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Statutory Protections against the Unauthorized Release of Capital Commitments in a Subscription Credit Facility

The market for subscription-backed credit facilities, also known as "capital call" or "capital commitment" facilities ("Subscription Facilities"), was recently unsettled by reports that an international private equity fund had allegedly released its investors' capital commitment obligations in violation of covenants under its Subscription Facility, potentially leaving the Subscription Facility lender exposed without sufficient collateral coverage with respect to the loan amounts outstanding. While most lenders have always been aware of this risk, many market participants have re-focused their attention on this issue and are now looking to better understand a lender's protections against a fund-borrower (the "Fund") and its investors following the unauthorized release of the investors' obligations to fund their capital commitments to the Fund.

A key to understanding the risks of a Fund releasing its investors' capital commitment obligations without lender consent is to examine the jurisdiction in which the Fund is organized. Jurisdictions differ on the statutory and common law protections available to lenders that might find themselves in this situation. Accordingly, prior to entering into a Subscription Facility (or allowing a new Fund to join an existing Subscription Facility), lenders should be comfortable with the Fund's governing law and understand any jurisdiction specific risk with respect to the enforceability of capital commitments.[1] Fortunately, from a US perspective, statutory law in jurisdictions in which Funds are frequently formed (e.g., Delaware and New York) provides some helpful protections to Subscription Facility lenders that find themselves in a situation where a Fund has released capital commitment obligations in violation of its contractual obligations under a Subscription Facility.

Under Delaware limited partnership law, Subscription Facility lenders can take comfort in the fact that even when a general partner releases the Fund's investors from the obligation to fund their capital commitments, so long as the lender reasonably relied on the capital commitment obligation when making a loan to the Fund, the capital commitment obligation will likely survive with respect to the repayment of that loan. Specifically, Section17-502(b)(1) of the Delaware Revised Uniform Limited Partnership Act (the "DRULPA") provides that notwithstanding any "compromise" of a capital contribution obligation, "a creditor of a limited partnership . . . 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] It is reasonable to infer that a release of capital commitments will likely constitute a "compromise," and thus a Subscription Facility lender should be able to reasonably rely on such statutory protections. Similarly, the Delaware statutory framework for limited liability companies provides for similar protections for Subscription Facility lenders that reasonably relied on the capital commitments.[3]

DRULPA Section 17-502(b)(1) was applied to a Subscription Facility dispute in 2004 in *In re LJM2 Co-Investment, L.P.*[4] There, the chief financial officer of Enron established a $400 million Fund that invested in businesses related to Enron. The Fund entered into a $120 million credit facility with a lender, which included an undertaking that if the Fund defaulted, the lender had the right to compel the general partner to issue capital calls to cure any payment default, up to the unfunded balance of the investors' commitments. When Enron filed for bankruptcy, the Fund defaulted on the credit facility. Accordingly, the general partner and, subsequently, the lender issued capital calls to repay the credit facility. The investors rebuffed the capital calls and purported to amend the Fund's partnership agreement to rescind the pending capital calls and require all future capital calls be subject to the consent of a majority in interest of the limited partners. Without enough funds to repay the credit facility, the Fund filed for bankruptcy. The bankruptcy trustee then issued an additional capital call and, upon the investors' refusal to fund, commenced litigation against the investors to enforce their capital contribution obligations. The investors petitioned the court to dismiss the statutory cause of action based on numerous arguments, including that the creditors could not demonstrate "reliance" on their unfunded capital commitments as required by the statute. While the court did not directly rule on whether or not the lenders actually relied on the unfunded capital commitments, the court denied the investors' motion to dismiss, holding that there was sufficient detail in the complaint to demonstrate reliance.[5] Thus, this case supports the proposition that it is reasonable to apply DRULPA Section 17-502(b)(1) to a typical Subscription Facility of a Fund organized as a Delaware limited partnership.

New York law has similar statutory protections. Under the New York Partnership Law, a "waiver or compromise" with respect to an investor's liability to fund its unpaid capital commitment "shall not affect the right of a creditor of a partnership, who extended credit . . . to enforce such liabilit[y]."[6] Additionally, US federal courts applying New York law have upheld this duty with respect to investors under New York statutory provisions. In *In re Securities Group 1980,* the US Court of Appeals for the Eleventh Circuit examined whether investors that were released from the partnership in connection with a tender offer remained obligated to fund their unfunded capital commitments to repay office lease obligations entered into by the Fund prior to such release. The released investors argued that although the lease was signed prior to the tender offer and resulting release, the obligation to make the lease payments at hand arose after they were released. The court required the released investors to make capital contributions to settle the lease obligations holding that "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 even further than the plain language of the statute, stating that the obligation of the investors to make capital contributions to the Fund's creditors should survive a release because "the limited partner, not the creditor, should bear the risk that the partnership's assets could become worthless."[8]

The elements under these statutory protections have shaped many Subscription Facility lenders' underwriting standards. Accordingly, many lenders require or will offer better terms to Funds that include specific language in their governing documents with respect to these elements, including specific acknowledgments by the Fund and its investors that any

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Subscription Facility lender is relying on the investor capital commitment obligations as their primary source of repayment.[9]

In addition to these statutory protections, Subscription Facility lenders facing an unauthorized release of capital commitment obligations of investors in a US-domiciled Fund may be positioned to pursue remedies against the Fund and its investors based on additional legal theories, including breach of contract, unjust enrichment, promissory estoppel and other theories of liability.

While no Subscription Facility lender would enter a Subscription Facility expecting that the investors' capital commitments would be released in violation of the Fund's contractual obligations, lenders can take comfort that even in such an extreme scenario, Delaware and New York statutory law contain creditor protections, so long as the lender can demonstrate that it reasonably relied on the capital commitments when it extended credit. While these protections exist in Delaware and New York, Subscription Facility lenders should also keep in mind that these protections vary from jurisdiction to jurisdiction. Accordingly, prudent Subscription Facility lenders should work with experienced counsel to understand both the statutory framework and other protections (or lack thereof) relating to the enforceability of capital commitments in the relevant jurisdiction.

Endnotes

1. We also recommend that, in addition to examining a jurisdiction's protections against an unauthorized release of capital commitments, lenders should evaluate other jurisdiction-specific risks, such as whether the capital commitments would be enforceable in a Fund's bankruptcy.
2. DEL. CODE ANN. tit. 6 § 17-502(b)(1) (2010).
3. See DEL. CODE ANN. tit. 6 §18-501 (2010).
4. *In re LJM2 Co-Investment, L.P.,* 866 A.2d 762 (Del. Ch. 2004).
5. *Id.* at 782 – 83.
6. N.Y. P'ship Law § 106(3) (McKinney 2018). Additionally, New York Limited Liability Company Law provides similar

liability companies, providing that notwithstanding a compromise of a capital commitment "a creditor of a limited liability company who extends credit in reliance on the obligation of any member may enforce the original obligation to the extent he or she reasonably relied on such obligation after the member signed a writing which reflects the obligation and the creditor extended credit before the compromise." N.Y. Ltd. Liab. Co. Law §502(b) (McKinney 2018).

7. *In re Sec. Group 1980*, 74 F.3d 1103, 1110 (11th Cir. 1996).
8. Id. at 1111 (citing *Kittredge v. Langley*, 252 N.Y. 405, 169 N.E. 626 (1930)).
9. For more information on these requirements, see our article "Model LPA Provisions for Subscription Credit Facilities" in this *Fund Finance Market Review Spring 2019*