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Not All Commitments Are Treated Equal

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In recent weeks, a number of transactions have come across our desks involving levered feeders set up as an investment vehicle for insurance-related investors. For regulatory reasons, these vehicles are established such that each such investor's commitment is comprised of both a loan commitment (the "Debt Commitment") and an equity commitment (the "Equity Commitment"). This structure presents a challenge for lenders trying to balance the requested borrowing base treatment for investor commitments of this type against the potential bankruptcy implications that this structure poses.

The private equity fund (a "Fund") will almost certainly seek inclusion of the entire investor commitment (*i.e.,* the Debt Commitment and Equity Commitment portions) in the borrowing base. However, the decision of whether to honor that request is by no means simple. A common issue of this structure is evaluating how to address a circumstance where an investor funds some, but not all, of a capital call. Is the funded portion allocated entirely to the Equity Commitment, or is the funded portion allocated *pro rata* between the Equity Commitment and the Debt Commitment? Many limited partnership agreements are silent on this point and thereby leave the lender with more questions than answers as to the ultimate outcome.

Despite the questions related to allocation of funding a capital call, the issue at the forefront of a lender's concern is the bankruptcy risk. The risk centers around the lack of precedent concerning the enforceability of Debt Commitments should a Fund commence bankruptcy proceedings. Generally, under the United States Bankruptcy Code (the "Code"), the debtor-in-possession or bankruptcy trustee gets to decide whether to assume (thereby keeping the parties bound to) or reject (thereby effectively voiding any continuing obligations under) an executory contract. The Code does not define what constitutes an "executory contract." However, most experts define an executory contract to be one in which both parties have material, unperformed obligations.

An important consideration for our analysis is that under the Code, a debtor-in-possession or bankruptcy trustee is prohibited from assuming an executory contract if the other party's

obligation is to “make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor” (Section 365(E)(2)(B) of the Code). Therefore, if a Fund commences bankruptcy proceedings in the United States, an investor with a Debt Commitment may argue that the document governing its obligation to fund a Debt Commitment (such agreement whether the limited partnership agreement or a separate side letter, a “Debt Agreement”) constitutes an “executory contract” under Section 365(c)(2) of the Code.

In contrast to Debt Commitments, lenders have legal precedent supporting the enforceability of Equity Commitments in a bankruptcy proceeding. In *Chase Manhattan Bank v. Iridium Africa Corp.*, investors argued that the limited liability company agreement was an executory contract that the Code prohibited from being assumed, and therefore, their obligation to fund their uncalled capital commitments should be void as a financial accommodation. The court rejected the argument, noting that the purpose of Section 365(c)(2) of the Code is to protect parties from extending new credit or funding, whose repayment relies on the fiscal strength of an already bankrupt debtor. The court held that the investor’s uncalled capital commitments were not “new” obligations and had long since been committed by the investors (“*these purchases are, for all practical purposes, existing debt obligations.*”). Thus, the court concluded that “*the [Investors] are not within the class of creditors Congress intended to protect under Section 365(c)(2) of the Bankruptcy Code*.”

Iridium gives lenders comfort that Equity Commitments can escape an investor’s executory contract argument, but the outcome is not as clear for a Debt Commitment. We could see an argument that an investor might make to distinguish the holding in *Iridium* where a Debt Commitment is involved on the basis that the Debt Agreement is an executory contract that is intended to be protected under Section 365(c)(2) of the Code and thereby unenforceable. Against this backdrop, lenders are faced with the challenge of evaluating whether such a distinction can be made. Clearly, inclusion of language in a limited partnership agreement whereby an investor agrees to fund its commitment without setoff, counterclaim or defense and waives any defense under Section 365(c) of the Code is favorable. But the case law is unsettled as to whether this is enough to avoid a Debt Commitment/executory contract argument.

Another mitigant that seems common is a suggestion of an investor letter whereby the investor explicitly agrees that, in the event of a bankruptcy proceeding, all capital contributions will be called and funded only in the form of equity (and not as loans) and that any unfunded capital contributions made in the form of loans prior to the bankruptcy will be automatically recharacterized as Equity Contributions. Some experts have proposed that this approach may undo the tax and other regulatory advantages that the structure intends to provide. Others have questioned whether an investor letter can actually affect the rights of the bankruptcy trustee in a Debt Commitment scenario, as the bankruptcy trustee is not a party to the investor letter and may view the investor letter as an ancillary component of an executory contract.

It is difficult to determine whether instances of a bifurcated investor commitment between a Debt Commitment and an Equity Commitment are isolated or if this is a growing trend. If the latter, lenders will be faced with the challenges of evaluating the risks and exploring possible solutions with reoccurring frequency.

(Note that the above analysis applies only to funds in the United States and therefore may differ in Europe and other jurisdictions.)