation be made by the appropriate legislative body of the governmental Investor, or statutory limits may exist on the amount of the judgment that may be satisfied.

For example, in Kentucky, while the state has waived its sovereign immunity with respect to contract claims, damages are capped at twice the amount of the original contract.[28] Certain states, including West Virginia, Louisiana and Connecticut, require the special approval of the legislature or some other administrative body before paying a claim.[29] Obviously, a Lender needs to be familiar with these particularities.

Seeking satisfaction of a judgment against a foreign governmental Investor that has defaulted on its capital commitment poses an additional set of issues, including whether or not such Investor has any commercial assets in the United States upon which a Lender can levy in the event the governmental Investor does not voluntarily settle a judgment awarded. In the event that the foreign governmental Investor does not have any commercial assets within the United States, a Lender may need to go abroad to seek enforcement of a judgment. Enforcing a US judgment abroad requires an analysis of whether or not the applicable foreign court will respect the judgment of the US court and if not, how such foreign court will rule if contractual liability needs to be re-litigated.

PRACTICAL CONSIDERATIONS

The good news is that Facilities have been around for many years and anecdotal evidence from active Lenders in the market during the financial crisis indicates that there have been no material governmental Investor defaults, despite significant budget issues faced by many governmental Investors. Additionally, there are practical reasons mitigating the likelihood that a state pension fund or other governmental Investor would renege on its commitment to fund capital contributions. These include the often severe default penalties found in partnership agreements, the bad publicity such Investor would likely receive and the damage the default might cause to the Investor's credit rating and reputation in the market. Thus, while the potential for such an Investor to claim immunity when a Lender exercises default remedies is nonetheless real and must

be considered in connection with formulating each Facility's borrowing base, the practical likelihood of this happening with frequency in practice may be remote.

Conclusion

There are numerous avenues by which governmental Investors have waived sovereign immunity with respect to commercial contracts. While there are complex legal issues surrounding the interplay between the doctrine of sovereign immunity and the capital commitments of governmental Investors, Funds, Lenders and their respective counsel have vetted many of these issues in connection with prior investments and often have the analysis readily available.

Accordingly, after careful review, Lenders are typically getting the comfort they need to include the majority of such Investors in the borrowing base. As no two jurisdictions are the same and the law continues to evolve, it is important for both Funds and Lenders to evaluate governmental Investors individually and stay current on sovereign immunity analysis.

For more information about the topics raised in this Legal Update, please contact your regular Mayer Brown lawyer, or:

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Endnotes

[1] *See* 5 Kenneth Culp Davis, Administrative Law Treatise 6-7 (2d. ed. 1984) (quoting William Blackstone's Commentaries Book III, Chapter 17 (1765-1769)).

[2] *Gray v. Bell*, 712 F.2d 490, 507 (D.C. Cir. 1983).

[3] *See Cohens v. Virginia*, 19 U.S. 264 (1821).

[4] 28 U.S.C. §1491.

[5] *See Hans v. Louisiana*, 134 U.S. 1 (1890), *Blatchford v. Native Village of Noatak*, 501 U.S. 775 (1991) and *Alden v. Maine*, 527 U.S. 706 (1999) (establishing that the immunity extends to state court).

[6] 28 U.S.C. §§ 1330, 1332, 1391(f), 1441(d), and 1602-1611.

[7] 28 U.S.C. §1491.

[8] NY Ct of Claims Act §8 (L. 1939, c 860); *Cal. Gov. Code* §814.

[9] *See* Or. Rev. Stat. §30.320, which requires a government agency to be "acting within the scope of its authority".

[10] For example, New York has vested exclusive jurisdiction in the New York Court of Claims for actions brought against the state of New York (*See* NY Ct. of Claims Act §8 (L. 1939, c 860)), Michigan, Pennsylvania, West Virginia, Ohio and Connecticut are among other states that have established judicial bodies to hear claims against the state (*See* Mich. Comp. Laws. Ann.. 600.605; 62 Pa. Consol. Stat. §§1721-1726; W. Va. Code §14-2-1; Ohio Rev. Code §2744.01 et seq.; and Ct. Gen. Stat. §4.142). In order to bring an action against the state of New Mexico under its statutory waiver of contractual immunity (N.M. Stat. Ann. §37-1-23), a plaintiff must (i) bring the claim within two years from the time of accrual, (ii) show that the contract is legally enforceable by pleading the basic elements of contract claims—offer, acceptance, consideration and mutual assent (*See Hartbarger v. Frank Paxton Co.*, 115 N.M. 665, 669 (1993))—and (ii) show that the governmental entity was not acting outside of its designated authority or power (*See Spray v. City of Albuquerque*, 94 N.M. 199, 201 (N.M. 1980)).

[11] *Hodges v. Rainey*, 533 S.E. 2d 578, 585 (S.C. 2000).

[12] *Kunzie v. Olivette*, 184 S.W. 3d 570 (Mo. 2006).

[13] *Commonwealth v. AMEC Civil, LLC*, 699 S.E. 2d 499, 516 (Va. 2010).

[14] *Supra* note 11.

[15] *See Tooke v. City of Mexia*, 197 S.W.3d 325 (Tex. 2006), which held that a public entity does not waive immunity despite a statutory provision permitting such entity to "sue and be sued."

[16] *TSU v. State Street Bank and Trust Company*, 212 S.W.3d 893 (Tex. App. 1st Dist. Jan. 11, 2007).

[17] *Harris Corp. v. Nat'l Iranian Radio & Television*, 691 F.2d 1344 (11th Cir. 1982).

[18] *Marlowe v. Argentine Naval Commission*, 1985 WL 8258 (D.D.C. 1985).

[19] *Creighton v. Qatar*, 181 F.3d 118 (D.C. Cir. 1999).

[20] *See*, e.g., *Drexel Burnham Lambert v. Committee of Receivers*, 12 F.3d 317 (2d Cir. 1993).

[21] *Seetransport Wiking Trader v. Navimpex Centrala Navala*, 989 F.2d 572 (2d Cir. 1993).

[22] 28 U.S.C. §1605(a)(2).

[23] *Id.*

[24] In order to limit its exposure to the US courts, it has been our experience that a number of foreign sovereigns will submit to binding arbitration with the Fund or a Lender.

[25] 504 U.S. 607 (1992).

[26] *Id.* at 619.

[27] *See* Section 31452 of the California County Employees Retirement Law (*Cal. Gov. Code* §31450 *et seq.*), which suggests that the assets of a California county retirement system are generally exempt from levy, execution, assignment, and any other collection process. Notwithstanding the express language of Section 31452 and a lack of certainty related thereto, we think there are good arguments that Section 31452 was intended to protect the pension benefits of the underlying beneficiaries from garnishment and not to shield a California county pension fund from liability for breach of contract.

[28] Ky. Rev. Stat. Ann. 45A.245 *et seq.*

[29] *See* W. Va. Code § 14-2-3 (An award by the Court of Claims is a recommendation by the court to the legislature, and is not binding); La. Const Art. XII, §10 (provides for the appropriation of funds by the legislature); and Ct. Gen. Stat. §4.158-160 (for claims in excess of $7,500, the Claims Commissioner may either
(i) grant the claimant permission to sue the state agency, in which case the state has waived sovereign immunity or (ii) recommend payment of the claim to the General Assembly, in which case the Assembly may accept, modify or reject the recommendation. Upon rejection, the Assembly may authorize the claimant to sue, or it may reject the claim altogether.).