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Article

Foreign Investor Capital: Collateral Enforceability and Minimization of Risk

Due to previous challenges in the United States fundraising market for sponsors of real estate, private equity and other investment funds (each a "Fund"), many Fund sponsors have sought to expand their sources of capital to include investors domiciled outside of the United States ("Foreign Investors"). As such, Fund sponsors are increasingly requesting that the unfunded capital commitments of these Foreign Investors be included in the borrowing availability (the "Borrowing Base") under the Fund's subscription credit facility (a "Subscription Facility").

While traditionally Funds have not chosen their lenders solely based upon whether such lender would include Foreign Investors' capital commitments in the Borrowing Base, it is becoming a more critical factor. Consequently, understanding and addressing collateral enforceability issues related to Foreign Investors has become increasingly important for lenders. Below we set out our views on common concerns regarding collateral enforceability and some possible solutions for minimizing such risk.

Subscription Credit Facilities and Foreign Investors

A Subscription Facility, also frequently referred to as a capital call facility, is a loan made by a bank or other credit institution (a "Lender") to a Fund. The defining characteristic of such Subscription Facility is the collateral package, which is comprised not of the underlying investment assets of the Fund, but instead by the unfunded capital commitments ("Capital Commitments") of the limited partners of the Fund (the "Investors") to make capital contributions ("Capital Contributions") when called from time to time by the Fund's general partner (the "General Partner"). The loan documents for the Subscription Facility contain provisions securing the rights of the Lender, including a pledge of (a) the unfunded Capital Commitments of the Investors, (b) the right of the General Partner to make a call (each, a "Capital Call") upon the Capital Commitments of the Investors after an event of default accompanied by the right to enforce the payment thereof, and (c) the account into which the Investors fund Capital Contributions in response to a Capital Call. Such rights of the Fund and its General Partner are governed by the Fund's constituent documents, including its limited partnership agreement or operating agreement (collectively, the "Constituent Documents").

Lenders have become comfortable with this collateral package because of (i) their ability to select high-credit quality Investors whose Capital Commitments comprise the Borrowing Base, and (ii) in the event that an Investor fails to fund its Capital Commitments, ability to enforce payment of its Capital Contributions in and under the laws of the United States. However, as the momentum toward including Foreign Investors in the Borrowing Base increases, Lenders are facing new challenges, including (i) the ability to determine the credit quality of Foreign Investors and (ii) the

ability to enforce the payment of Capital Contributions from these Foreign Investors.

Key Issues

The three primary collateral enforceability issues that arise in connection with Foreign Investors include (i) as with all Investors, obtaining financial and other information during the due diligence process necessary to properly assess such Foreign Investor's creditworthiness; (ii) obtaining jurisdiction in the courts of the United States over such Foreign Investor; and (iii) enforcing judgments issued by a court of the United States against such Foreign Investor.

Due Diligence

The Subscription Facility due diligence process typically includes obtaining and reviewing (i) the Constituent Documents of the Fund; (ii) the form subscription agreements ("Subscription Agreements") executed by each Investor detailing, among other things, such Investor's willingness to be bound by the terms and conditions of the Constituent Documents and disclosing, among other things, certain information of such Investor; and (iii) other side agreements ("Side Letters" and, together with the Subscription Agreements, the "Subscription Documents") detailing alterations or exceptions, if any, to the Fund's partnership agreement and/or the form of Subscription Agreement.

For Investors domiciled in the United States ("US Investors"), Lenders have typically included in the Borrowing Base investment-grade, non-investment grade and non-rated institutional Investors. Assessment of the credit quality of such Investors has been relatively uncomplicated. Conversely, with regard to Foreign Investors, Lenders have been reluctant to assess their credit quality, often citing lack of financial information, which Foreign Investors are reluctant to provide for confidentiality reasons.

Nevertheless, Fund sponsors are becoming more aware of the need to obtain financial information from their Foreign Investors and are raising the matter earlier in the solicitation process. We anticipate that acquiring financial information from Foreign Investors whom the Fund would like included in the Borrowing Base will become a more customary part of the overall diligence process. However, many Foreign Investors have and are continuing to push back on requests for non-public information. It is not uncommon for a Foreign Investor to negotiate such a provision in its Side Letter with the caveat that it will cooperate with reasonable information requests from the Fund sponsor if necessary in connection with obtaining a Subscription Facility. Lenders will almost certainly require financial information from the Foreign Investor (or its parent entity) before giving the Fund full Borrowing Base credit for such Investor (credit that is typically at a 90% advance rate). Where the Foreign Investor is a subsidiary or special purpose vehicle owned by a parent entity with substantial credit quality, a guarantee or comfort letter providing direct credit linkage to the parent will often be required by Lenders before giving full Borrowing Base credit to the subsidiary or special purpose vehicle. Lenders are more often than not gaining comfort regarding credit quality from most Foreign Investors by obtaining financial and/or other information regarding such Foreign Investors from publicly available sources. We have also seen, and expect to see more, Lenders cooperating with their foreign affiliates to obtain additional information. Lenders relying on such information are often giving creditworthy Foreign Investors some Borrowing Base credit (at times at a 60-65% advance rate), which are often subject to tight concentration limits (both individually and as a class of Foreign Investors) and sometimes even skin-in-the-game tests aimed to limit the Lenders' risk and overall exposure to this class of Investor. We expect to see the treatment of Foreign Investors develop over the coming years as the information becomes more transparent and these Investors become more critical to a Fund's Borrowing Base.

Jurisdictional Issues

Foreign Investors can take the form of either individuals or entities, including governmental pension plans, state endowment funds, sovereign wealth funds and other instrumentalities of foreign governments ("Governmental Investors"). Such Governmental Investors are becoming more prevalent and are often some of the largest Investors in the Investor pool. For Lenders, the common concern with including such Investors in the Borrowing Base has been whether certain sovereign immunity rights, rooted in the common law concept that "the King can do no wrong," could provide a defense against enforcement of such Investor's obligation to make Capital Contributions after an event of default. Although sovereign immunity in its purist form could shield a governmental entity from all liability, 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.[1]

With regard to Foreign Investors generally, some Lenders have been reluctant to include such Investors due to concern with litigating and enforcing judgments in a United States court. A United States court's ability to hear a case involving allegations against a foreign person or entity is governed by the laws of the applicable state and the Constitution. The laws of most, if not all, states provide that parties to a contract may select their governing law and venue for litigating disputes arising under such contract. For this reason, most, if not all, Subscription Documents and Constituent Documents include these provisions. Most often, either New York or Delaware is selected as the governing law and venue under these documents. Furthermore, most, if not all, Constituent Documents include provisions that would allow the General Partner (or Lender in the case of a default and failure of such Foreign Investor to fund its Capital Contribution) to liquidate the applicable Foreign Investor's partnership interest or offset damages against distributions that would otherwise be payable to the Foreign Investor.

Lenders can additionally gain comfort by obtaining Investor consent letters, also commonly referred to as Investor letters or Investor acknowledgments ("Investor Letters"), wherein such Foreign Investor would confirm its unconditional obligation to fund its Capital Contribution, in accordance with the Subscription Documents and Constituent Documents. These letters could also address forum, venue and sovereign immunity provisions directly in favor of the Lenders.

To the extent that forum and venue selection provisions are included in the Subscription Documents, Constituent Documents or Side Letters, the Lender can seek to enforce such provisions against a defaulting Foreign Investor, as assignee of the General Partner's rights, under the collateral documents of the Subscription Facility. Such Lender could file a lawsuit or arbitration claim directly against such Foreign Investor in the applicable United States court or tribunal. While service of process on such Foreign Investor is always a concern when filing such a lawsuit or arbitration claim, Lenders could gain comfort by requesting in an Investor Letter (i) the designation of a United States entity to accept service of process and/or (ii) the express waiver of any objection as to adequacy of such service of process, so long as it has been effected. Similarly, as Fund sponsors become more aware, it is likely that such Fund sponsors will include comparable provision in Subscription Documents and Side Letters. Alternatively, the inclusion of arbitral provisions in Subscription Documents, Constituent Documents or Side Letters would avoid recognition and enforcement issues in most instances and would mitigate sovereign immunity claims in the case of most Governmental Investors. Immunity concerns (except to the extent otherwise covered in the Foreign Investor's Subscription Documents, Side Letters or Investor Letters) could additionally be overcome via the Foreign Sovereign Immunities Act of 1976 and

the exceptions included within Sections 1605-1607 thereof, including an exception for commercial activity that has a nexus to the United States.

Enforcement of Judgments

If a judgment is obtained against a Foreign Investor in a United States court, it may be difficult for the Lender to enforce such judgment against such Investor in the United States, unless such Foreign Investor has assets in the United States that are not otherwise subject to immunity. Therefore, the concern for many Lenders is whether such judgment could be enforced against such Foreign Investor in its country of domicile. While there is currently no treaty between the United States and any other country regarding recognition and enforcement of judgments, the United States is a party to some multilateral treaties requiring the recognition and enforcement of arbitral awards. For this reason, it is generally advisable to include submission to arbitration provisions in Subscription Documents, Side Letters and Investor Letters, as applicable, in which Foreign Investors are a party.

To the extent that enforcement is sought in the Foreign Investor's country of domicile, the law of such country will determine whether any judgment is enforceable. Most countries with developed legal systems do have laws that provide for the recognition of legitimate judgments issued abroad. If the amount of damages does not appear excessive, foreign countries will typically consider, among other matters, whether (i) the court had proper jurisdiction, (ii) the defendant was properly served or otherwise had sufficient notice, (iii) the proceedings were fraudulent or otherwise fundamentally unfair, and (iv) the judgment violates the public policy of such foreign country. As with most litigation involving foreign parties, local foreign counsel should be consulted as to the particular laws of the applicable country.

Conclusion

As fundraising challenges persist, Funds will continue to seek additional sources of capital, including Foreign Investor capital. As Lenders adapt to meet the changing needs of their clients, we expect to see the Capital Commitments of Foreign Investors being included in the Borrowing Bases of more Subscription Credit Facilities. Those Lenders that can quickly and effectively evaluate the creditworthiness of these investors will be well-positioned to receive additional opportunities from their Fund clients.

Endnotes

[1] "Sovereign Immunity Analysis in Subscription Credit Facilities," Mayer Brown Legal Update, November 27, 2012.