Enforceability of Capital Commitments in a Subscription Credit Facility

Introduction

A subscription credit facility (a "Facility"), also frequently referred to as a capital call facility, is a loan made by a bank or other credit institution (the "Creditor") to a closed end real estate or private equity fund (the "Fund"). The defining characteristic of a Facility is the collateral package: the obligations are typically not secured by the underlying assets of the Fund, but instead are secured by the unfunded commitments (the "Capital Commitments") of the limited partners of the Fund (the "Investors") to fund capital contributions ("Capital Contributions") when called from time to time by the Fund or the Fund's general partner. The loan documents for the Facility contain provisions securing the rights of the Creditor, including a pledge of (i) the Capital Commitments of the Investors, (ii) 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 (iii) the account into which the Investors fund Capital Contributions in response to a Capital Call.

As we come out of the recent financial crisis, Investors appear willing to again make Capital Commitments to Funds, and the number of Funds in formation and seeking Capital Commitments appears to be up markedly from the recent past. Correspondingly, Fund inquiries for Facilities are also on the rise. As Creditors evaluate these lending opportunities, they naturally inquire into the enforceability of Investors' Capital Commitments in the event of a default under a Facility. This Legal Update seeks to address the current state of the law on point.

Enforceability of Capital Commitments

Although the subscription credit facility product has been around for many years, the volume of published case law precedent on point is limited. Creditors typically see this as a good thing: few Facilities have defaulted and thus there has been little need for litigation against Investors seeking to compel the funding of Capital Contributions. Anecdotal evidence during the financial crisis certainly supports this positive performance, as very few Investor defaults, let alone Facility defaults, have been reported by active Creditors in the market.

There is, however, published legal precedent supporting Creditors' enforcement rights, and it is generally accepted that a Creditor can enforce the Capital Contributions of the Investors under two separate theories of liability: state statutory law and general contract law. We examine each in turn below. Additionally, a Creditor's rights to the Capital Commitments of the Investors should not be materially impaired by a Fund's bankruptcy proceeding. While there is not definitive legal authority negating all possible defenses an Investor could raise, there is sufficient law on point to give Creditors' ample comfort that the collateral supporting a Facility is enforceable.

STATE STATUTORY RIGHT OF CREDITORS TO CAPITAL COMMITMENTS

Delaware Statutory Law. Most Funds are formed as either limited partnerships or limited liability companies, and the vast majority of stateside Funds are organized under Delaware law. Delaware statutory law contains specific provisions addressing the obligations of an Investor to a Fund: "Except as provided in the partnership agreement, *a partner is obligated to the limited partnership to perform any promise to contribute cash or property or to perform services*, even if that partner is unable to perform because of death, disability or any other reason."[1] In addition, an Investor's obligation to honor its promise to make Capital Contributions explicitly extends for the benefit of Creditors, and although an Investor's obligations to the Fund can be "compromised" by consent of the other Investors, this compromise will not excuse the liability or obligations of the Investor in question to Creditors of the Fund. Title 6, Section 17-502 (b)(1) of the Delaware Code provides:

> Unless otherwise provided in the partnership agreement, the obligation of a partner to make a contribution or return money or other property paid or distributed in violation of this chapter may be compromised only by consent of all the partners. Notwithstanding the compromise, a creditor of a limited partnership who extends credit, after the entering into of a partnership agreement or an amendment thereto which, in either case, reflects the obligation, and before the amendment thereof to reflect the compromise, may enforce the original obligation to the extent that, in extending credit, the creditor reasonably relied on the obligation of a partner to make a contribution or return.[2]

The Revised Uniform Partnership Law, adopted by most states, contains similar provisions allowing a Creditor to enforce its rights against an Investor, even if the Investor's obligations to the Fund have been compromised.[3] The Delaware LLC statutory framework provides similar protections for Creditors.[4]

A Delaware Superior Court has confirmed a Creditor's cause of action against an Investor to compel the funding of its Capital Commitment under Delaware statutory law. In *In re LJM2 Co-Investment, L.P.*, a Delaware limited partnership was formed by Andrew Fastow, the then-CFO of Enron, for the purpose of making investments in energy and communications businesses related to Enron. The Fund secured nearly $400 million in Capital Commitments and entered into a $120 million syndicated Facility, in what appears to have been a "No Investor Letter" transaction.

The Facility included an "Undertaking" pursuant to which, if the Fund defaulted, the Creditors could issue Capital Calls to cure any payment default. When Enron went bankrupt, the Fund defaulted and the Investors declined to fund Capital Calls issued by both the general partner and subsequently by the Creditors. Instead, the Investors amended the Partnership Agreement, in violation of the Facility provisions, to compromise and rescind the Capital Calls. Without additional Capital Contributions, the Fund could not meet its obligations and filed for bankruptcy. The bankruptcy trustee issued an additional Capital Call—which the Investors again declined to fund—and then commenced litigation against the Investors.

The Investors moved to dismiss the statutory cause of action under Title 6, Section 17-502(b)(1) of the Delaware Code based on a variety of arguments, including that the Creditors could not demonstrate "reliance" on their Capital Commitments as required by the statute. The court ruled in favor of the

Creditors, holding that they stated a claim for relief under Section 17-502(b)(1) and that the Creditors adequately alleged reliance on the Capital Commitments.[5] While not an ultimate ruling, the framework set forth by the court looked quite favorable for the Creditors, and the case appears to have been resolved prior to the issuance of any subsequent opinions.

New York Statutory Law. New York law imposes a similar duty on Investors for "unpaid contributions" to the Fund, and this obligation extends for the benefit of the Fund's Creditors.[6] Additionally, an Investor may be liable with respect to its unfunded Capital Commitment even after exiting the Fund. In *In re Securities Group 1980*, the trustee of the Fund's bankruptcy estate brought an action seeking to enforce the Investors' Capital Commitments, which they had declined to fund after principals of the Fund sponsor were convicted of tax fraud. The Federal Court of Appeals, affirming the Federal Bankruptcy Court, held that the Investors were obligated to fund their Capital Contributions irrespective of the alleged fraud committed by the Fund Sponsor: "Under the statutory provision [of New York law], even if a debt to a partnership creditor 'arises' after the limited partner's withdrawal, the withdrawn limited partner is nevertheless liable for the debt if the creditor 'extended credit' before the amendment of the limited partnership certificate."[7] The court went on to uphold the liability of the Investors to the Fund's Creditors reasoning that "the limited partners should bear the risk that the partnership's assets could become worthless."[8]

CONTRACTUAL RIGHT TO CAPITAL COMMITMENTS

Breach of Contract. Under a theory of contract liability, an Investor's obligation to fund its Capital Commitment is an enforceable contractual obligation pursuant to the terms of the partnership agreement (the "Partnership Agreement"). An Investor is held accountable for its Capital Commitments on the ground that it has entered into a contractual relationship with the other partners to make Capital Contributions or contribute other property to further the Fund's financial growth. Accordingly, the failure of an Investor to honor its obligations would constitute a breach of contract, and the Investor would be liable for such a breach.[9]

To rely on a theory of contractual liability, the Creditor needs to have standing to assert the claim for breach. To help establish standing, the Partnership Agreement and the Facility documents should contain affirmative language evidencing: (i) the right of the Fund or general partner to make Capital Calls on the Investors and their obligation to fund their related Capital Contributions and (ii) a pledge by the Fund of its right with respect to such Capital Calls and the enforcement thereof to Creditors. If the Partnership Agreement provisions create the contractual obligation and the Facility documents contain the requisite pledge, the Creditors will be well-positioned legally to enforce the Investor's Capital Commitments.[10]

Iridium. A federal district court's ruling in *Chase Manhattan Bank v. Iridium Africa Corporation* illustrates the importance of the Partnership Agreement in protecting the rights of Creditors. In this case, the Creditor entered into a $800 million Facility with Iridium LLC based on provisions in the Iridium LLC agreement (the "LLC Agreement") that the Creditor had the right to call on Iridium's members' Reserve Capital Call obligations ("RCC Obligations"), and a certificate from the secretary of Iridium LLC certifying that the LLC Agreement was "true and correct." Under the terms of the Facility, the Creditor was assigned Iridium's RCC Obligations. When Iridium defaulted on its loan, the Creditor sought to enforce the assignment of the RCC Obligations. In resolving the dispute, the district court reviewed the language of the LLC Agreement, which contained provisions stating that a member's duty to perform its RCC Obligations was "absolute and unconditional" and that each member "waived in favor of [the Creditor] any defense it may have or acquire with respect to its obligations under the [RCC]." Therefore, the court granted summary judgment in favor of the Creditor on its breach of contract claim against the Investors.[11]

Material Breach. An Investor may argue, under contract law, that it should be excused from further performance of its obligations to a Fund in instances where there has been a material breach by the Fund or its General Partner. This is a relatively well-established general legal principle.[12] However, this release of an Investor's liability has been held not to extend to the obligations the Investor owes to Fund Creditors. In distinguishing the relationship between an Investor's duty to the Fund and other parties contracting with the Fund, a Massachusetts Court of Appeals held that "relations of a limited partner to the partnership … are more complex in that other limited partners and third parties *rely on an expressed obligation*, made public by filing, *to contribute resources to the partnership*."[13] The court further noted that the Uniform Partnership Law places an emphasis on protecting the rights of outside parties that rely on the commitments of limited partners in extending credit to the partnership, because, without this guarantee, Creditors would be unlikely to enter into the loan with the limited partnership.[14] In fact, in a different case, even where the Fund's principals were convicted of fraud in relation to the Fund, a court has held that the obligation to pay Capital Commitments to Creditors was not excused.[15] These case precedents provide strong authority supporting the enforceability of Capital Commitments—even in the case of a material breach by the Fund. However, it is still advisable to require language in the Partnership Agreement and, if applicable, the Investor Letter, that Capital Contributions will be funded by the Investor "without set-off, counterclaim or defense" to further weaken any material breach defense.

ENFORCEABILITY OF CAPITAL COMMITMENTS IN BANKRUPTCY PROCEEDINGS

In the event of the bankruptcy of the Fund, the causes of action entitling the Creditor to relief will not change—they will still be based on the same statutory and contractual theories. But the context of the proceedings, and the potential defenses asserted by the Investors, will likely change. A Creditor's rights will be subject to the applicable provisions of the U.S. Bankruptcy Code (the "Code") and will likely be represented by the Fund itself, as debtor-in-possession ("DIP") or a bankruptcy trustee (the "Trustee"). Within a bankruptcy, the DIP or the Trustee acts on behalf of the Fund and seeks to maximize the value of the Fund's estate to pay off its obligations to its creditors. As such, the Trustee typically seeks to marshal Fund assets by making a Capital Call and bringing litigation against the Investors if necessary.[16]

In a Fund bankruptcy, an Investor's primary argument is likely to be that its remaining Capital Commitment is an "executory contract" under Section 365(c)(2) of the Code, rendering the obligation voidable. An "executory contract," although not specifically defined in the Code, is generally considered to be a contract where both counterparties have material, unperformed obligations. Generally, in bankruptcy, the DIP or the Trustee gets to decide whether to assume an executory contract (and be bound thereunder) or to reject it and thereby effectively disaffirm any such continuing obligations. However, under Section 365(c)(2) of the Code, a DIP or Trustee is prohibited from assuming an executory contract if it is by a third party to "make a loan, or extend other debt financing or financial accommodations to or for the benefit of the debtor, or to issue a security of the debtor."[17]

In *Iridium*, the Investors argued that the LLC agreement containing their RCC Obligations was a financial accommodation contract that the Code prohibited from being assumed. The court rejected this argument, noting that the purpose of Section 365(c)(2) of the Code is to protect parties from extending additional credit or funding whose repayment relies on the fiscal strength of an already bankrupt debtor. The court held that the RCC Obligations, in contrast, were not "new" obligations, having long since been committed by the members: "In these circumstances, the Court concludes that the [members] are not within the class of creditors Congress intended to protect under Section 365(c)(2) of the Bankruptcy Code."[18]

This ruling leaves an important consideration from a practitioner's perspective, as tax considerations have caused some Funds to allow for Capital Contributions to be funded in the form of loans instead of equity. While we would be hopeful a court would look through this phraseology to the substance of what an Investor's Capital Contributions are, the "loan" language might give an Investor a stronger basis to argue that the applicable agreement was one to extend a loan or financial accommodation, and thus non-assumable under Section 365(c)(2). To help better protect the Creditor against this possibility, we prefer to see explicit language in the applicable Partnership Agreement and, if applicable, in the Investor Letter, substantially to the effect that, in the event that any loans funded in lieu of Capital Contributions under the Partnership Agreement would be deemed to be an executory contract or financial accommodation in connection with a bankruptcy or insolvency proceeding, each Investor irrevocably commits to cause any amounts that would otherwise be funded as loans to be made as a Capital Contribution to the Fund.

Conclusion

While there is not a definitive case fully vetting and dismissing every argument Investors could potentially assert in attempting to avoid honoring their Capital Commitments, the existing statutory and case law provide significant comfort that Investors' Capital Commitments are enforceable obligations, even in a Fund bankruptcy context.

Endnotes

1 DEL. CODE ANN. tit. 6, § 17-502(a)(1) (2010) (emphasis added).

2 DEL. CODE ANN. tit. 6 § 17-502(b)(i) (2010).

3 *See* UNIF. P'SHIP LAW § 502(c) (provisions allowing a Creditor to enforce its rights against a limited partner, even if a limited partner's obligations to the limited partnership have been compromised).

4 *See* DEL. CODE ANN. tit. 6, § 18-502 (2010).

5 *See* In re LJM2 Co.-Investment, L.P., 866A. 2d 762 (Del. Super. Ct. 2004).

6 N.Y. P'SHIP LAW § 106(1)(b) (limited partner liable for "any unpaid contributions which he agreed in the certificate to make in the future at the time and on the conditions stated in the certificate"); *see also* § 106(3) ("[T]he liabilities of a limited partner … can be waived or compromised only by the consent of all members; but a waiver or compromise shall not affect the right of a creditor of a partnership, who extended credit … to enforce such liabilities.").

7 *In re Sec. Group 1980*, 74 F.3d 1103, 1110 (11th Cir. 1996); *see also Int'l Investors v. Bus. Park Fund*, 991 P.2d 219 (Alaska 1999) (limited partners liable to creditors who extend credit based on limited partners' capital commitments).

8 *Id*. at 1111 (citing *Kittredge v. Langley*, 252 N.Y. 405, 169 N.E. 626 (1930)).

9 Each case cited hereunder was decided under Delaware or other U.S. law. While applicable local counsel should be consulted in connection with funds that have parallel or feeder vehicles formed in other jurisdictions, other jurisdictions do have precedent consistent with these holdings. For example, Appleby has confirmed that,

assuming that the New York law Facility documentation creates a valid and enforceable security interest over the Capital Commitments, Creditors will be well placed legally to enforce the Investor's Capital Commitments in a Fund governed by the laws of the Cayman Islands (Mayer Brown LLP does not opine on the laws of the Cayman Islands). *See also Advantage Capital v. Adair* [02 Jun 2010] (QBD) Claim no. HQ10X01837 (Order for breach of contract granted in favor of private equity fund that sued a limited partner for repudiation under English law).

[10] *See NAMA Holdings, LLC v. Related World Mkt. Ctr., LLC*, 922 A.2d 417, 434 (Del. Ch. 2007) ("As a general rule, only parties to a contract and intended third-party beneficiaries may enforce an agreement's provisions."); *see also Insituform of N. Am., Inc. v. Chandler*, 534 A.2d 257, 268 (Del. Ch. 1987) ("It is universally recognized that where it is the intention of the promisee to secure performance of the promised act for the benefit of another, either as a gift or in satisfaction or partial satisfaction of an obligation to that person, and the promisee makes a valid contract to do so, then such third person has an enforceable right under that contract to require the promisor to perform or respond in damages.").

[11] *Chase Manhattan Bank v. Iridium*, 307 F.Supp 2d 608, 612-13 (D. Del. 2004). Similarly, the Bankruptcy Court in *In re Securities Group 1980* held that the Investors were liable under a contractual theory of liability under the applicable Partnership Agreement. See 74 F.3d at 1108.

[12] *Partnership Equities, Inc. v. Marten*, 15 Mass. App. Ct. 42, 45, 443 N.E.2d 134, 136 (Mass. App. Ct. 1982) ("If [limited partner's] enrollment were merely a bilateral agreement between the defendants and the general partners, the principle of contact law upon which the defendants rely, that a material breach excuses nonperformance might well apply.").

[13] *Id.* (emphasis added).

[14] *Id.* at 45.

[15] *In re Securities Group 1980*, 74 F.3d at 1109 ("[A] material breach of the partnership agreement … would not excuse a limited partner's commitment to contribute additional capital on the conditions stated in the certificate [of limited partnership].").

[16] *See Lowin v. Dayton Sec. Assoc.*, 124 B.R. 875, 892-93 (M.D. Fla. Bankr. 1991); *see also In re LJM2 Co-Investment, L.P.*, 866A.2d 762, 781 (Del. Super. Ct. 2004).

[17] 11 U.S.C. § 365(c)(2).

[18] *Chase Manhattan Bank v. Iridium Africa Corp.*, 2004 WL 323178 at *4 (D. Del. 2004); *see also Lowin*, 124 B.R. at 901 (stating that a Trustee's enforcement of the limited partners' Capital Commitments "is not the equivalent of requiring the limited partner defendants to extend new credit to the debtors in the form of loans, lease financing or purchase of discount notes").

For more information about the enforceability of Capital Commitments, or any other matter raised in this Legal Update, please contact:

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