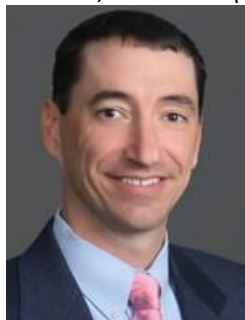


## The Enforceability Of Debt Capital Commitments

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Zachary K. Barnett



Rue K. Toland



Matthew A. McDonald

A subscription credit facility is an extension of credit by a bank, financing company, or other credit institution (each, a “lender”) to a closed-end real estate or private equity fund (“fund”). The defining characteristic of such a facility is the collateral package securing the fund’s repayment of the lender’s extension of credit, which is composed of the unfunded commitments (equity or debt “capital commitments”) of the limited partners to the fund (“investors”) to make capital contributions when called upon by the fund’s general partner, not the underlying investment assets of the fund itself. The loan documents for the facility contain provisions securing the rights of the creditor, including a pledge of (1) the capital commitments of the investors, (2) the right of the fund to make a call (each, a “capital call”) upon the capital commitments of the investors after an event of default and to enforce the payment thereof, and (3) the account into which the investors fund capital contributions in response to a capital call.

While there is no definitive U.S. Supreme Court or federal circuit court of appeals case law addressing this issue, parties to facilities are generally comfortable that investors’ equity capital commitments are enforceable obligations. We are not aware of any case law in contravention of the decisions **discussed here** on the enforceability of equity capital commitments in a facility.<sup>[1]</sup> Nor are we aware of any institutional investor payment defaults under a facility, which would have brought this issue to a head. However, the case law is less certain with respect to the enforceability of debt capital commitments within the fund structure.

### Tax Rationale

Some funds are comprised entirely of debt capital commitments. In addition, even when a particular investor’s commitment consists of the obligation to make an equity capital contribution, that equity capital commitment may switch in whole or in part to a debt capital commitment as the obligation flows

from a feeder fund through blocker entities down to the fund borrower. Including debt capital commitments within the fund structure is driven largely by tax reasons.

Non-U.S. investors can receive more favorable tax treatment of their investments when the investment is structured, in part, as a debt capital commitment within the fund structure. By switching a portion of the equity capital commitment to debt, the investor can effectively block connected income, which would cause the foreign investor to be treated as a U.S. taxpayer. In addition, a blocker entity within the fund structure can take an interest deduction on account of a debt capital commitment that is unavailable with respect to an equity capital commitment, and this deduction will minimize the tax cost of the blocker. Tax-exempt entities employ debt investments in blockers to reduce their unrelated business taxable income (UBTI). Finally, investors' withholding rates on interest are lower than the withholding rates on equity.

### **Enforceability of Debt Capital Commitments**

Despite the numerous tax reasons for employing debt capital commitments within a fund structure, the lack of certainty around the enforceability of such debt capital commitments in a fund bankruptcy scenario should cause parties to consider whether to require only equity commitments to mitigate the risk that debt capital commitments within the fund may render an investor's commitment unenforceable.

Section 365(c)(2) of the Bankruptcy Code governs the enforceability of contracts between a debtor and nondebtor third parties where "such contract is a contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor." 11 U.S.C. § 365(c)(2). In the event of a facility default, a debt capital commitment owed directly to a fund borrower would likely be deemed unenforceable as a "financial accommodations contract" under § 365(c)(2) of the Bankruptcy Code. The practical effect of § 365(c)(2) is to permit a lender to decline to advance post-petition funds to a trustee or Chapter 11 debtor in possession, even if the lender had a pre-bankruptcy contractual obligation to do so. In the hypothetical fund bankruptcy scenario, the feeder vehicle owing a debt capital commitment to a blocker below it in the fund structure could argue that it does not need to honor its debt capital commitment to the blocker because the subsidiary fund was in bankruptcy.

It is generally accepted that § 365(c)(2) permits an entity to decline to comply with a financial accommodations contract for the benefit of a debtor in bankruptcy, and prevents the debtor from enforcing that obligation following the bankruptcy filing. See, e.g., *In re Marcus Lee Assocs. LP*, 422 B.R. 21, 35 (Bankr. E.D. Pa. 2009) (finding that § 365(c)(2) absolved the lender from the obligation to fund under a construction loan to the debtor borrower post-petition). What is not clear is whether § 365(c)(2) similarly permits an entity that is a party to a financial accommodations contract with a nondebtor parent of a bankruptcy entity to decline to honor its debt capital commitments under that contract. In other words, when an equity capital commitment flips to a debt capital commitment and then reverts to an equity capital commitment when made directly to the fund, it is unclear whether a bankruptcy court would deem the obligation an enforceable equity capital commitment or an unenforceable financial accommodations contract.

We are not aware of any definitive case law addressing the enforceability of debt capital commitments within a fund structure. In the absence of guidance from the courts on this issue, lenders relying on such obligations to secure their loan commitments can make several arguments in support of the enforceability of debt capital commitments within a fund structure.

First, lenders could argue that § 365(c)(2) should not apply in the context of a fund bankruptcy because the debt capital commitment is not an obligation to the fund borrower itself (the bankrupt entity) but rather to another entity upstream within the fund structure. When courts have examined whether a contract to loan funds to a third party is a financial accommodation “to or for the benefit of” the debtor, they have focused on factors such as whether the proceeds of the loan are disbursed directly to the debtor and whether the debtor incurs any secondary liability for repayment of the loans. See, e.g., *In re Sun Runner Marine Inc.*, 945 F.2d 1089, 1092 (9th Cir. 1991) (holding that the retail boat dealer floor plan financing agreement was a financial accommodation to the debtor boat manufacturer because the proceeds were disbursed directly to the debtor and the debtor incurred secondary liability for the repayment of the dealer loans). In the fund context, the fund proceeds of the debt capital commitment would be paid indirectly to the fund in the form of equity capital commitments from a parent entity and the fund would have no secondary liability to repay the debt, distinguishing the fund structure from circumstances in which courts have found § 365(c)(2) to apply.

In addition, bankruptcy courts are courts of equity that may look beyond the form (e.g., the tax structure) of a transaction to its substance (e.g., an equity commitment from the investor). See, e.g., *In re: Dornier Aviation (N. Am.) Inc.*, 453 F.3d 225, 233 (4th Cir. 2006) (“[a] bankruptcy court’s equitable powers have long included the ability to look beyond form to substance”) (citing *Pepper v. Litton*, 308 U.S. 295, 305, 60 S. Ct. 238, 84 L. Ed. 281 (1939)).

In our scenario, the initial and fundamental transaction is not a debt capital commitment from the investor to the fund; it is an equity capital commitment. The investor makes its equity capital commitment to a feeder vehicle, the feeder vehicle or an intermediary entity then makes a debt capital commitment down to a blocker, which, in turn, makes a debt capital commitment to the fund. Notwithstanding the fact that a portion of the investor’s capital commitment is treated as a debt capital commitment for tax purposes within the fund structure, a bankruptcy court very well could use its equitable powers to recognize that the investor’s commitment, on which a lender relies, is a capital commitment.

Finally, in situations where an investor’s commitment splits into both debt and equity components at a particular level within the fund structure, even if the court were to find that the debt portion was not enforceable, the portion of the investor’s commitment that remained as equity should continue to be enforceable under generally accepted theories of the enforceability of capital commitments. The federal district court decision in *Chase Manhattan Bank v. Iridium Africa Corp.*, 307 F. Supp. 2d 608 (D. Del. 2004), remains good law and parties can take comfort that there has been no subsequent case law calling into question the enforceability of equity capital commitments in similar circumstances.

However, in order to avoid the argument that a contractual obligation to provide both debt and equity should be treated as a single financial accommodations contract (and thus be unenforceable under §365(c)(2)), parties should consider documenting the debt and equity commitments in the subscription agreement rather than solely within the applicable limited partnership agreement. Parties should also consider including in their facility documentation a representation and warranty that the debt capital commitment is not a financial accommodations contract and that the applicable investors and fund entities waive any defenses under §365(c) of the Bankruptcy Code. We note, however, that it is unclear whether such provisions would be enforceable in a bankruptcy context.

## **Conclusion**

While we are not aware of any definitive case law addressing whether § 365(c)(2) would render an

investor's capital commitment unenforceable when that capital commitment is initially made as equity but is treated as debt within the fund structure, the arguments discussed herein could be employed to defend the enforceability of the initial equity capital commitment. Nevertheless, parties should consider whether the tax benefits of incorporating debt capital commitments into a fund structure outweigh the risks that such debt capital commitments could render the investors' capital commitments unenforceable in a bankruptcy scenario.

—By Zachary K. Barnett, Rue K. Toland and Matthew A. McDonald, Mayer Brown LLP

*Zachary Barnett is a partner and Rue Toland and Matthew McDonald are associates in Mayer Brown's Chicago office.*

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[1] See Mayer Brown Legal Update, Enforceability of Capital Commitments in a Subscription Credit Facility, July 7, 2011.

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