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FUND FINANCE FRIDAY

# Capital Commitments in the Form of Investor Loans in the U.S.

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We have seen several transactions this fall where an investor’s capital commitment is, at least in part, structured in the form of a “loan commitment” (“Debt Commitment”) and not purely in the form of an equity capital commitment (“Equity Commitment”), as is traditionally the case. In these arrangements, investors and the fund, either in the partnership agreement or in a separate contract or side letter (“Debt Agreement”), agree that the fund may issue a traditional capital call for a capital contribution in the form of equity (“Equity Contribution”) or in the form of a loan (a “Debt Contribution”). Given the recent influx of funds utilizing this arrangement, we thought it might be helpful to include a refresher in this week’s *Fund Finance Friday* as to the potential risk created by Debt Commitments.

The risk centers around the lack of precedent concerning the enforceability of Debt Commitments should the fund file bankruptcy. 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. While an "executory contract" is not specifically defined in the Code, it is generally considered to be a contract where both parties have material, unperformed obligations remaining. 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)). Therefore, if a fund files bankruptcy in the United States, an investor with a Debt Commitment may argue that its Debt Agreement constitutes an "executory contract" under Section 365(c)(2) of the Code. Thus, for years, lenders have liked to see that the “no setoff, counterclaim or defense” language in a partnership agreement includes “any defense under Section 365(c) of the Code.”

On the other hand, in the traditional capital commitment space, lenders have strong legal precedent supporting the enforceability of Equity Commitments in a fund bankruptcy. In fund finance’s most famous case, *Chase Manhattan Bank v. Iridium Africa Corp.*, the 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, in contrast, were not "new" obligations, instead having 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*."

But what if the capital commitments are expressly to be funded in the form of *loans* instead of as *equity* under the applicable partnership agreement? The rationale behind the *Iridium* decision would certainly be equally applicable, and we hope a court would look through the phraseology to the substance of what investor Debt Commitments actually are and differentiate appropriately. However, the "loan" language might give an investor a basis to distinguish the *Iridium* precedent and argue that the Debt Agreement is an executory contract, and thus its Debt Commitments are non-enforceable under Section 365(c)(2). And this is the risk that gives us a little pause.

To help protect a subscription finance lender and a fund against this possibility, we prefer to see explicit language in the partnership agreement or Debt Agreement (or if necessary, an investor letter) addressing the point. Ideally, the investor explicitly agrees that, in the event of a fund bankruptcy, 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.

Note that the above analysis applies only to funds in the United States and therefore differs in Europe and other jurisdictions. We will address this issue in other jurisdictions in an upcoming edition, so stay tuned.