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FUND FINANCE FRIDAY

Investors, We're Relying on You

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Delaware remains the most popular jurisdiction for the domestic formation of private equity and venture capital funds (a "Fund") as either a limited partnership or limited liability company. In fact, 54.8% of the deals closed by Cadwalader in 2023 had a Delaware component. A myriad of reasons could be cited as the basis for this fact, but lenders are generally fine with this choice based on specific protections a lender is afforded under Delaware statutory law related to the obligations of an investor to a Fund. In particular, Title 6, Section 17-502(a)(1) of the Delaware Code provides "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." Even more important, an Investor's obligation to honor its promise to make capital contributions expressly extends for the benefit of creditors and Delaware law provides a statutory basis for a lender to assert a reliance claim to avoid a financial loss.

6 Del. C. §17-502(b)(1) 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.

In its most simplistic terms, the practical effect of the above is to confer the benefit of the obligations of investors to a Fund on a lender who has reasonably relied upon the capital call rights contained in the partnership agreement as a source of repayment. To put is another way, a lender can argue reliance based on an assertion that it would not have extended credit to a Fund but for the Fund's right to call capital from its investors. What constitutes a lender's

demonstration of reasonable reliance is somewhat based in theory and academic debate, as the case law on the point is limited. Fund finance practitioners often suggest that evidence of reliance may include one or more of the following:

- express provisions in the credit agreement that the lender is relying on the obligations of the investors to fund their respective capital commitments, such as the following:

Reliance. The Borrowers agree that the Administrative Agent, the Letter of Credit Issuer and each Lender has entered into this Credit Agreement, extended credit hereunder and at the time of each Loan or each issuance of a Letter of Credit, will make such Loan or issue such Letter of Credit in reasonable reliance on the obligations of the Investors to fund their respective Capital Commitments and accordingly, it is the intent of the parties that such Capital Commitments may be enforced by the Administrative Agent, on behalf of the Secured Parties, pursuant to the terms of the Loan Documents, directly against the Investors without further action by any Credit Parties and notwithstanding any compromise of any such Capital Commitment by any Credit Party after the Closing Date as provided in 6 Del. C. §17-502(b)(1).

- references in the lender's underwriting materials to the capital contribution obligations of investors as a source of repayment of any credit extensions;
- maintain records of communications with the general partner and limited partners of a Fund regarding the basis on which any credit extensions will be repaid; and
- obtain an investor letter whereby an investor acknowledges the lender's reliance on it to fund capital and agrees to make capital contributions to repay the debt (preferably expressly stating such obligation to fund is without counterclaim, setoff or defense).

The leading caselaw in this area is *In re LJM2 Co-Investment, L.P. Ltd. Partners Litig.*, 866 A.2d 762 (Del. Ch. 2004), whereby the Delaware Court of Chancery held that the bankruptcy trustee of the limited partnership adequately demonstrated that the lenders reasonably relied, for purposes of 6 Del. C. §17-502(b)(1), on the limited partners' representations that they would honor their capital commitments, and the court allowed the lenders to enforce the capital commitments.

LJM2 Co-Investment, L.P. ("LJM2") was a Delaware limited partnership formed by Andrew Fastow, the then-CFO of Enron, for the purpose of investing in energy and communications businesses related to Enron. The Fund raised approximately $400 million in capital commitments and entered into a $120 million unsecured subscription facility with language that if the Fund defaulted, the lenders 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 lenders. The investors also amended the Fund's partnership agreement, in violation of the subscription facility terms, to compromise and rescind the capital calls. Without additional capital contributions, the Fund could not meet its obligations and also filed for bankruptcy. The bankruptcy trustee issued an additional capital call, which the investors did not fund, and litigation against the investors ensued.

The bankruptcy trustee argued that the lenders reasonably relied on the Fund's partnership agreement to extend credit to LJM2 because: (i) under that the Fund's partnership agreement, the limited partners were obligated to contribute capital only when called for by the general partner and (ii) the lenders, through the credit agreement and a separate contractual general

partner “undertaking” to issue drawdown notices to the limited partners to the extent necessary to cure payment defaults under the subscription facility, compelled the general partner to make capital calls if LJM2 defaulted.

The investors raised a number of unsuccessful arguments in an effort to have the statutory cause of action under 6 Del. C. §17-502(b)(1) dismissed, including that the lenders could not demonstrate reliance on their capital commitments as required by the statute. The court denied the investors’ motion to dismiss and ruled that the lenders claim for relief under Section 17-502(b)(1) could continue because the lenders adequately alleged reliance on the capital commitments and investors obligation to fund capital contributions. Unfortunately for those hoping for additional case law on the topic, the case presumably settled without the issuance of any further court opinions. However, the court’s rationale for denying the motion to dismiss is frequently cited as a “win” for creditors and a framework for how a Delaware court would decide similar arguments.

In conclusion, Delaware statutory law provides a basis for a lender to preserve a claim by demonstrating reliance on the investors to fund capital contributions. Whether it is a reference in the credit agreement, inclusion of provisions in the bank’s underwriting materials, communications with a general partner or a combination thereof, establishing indicators of reliance is important for any lender extending credit on the basis that investors will fund capital for its repayment if the Fund experiences distress. If litigation were to ensue, a lender’s claim of reliance would seem to be a respected by the Delaware courts, but establishing the claim starts with preliminary planning and credit agreement terms that matter when they matter.