CADWALADER

Laying the Groundwork on Foreign Sovereign Immunity

September 22, 2023

By Joe Zeidner
Special Counsel | Fund Finance

The doctrine of sovereign immunity is a foundational element of the interplay between a governmental investor's contractual obligation to satisfy capital calls and a fund's or lender's ability to enforce that obligation against the investor. We recently completed our comprehensive series on sovereign immunity across all fifty states of the United States, as well as England and Wales and a cameo from the Cayman Islands. In this article we look at the rest of the world. We assess key statutory and equitable principles, deconstruct how to satisfy judgments against foreign sovereigns and peruse related side-letter provisions so you can understand how to mitigate the risks of these international investors in your fund finance facilities.

Background: The King or Queen Can Do No Wrong

Before diving into the deeper aspects of foreign sovereign immunity, let's quickly recap the fundamentals from our prior articles. Sovereign immunity is derived from the common-law concept that "the King or Queen can do no wrong." Governmental entities such as sovereign wealth funds, foreign governments, and their agencies and instrumentalities may benefit from sovereign immunity rights to not be sued or found liable for certain actions. Such entities are frequently private-equity investors and so these rights could limit enforcement against them when called on to contribute capital by a fund or lender.

While sovereign immunity is a very nuanced topic with broad application, there are two predominant categories into which it falls: immunity from suit and immunity from enforcement. Immunity from suit is the theory that a sovereign cannot be forced to adjudicate legal claims against it in any court except its own courts. This stems from the idea that other courts do not have the authority to try cases and rule against the sovereign without the sovereign's approval. Immunity from enforcement means that even if the proper court finds the sovereign liable, the counterparty is unable to recover or receive payment on the judgment from the sovereign's assets. This principle originally arose from the mandate that the sovereign originated its courts for the benefit of the sovereign's subjects and so its courts had no power to require the sovereign to be bound by the courts' judgments.

To read about this topic as it relates to U.S. government investors or from an English, Welsh or Cayman perspective, our prior series can be found **here**. Next we turn to the seminal U.S. statute on foreign state immunity, the Foreign Sovereign Immunities Act of 1976 ("FSIA").

Foreground: Foreign Sovereign Immunities Act of 1976

The FSIA was the first statute to codify the criteria for a restrictive theory of sovereign immunity. Rather than permitting absolute immunity under all circumstances, the FSIA's restrictive approach distinguishes between a foreign government's entitlement to nearly complete

immunity for public acts versus a limited scope of immunity for private acts. As detailed below, this dichotomy is critical in the fund finance context.

The FSIA does grant foreign states sovereign immunity from the jurisdiction of U.S. courts generally. But such immunity will not apply if the foreign state's conduct meets certain FSIA exceptions for which public policy weighs more heavily toward a possible finding of sovereign liability. The two exceptions that could most commonly apply in the fund finance space are (1) if the sovereign explicitly or implicitly waives immunity and (2) the so-called "commercial activity" exception.

Under the FSIA, foreign government investors can explicitly waive sovereign immunity by contract. For fund finance, this could be in the form of a written waiver in an investor consent in favor of a lender. Investor consents provide important protections for lenders in the context of a fund of one. Having a foreign state investor expressly waive sovereign immunity if it receives a capital call from a lender gives the lender comfort it may bring suit and enforce remedies against the investor pursuant to the FSIA. A foreign state investor may also implicitly waive its immunity. For example, if the investor executes a contract for which the choice-of-law provision is governed by U.S. law or the law of a U.S. state, the implication under the FSIA is that the investor has agreed to waive its sovereign immunity with respect to that contract. While not as strong as an explicit waiver, an implicit waiver can still bolster any claims brought by a fund or lender against the investor.

Foreign sovereign entities may also forgo their immunity under the FSIA based on the "commercial activity" exception. This exception is the most frequently relied on in fund finance because it is not common for foreign states to expressly waive sovereign immunity outside of a fund of one. We next dissect the theoretical underpinnings and statutory requirements of this framework to give you insight in how it might impact your deals.

Tending the Field of Commercial Activity

The idea behind the commercial-activity exception is that if a foreign government is acting as a private player within a market rather than as a regulator of the market, its conduct is commercial in nature. As such, it should be on an even playing field with other market participants. If a foreign sovereign could avoid its contractual obligations merely by claiming immunity, it would give the government entity an unfair advantage to shirk its liabilities based on bad business choices. It could also chill the market by dissuading others from doing business with the sovereign.

The commercial-activity exception can allow a plaintiff to sue a foreign state investor in U.S. court. To qualify, the plaintiff's primary claims must be "based upon" commercial activity by the investor, or an act by the investor that derives from commercial activity, pursuant to one of three scenarios. Proceedings may be filed with respect to a foreign governmental entity that engages in commercial activity in the United States. When a foreign state actor performs an act in the United States that is connected with commercial activities outside the United States, suit may also be brought under the FSIA. Lastly, legal actions can be instigated against a foreign sovereign investor if it performs an act outside the United States that is connected with commercial activities outside the United States but such act causes a direct effect in the United States. The direct effect need not be substantial or foreseeable, but must only occur as an immediate consequence from the commercial actions of the foreign sovereign.

A foreign government entity subscribing for a limited-partnership interest in a fund is inherently commercial activity. A legal dispute by a fund or lender against the government investor in the fund finance setting will almost certainly be based upon that commercial activity or an act related to it. So to determine if one of the above prongs is met, funds and lenders alike should carefully consider if there is sufficient contact between that activity and America. Factors that may help establish such connection are if the sovereign has a capital commitment to a Delaware fund vehicle or with a U.S.-based sponsor, if significant investment activities of the fund will be in the United States, or if the lender is located or is lending out of a branch located in the United States. Any one of these may be enough to anchor the necessary nexus. This analysis can be complex and require both factual and legal assessment, and we suggest any fund or lender undertake it with advisement from their counsel.

Expanded Landscape: Quasi-Governmental Entities and International Organizations

Although foreign quasi-governmental entities and supranational organizations are less often seen in fund finance deals, they are investors in funds from time to time. These institutions are typically formed by treaty or other form of intergovernmental arrangement and may engage in economic, regulatory, public health or humanitarian efforts. Examples include the United Nations, the World Bank, the International Monetary Fund, the World Health Organization and UNESCO. Such organizations generally receive sovereign immunity under U.S. law pursuant to the International Organizations Immunities Act ("IOIA").

The IOIA predates the FSIA by over thirty years and was designed to provide international organizations similar immunity from judicial process and enforcement to what is enjoyed by foreign states. Because it was enacted at a time when the United States granted far greater amnesty to other sovereigns, the IOIA was previously thought to extend sovereign immunity further than the restrictive theory promulgated by the FSIA. But in 2019, the U.S. Supreme Court held that both statutes prescribe the exact same immunity. The purpose of the IOIA was to link legal proceedings and liability for quasi-governmental entities to the same types and degrees of immunity afforded to foreign governments to ensure parity between the two.

Thus when ascertaining the sovereign immunity enjoyed by an international agency investor in a fund, the default analysis turns on virtually the same waiver or commercial activity requirements of the FSIA. The Supreme Court did note in dicta that an international organization may specify a different level of immunity in its charter. So care should be taken when evaluating any procedural requirements for bringing suit and enforcing against a quasi-governmental investor.

Plowing Enforcement of U.S. Judgments in Foreign Jurisdictions

Since foreign states generally do not retain sovereign immunity under the FSIA when operating as commercial actors with a nexus to the United States, a fund or lender should be able to institute claims and invoke remedies against those sovereigns in a U.S. tribunal. But a finding of liability in the United States does not guarantee the fund or lender can recover from the sovereign’s assets abroad. A U.S. judgment may or may not be enforceable in other jurisdictions. The fund or lender should evaluate offshore prosecution rules to consider if the contractual obligations of the investor may need to be re-litigated.

America does not participate in bilateral or multilateral treaties or conventions that govern the mutual recognition and enforcement of foreign judgments. In the absence of such an accord, whether the courts of another country will recognize and enforce a U.S. judgment will depend on that nation's laws and disposition toward international comity. Judgments from a U.S. arbiter will first need recognition by a court in a foreign country to be enforced there.

Overseas judicial systems may only acknowledge U.S. judgments if certain measures are met. There can be different rules depending on location, and prosecution may vary widely. Frequently factors include whether the U.S. court had appropriate jurisdiction, if the defendant was properly served notice of the claims against it and whether the judgment falls within the foreign country's public-policy regime. If any of those are lacking, it could defeat enforcement. Default judgments or those seeking punitive damages may also be less likely to be recovered on.

Still, because of the strong abrogation of sovereign immunity for commercial activity under the FSIA, it is significantly more likely that U.S. judgments will be recognized and enforceable in foreign courts. It just requires prudent planning of the U.S. litigation with conscientious consideration of the anticipated administration elsewhere.

Cultivating Equitable Considerations

Within the complex landscape of foreign sovereign immunity, funds and lenders may also find assurance through practical considerations and equitable legal theories. On the whole, investors (including foreign state investors) have a strong track record of almost no material defaults that have adversely impacted credit facilities, including during economically troubled times. Continued financial stability contributes to bolstered confidence for lenders to extend borrowing-base credit for foreign sovereigns. Courts have construed sovereign immunity concerning governmental investors favorably for other market participants. This, coupled with other pragmatic and equitable constructs, further solidifies the comfort of funds and lenders in the face of foreign sovereign immunity.

Safeguards exist within the confines of commercial conventions to prevent investors from reneging on their contractual obligations. Penalties for limited-partner defaults outlined in partnership agreements act as a strong deterrent. Many foreign sovereigns are frequent investors in funds. A default or other bad acts by the investor in one fund could tarnish its reputation and prospective ability to participate in others. Negative-ratings repercussions could also impact credit-rated investors. So although a foreign state investor could assert sovereign immunity if a fund or lender seeks its capital contributions, the disadvantageous implications for the investor may make the likelihood of this occurring remote.

The equitable-law concept of unjust enrichment may further provide comfort for funds and lenders. Put simply, unjust enrichment occurs when one party gains a benefit or financial advantage from another party at the expense of that other party. This most often occurs if the other party fulfills its obligations under a contract while the first party does not. If a fund makes investments that could return profits to the investor, or a lender bridges capital calls that would otherwise have been contributed by the investor, there is likely to be a direct benefit to the investor. Courts may find it unjust if the sovereign could shirk its responsibility to contribute capital under the guise of immunity, and might require the investor to provide commensurate compensation to the fund or lender.

While we acknowledge the genuine potential for a government investor to raise foreign sovereign immunity when a fund or lender invokes default remedies, prudent credit facility structuring must take into account the practicality of such scenarios. The remote likelihood of even occasional occurrences necessitates a balanced approach when formulating borrowing bases. Fund finance practitioners should evaluate the risks and align their credit analysis with the actual probabilities in practice.

Harvesting Sovereign Immunity Solutions in Side Letters

No good discussion of sovereign immunity in fund finance would omit a brief description of its implication in side letters. Side letters of foreign governmental investors regularly contain provisions on their immunity rights. The investor might require the fund to expressly acknowledge its sovereign immunity and that the investor retains all of those rights as a limited partner of the fund. Reciprocally, the fund may require that the sovereign agree its immunity rights do not restrict the investor's obligations in respect of its capital commitment under the limited partnership agreement. This second requirement can be quite helpful for a lender in structuring the facility borrowing base. Although the foreign investor will have called out its sovereign immunity rights, it will also have endorsed its commitment to remit capital contributions when called on by the fund to do so. That capital-call right will pass to the lender during an event of default under the credit facility pursuant to the lender's security interests.

It is far less common to see a side-letter provision that reserves sovereign immunity but without that mitigating language. Arguably, though, it may put the fund and the lender in the same position. The FSIA statutorily removes sovereign immunity in the commercial setting. It also precludes immunity when explicitly or implicitly waived by the sovereign. But it does not expressly permit the inverse: allowing parties to contractually agree that sovereign immunity applies when an FSIA exception would otherwise exclude it. United States case law tends to allow parties to agree to limit rights they would have under legislation, although not to expand rights that by statute have been lost.

So even without a mitigating provision in the side letter, the foreign state investor may only be able to claim sovereign immunity to the extent it is retained under the FSIA. If the commercial-activity exception applies, the amount maintained could be significantly limited. Even so, the fund and lender would be wise to question the investor's intentions. If it asserts or implies a right to disclaim its capital-contribution obligations, the lender should take pause in deciphering how to underwrite the investor's commitment. This is particularly the case since the vast majority of side-letter reservation of sovereign immunity provisions contain curative language.

Conversely, we've seen foreign governmental investors get creative in other attempts to sidestep the FSIA while including what appears to be mitigating mechanics. The standard reservation of sovereign immunity is followed by the customary conditions that the investor is still obligated to fund its capital commitment. Then language is inserted between those sentences stating the fund and general partner will not contend the investor's commitment is commercial activity, whether inside, outside or having a direct effect on the United States. Because the purportedly mitigating provision follows the "no commercial activity" statement, it's clear the investor is attempting to (perhaps falsely) make the lender feel comfortable. What's unclear is if the fund or lender would have a path forward to assert there is a commercial act by the government entity and so it cannot claim sovereign immunity. It could be helpful for the

lender if it is carved out of the restriction on making such assertion to clarify only the fund and general partner may not argue the investor's commitment is commercial activity.

As with any side-letter provision, the devil is in the details. Funds and lenders should consult their counsel on how to construe any such formulations.

Final Thoughts

When a fund or lender assesses the creditworthiness of foreign government investors, it should fully evaluate if sovereign immunity could affect the bringing of suit, enforcement and recovery against the investors' capital commitment. The most ideal paradigm may be to receive an express waiver of the investor's sovereign immunity rights as a defense of contract claims. In lieu of that, the FSIA and equitable and practical considerations are quite likely to protect the fund's or lender's position.

Last Chance to Participate in Investec's Private Equity Trends Survey!

September 22, 2023

Investec's Private Equity Trends survey (formerly known as GP Trends) closes on the 28th September, so don't miss your chance to share your thoughts and experiences and contribute to a better understanding of the industry.

Private Equity Trends provides valuable insights into the latest trends and challenges facing General Partners and by taking part you will also get an exclusive first look at the final report before it is shared publicly.

Senior private equity professionals, take the survey now by clicking **here**.

What We're Reading

September 22, 2023

Here's what we're reading this week.

- Sponsor consolidation is likely to accelerate in response to challenging fundraising conditions, according to sources cited in the FT's ***Private equity is in for rampant consolidation*** published this week. From our vantage, while not covered in the article, rising compliance costs in the wake of the SEC's proposed private funds rule is likely to disadvantage middle-market sponsors and accelerate sponsor M&A.
- Goldman Sachs Asset Management raised $14.2 billion for its Vintage IX fund, exceeding the target of $12 billion for the seondaries fund. Reuters covered the fund close **here**.
- Reliance on NAV loans has increased as leveraged lending costs have increased and exits have slowed. New entrants in the lending market have included a number of non-banks entities. See the FT's ***Defending the portfolio': buyout firms borrow to prop up holdings***.
- "You don't want to be a second mover in AI," according to Blackstone's Steve Schwarzman, who continues, "If someone has already improved their company and you haven't, the improved company will be a formidable competitor, much more than it is today." The **comments**, made at the IPEM summit in Paris this week highlights the rapid move to integrate technology into internal processes at PE firms. Last week the Wall Street Journal **highlighted** the industry demand for data science and engineering talent.
- Year-to-date corporate bankruptcies in the U.S. surpassed full-year totals for both 2021 and 2022 as companies come to terms—or fail to come to terms—with higher financing costs, according to **S&P Global Market Intelligence**.

Just Weeks Away - Finance Forum on October 19

September 22, 2023

Our seventh Annual Finance Forum is October 19 at The Ritz-Carlton in Charlotte, and we would love to see you there!

Leaders from over 150 of the world's top financial institutions are registered for an interactive day with the industry's foremost experts. We are going to take deep dives into the wide range of challenges and opportunities that will shape the global financial landscape in 2024 and beyond.

Click **here** to view some of the organizations that have registered to attend and **here** to meet our moderators!

Current panel topics include:

- Coming of Age: What's Next for a Maturing Fund Finance Industry?
- What's Really Going On: A Close Look at the CRE Market
- Pessimistic or Opportunistic: A Credit Strategy for Volatile Times
- The New Chapter in Fund Finance
- Market Update: Distressed CRE and Workout Trends
- A Conversation with the Chief Credit Officer
- Worlds Collide: Structured Products Meets Fund Finance in CFOs and Rated Feeders
- Sultans of Swing: What (and Who's) Groovin' in CMBS?
- Refocusing on Restructuring: Distressed Credit and Special Situations
- Not-So-Risky Business: Keys to the Effective Structuring of Capital Relief Trades
- Setting the C-PACE in the CMBS Market
- Financing the Financiers: Bank Leverage of Private Credit Originators
- NAVer Fear: New Approaches in the NAV and Secondary Market

- Getting to Yes: Terms and Trends in CRE Lending

For more information about this event, please contact **Cori Niemann**.