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Article

Enforcement of Forms of Credit Support in Fund Finance

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Private investment funds ("Funds") employ a variety of financing structures to improve liquidity and/or obtain leverage, and lenders similarly rely on a variety of collateral and credit support packages for repayment in connection therewith.[1] Three types of credit support commonly used in the fund finance market are (i) the unfunded equity capital commitments of limited partners of a Fund ("Capital Commitments"), (ii) a guaranty ("Guaranty") and (iii) an equity commitment letter ("ECL").[2] In the event a Fund and/or a lender must attempt to monetize any of these forms of credit support for purposes of repaying a credit facility, the unique characteristics of each will dictate how the parties can effectively realize the applicable credit support. This article will discuss the enforcement of a Capital Commitment, Guaranty or ECL by the applicable party in connection with a credit facility.

Capital Commitments

Capital Commitments may be used as credit support in a credit facility that is not a standard subscription-backed credit facility or a capital call facility ("Subscription Facility"), whereby the unfunded Capital Commitments may be viewed by a lender as a potential source of repayment rather than as a direct part of the collateral.[3] In such a credit facility, the loan documents may include representations, warranties and covenants related to the amount of unfunded Capital Commitments that must be reserved by the Fund for the duration of the facility, with the expectation that if the underlying assets of the Fund are insufficient to repay the facility, there is another liquid and substantive source of repayment that the Fund and the lender may rely upon. Following a default by the Fund under a Subscription Facility, a lender may directly enforce the right of the general partner of the Fund to make a Capital Call upon the unfunded Capital Commitments of the limited partners and require the payment of capital contributions by the limited partners pursuant to the terms of the limited partnership agreement and in accordance with the Subscription Facility documents.

Contrasted with other types of credit support, such as a Guaranty, the obligation of the limited partners to honor their Capital Commitments and make capital contributions in response to a capital call will run directly in favor of the Fund as opposed to the lender. When Capital Commitments are used as credit support as opposed to collateral, the lender will not have the ability to directly enforce the payment of Capital Commitments by limited partners. Instead, the Fund will need to exercise its rights to enforce payment of the Capital Commitments. The limited partnership agreement of a Fund will likely require limited partners to make capital contributions within 10 to 15 days following a capital call and may provide an excuse right for certain investors with respect to such capital call. If a limited partner fails to pay its capital contribution pursuant to the terms of the limited partnership agreement, only then will the Fund be allowed to pursue additional

enforcement tools at its disposal pursuant to the limited partnership agreement, including the ability to designate any limited partner that fails to make its capital contribution as a "defaulting limited partner" under the limited partnership agreement. Such designation permits the Fund to apply remedial measures with respect to such limited partner's limited partnership interests, including, without limitation, charging default interest, reducing the value of such limited partner's limited partnership interests and potentially even forcing a full divestment thereof. The various punitive rights available to a Fund under the terms of its limited partnership agreement in respect of a defaulting limited partner are likely to encourage a limited partner to comply with its Capital Commitment before the Fund is forced to seek recourse beyond what is permitted under the terms of the limited partnership agreement.

It is generally accepted that a Fund can enforce the Capital Commitments of the limited partners under two separate theories of liability: state statutory law and general contract law. Delaware statutory law, for instance, contains specific provisions that obligate a limited partner of a Fund to contribute cash and property pursuant to the terms of the Fund's limited partnership agreement.[4] Under general contract law, a Fund may also rely on breach of contract and material breach tenants of law to enforce the Capital Commitments.

BREACH OF CONTRACT

Under a theory of contract liability, a limited partner's obligation to fund its Capital Commitment is an enforceable contractual obligation pursuant to the terms of the limited partnership agreement. To rely on a theory of contractual liability, the Fund's limited partnership agreement should contain affirmative language evidencing the right of the Fund or its general partner to make capital calls on the limited partners and the obligation of the limited partners to fund their related Capital Commitment. If the Fund's limited partnership agreement provisions create this contractual obligation, the Fund will be well-positioned legally to enforce each limited partner's Capital Commitment.

MATERIAL BREACH

Under contract law, a limited partner may argue that it should be excused from further performance of its obligations to a Fund in instances where the Fund or its general partner has committed a material breach of its own obligations. The ability to extinguish a limited partner's Capital Commitment in such instance, however, will generally not extend to obligations owed to creditors of the Fund. Courts have emphasized protecting the right of outside parties who rely on the Capital Commitments of limited partners in extending credit to the Fund. Without such assurance that a limited partner will be obligated to honor its Capital Commitment, creditors would be unlikely to enter into a credit facility with the Fund. Even when Capital Commitments are not directly pledged to a lender as collateral under a credit facility, a lender will still rely on the Fund's ability to enforce each limited partner's Capital Commitment in order to repay any loan made to the Fund. This reliance by a lender is evidenced when the credit facility documents specifically contemplate the use of Capital Commitments as credit support through certain representations, warranties and covenants related thereto, as discussed above. While case precedent provides strong authority supporting the enforceability of Capital Commitments, even in the case of a material breach by the Fund, requiring language in the limited partnership agreement that capital contributions will be funded by the Investor "without set-off, counterclaim or defense" may further weaken any material breach defense.

Finally, a Fund's rights to the Capital Commitments of the limited partners should not be materially impaired by a Fund's bankruptcy proceeding, and the causes of action entitling a Fund to enforce the Capital Commitments should not change in bankruptcy—they will still be based on the same statutory and contractual theories discussed above. A Fund should be able to enforce the terms of the limited partnership agreement and the Capital Commitments of the limited partners following a default by the Fund under a credit facility, and ultimately the Capital Commitments should continue to be enforceable against the limited partners, notwithstanding any bankruptcy or insolvency of the Fund.

Guaranties

A Guaranty is an agreement by one entity ("Guarantor") in favor of a lender to support the repayment by a principal obligor of its outstanding obligations to such lender in connection with a credit facility. When a Guaranty is used in the fund finance market, the Guarantor is most commonly a Fund that provides a Guaranty in support of the obligations incurred by one of its subsidiaries or portfolio companies, but a Guaranty may also be provided by a sponsor, a feeder fund or portfolio company, in each case to support repayment by the Fund of its obligations. The obligation of the Guarantor to make payments under a Guaranty on behalf of the principal obligor, should it default on its obligations, runs directly in favor of the lender.

There are several types of Guaranties employed in the fund finance market, and they will vary both in scope of the guaranteed obligations and the liability of the Guarantor thereunder. A guaranty of payment will typically be an absolute and unconditional Guaranty that permits the lender to seek payment directly from the Guarantor without any obligation to first seek payment from the principal obligor. A guaranty of collection, also known as a conditional guaranty, will require that the lender exhaust its remedies against the principal obligor (including, without limitation, foreclosing on any collateral) prior to seeking payment from the Guarantor. Under New York law, a guaranty of payment is presumed unless the parties have otherwise explicitly agreed that the Guaranty is a guaranty of collection.[5] Understanding the nexus between the Guarantor and the principal obligor will allow a lender to assess the validity of a Guaranty and whether the Guarantor has received adequate and fair consideration in exchange for providing the Guaranty. This analysis is fundamental to the enforceability of the Guaranty, is particularly relevant in respect of an upstream or cross-stream Guaranty and will be necessary to help avoid any fraudulent transfer defenses that other creditors of a Guarantor may invoke if a Guarantor is later deemed insolvent after making a payment under the Guaranty.[6]

A Guaranty will ideally include a waiver of defenses, counterclaims and offset rights (including with respect to those rights arising under the US Bankruptcy Code that may pertain to a bankrupt primary obligor) by the Guarantor in respect of the primary obligor's obligations to the lender and other suretyship defenses available to a Guarantor under applicable law. Suretyship defenses available to the Guarantor may include, without limitation, a lack of validity or enforceability of the underlying agreement between the primary obligor and the lender, failure of the lender to assert any claim or demand against the primary obligor, and any change in the payment terms by the primary obligor in respect of the primary obligation. Another optimal feature of a Guaranty from the lender's perspective is the requirement that the Guarantor subordinate any claims it may have against the primary obligor arising from payments made by the Guarantor on behalf of

the primary obligor pursuant to the Guaranty to the claims of the lender against the primary obligor for repayment of the primary obligations in full. A Guaranty may also include other representations, warranties and covenants by the Guarantor, creating contractual obligations between the Guarantor and the lender that are independent of the guaranteed obligations of the primary obligor. The ability of a Guarantor to issue a Guaranty may be restricted, however, by such Guarantor's organizational documents and will necessitate a careful review by experienced legal counsel of such organizational documents to ensure that the issuance of the Guaranty is not prohibited.

Due to the fact that a Guaranty is a contract between two parties, under a theory of contract liability, a Guarantor's obligation to pay the lender pursuant to the terms of the Guaranty should be an enforceable contractual obligation, subject to certain defenses discussed above. Upon a breach by the Guarantor of the contractual obligation established under and pursuant to the Guaranty, the lender may immediately enforce any remedies available to it in respect of such breach, including seeking specific performance thereunder. The lender to which the Guaranty is issued is in direct contractual privity with the Guarantor and there should be no need to further establish standing to assert a claim for breach of the Guaranty (as may be necessary with respect to an ECL, discussed below). Assuming the various waivers of defenses and other supporting provisions discussed above are included in the Guaranty (and there are not concerns regarding receipt of adequate and fair consideration), a lender should be able to enforce the terms of the Guaranty following a default by the primary obligor and ultimately the Guaranty should continue to be enforceable against the Guarantor, notwithstanding any bankruptcy or insolvency of the primary obligor.

Equity Commitment Letters

An ECL is an agreement that evidences a commitment to contribute capital or other financial support by one entity (the "ECL Provider") in favor of another entity (the "ECL Recipient") and should be distinguished from other similar arrangements, such as a keepwell agreement, pursuant to which a sponsor may undertake to monitor and safeguard the financial health of a Fund, or a letter of support/comfort letter, the purpose of which is to provide a lender with some assurance that a Fund will be able to meet its obligations to such lender. The obligation of the ECL Provider to contribute capital under and pursuant to the terms of the ECL runs in favor of the ECL Recipient, with only the ECL Recipient having the right to directly enforce the terms of the ECL. A lender, however, may be specifically designated as a third-party beneficiary under the terms of the ECL, and the rights of the ECL Recipient under and pursuant to the ECL can also be collaterally assigned to a lender under a credit facility. For purposes of the fund finance market, an ECL will also likely include, among other things, waivers of defenses, counterclaims and offset rights (including with respect to those rights arising under the US Bankruptcy Code that may pertain to a bankrupt ECL Recipient) in respect of the ECL Provider's obligation to contribute capital to the ECL Recipient and other suretyship-related defenses that may be available to an ECL Provider under applicable law.

Due to the fact that an ECL is a contract between two parties, under a theory of contract liability, an ECL Provider's obligation to contribute capital to the ECL Recipient is an enforceable contractual obligation. Upon a breach by the ECL Provider of the contractual obligation established under and pursuant to the ECL, the ECL Recipient (or a lender on its behalf) may immediately enforce any remedies available to it in respect of such

breach, including seeking specific performance thereunder. If the lender wants to enforce the terms of the ECL, it must rely on a theory of contractual liability and will require the lender to have standing to assert a claim for breach of the ECL. To do so, the ECL and the related credit facility documents should contain affirmative language evidencing (i) the right of the ECL Recipient to require the ECL Provider to honor its obligation to provide capital and (ii) a pledge by the ECL Recipient of its rights to receive such capital and the enforcement thereof to a lender. Assuming the ECL includes the waivers of defenses and other supporting provisions discussed above, the lender should have standing under the terms of the ECL to enforce its provisions following a default by the ECL Recipient under the credit facility, and ultimately such ECL should continue to be enforceable by the lender, notwithstanding any bankruptcy or insolvency of the ECL Recipient.

Comparing Enforcement of Capital Commitments, Guaranties and ECLs

The nuances specific to Capital Commitments, Guaranties and ECLs will dictate the means of enforcing the applicable credit support in connection with a credit facility.

The use of unfunded Capital Commitments as credit support will run in favor of the Fund, and the Fund itself will have the ability to enforce the payment of the unfunded Capital Commitments when used simply as credit support (as opposed to collateral that is pledged to the lender under a Subscription Facility). In contrast, a Guaranty runs in favor of the lender and allows the lender to seek payment directly from the Guarantor. An ECL will run directly in favor of the ECL Recipient, however, the use of a collateral assignment of an ECL will permit the lender to enforce the terms of the ECL on behalf of the ECL Recipient.

Conclusion

Capital Commitments, Guaranties and ECLs should all be enforceable forms of credit support that can be enforced by a Fund and/or a lender, even in a primary obligor/Fund bankruptcy context. Notwithstanding the generality of the foregoing, it is important that experienced legal counsel is consulted in connection with employing any such form of credit support under a given credit facility to review the relevant documentation evidencing the related credit support obligation to ensure that the duties and obligations thereunder are clear and that a Fund and/or a lender can reasonably expect to rely on the same for purposes of repaying a credit facility. Following such a review, each party should be confident that enforcing Capital Commitments, Guaranties and ECLs is not a prohibitive undertaking that would deter their use in connection with finding creative solutions to provide credit support in the fund finance market.

Endnotes

[1] For a detailed update on current trends and developments in the fund finance market, please see Mayer Brown's *Fund Finance Market Review Spring 2019* on p. 1

[2] For a more detailed review of the use of Capital Commitments, Guaranties and ECLs as credit support, please see our article, "Forms of Credit Support in Fund Finance," in Mayer Brown's *Fund Finance Market Review Spring 2018* (available at: https://www.mayerbrown.com/en/perspectives-events/publications/2018/03/forms-of-credit-support-in-fund-finance).

[3] For a more detailed explanation of the use of Capital Commitments in connection with a subscription facility and features of the subscription-backed credit facility product in general, please see our article, "Subscription Credit Facility Market Review," in *Fund Finance Market Review Fall 2016* (available at: https://www.mayerbrown.com/en/perspectives-events/publications/2016/09/subscription-credit-facility-market-review).

[4] DEL. CODE ANN. tit. 6, § 17-502(a)(1) (2018).

[5] N.Y. Gen Oblig Law § 15-701 (2018).

[6] *See* Restatement (Third) of Suretyship and Guaranty § 9.

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