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Finance & Transactions Group

# ThePracticalLender

Highlighting the practical effects of law on the finance business.

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## THE USE OF CAPITAL CALL AGREEMENTS: BRIDGING THE GAP IN TODAY'S CREDIT ENVIRONMENT

Tight credit markets and the large number of recent financial restructurings have led to an increased use of capital call agreements. In new transactions, the lenders and the owners (or private equity funds sponsoring a leveraged buyout) may disagree on the initial amount of equity needed to fund and operate a borrower. In restructurings, existing lenders may only be willing to make credit accommodations to a troubled borrower if that borrower's owners agree to make future investments in the borrower. Capital call agreements are a mechanism for bridging these and other disagreements and conflicting perceptions.

These agreements, also often called support or keep-well agreements, are basically contracts whereby one party, typically the owner, agrees to invest in the borrower or a related entity, upon the triggering of certain conditions. These agreements have several advantages over other types of credit enhancements such as guaranties and letters of credit. Unlike a guaranty, a capital call agreement avoids the common law defenses available to a surety or guarantor and the issue of subrogation. Under the common law, a guarantor (or surety) is a favored party and, as a result, is given a number of legal protections. For example, if a lender were to release any portion of a borrower's collateral (including releases given in connection with the sale of such collateral) without the consent of the guarantor, such release could have the effect of voiding the underlying guaranty. While a properly drafted guaranty agreement should avoid such issues, the availability of common law defenses is often seen by a guarantor as a bargaining chip in negotiations with the lender.

Further, under the common law, if a guarantor performs under a guaranty and pays the lender, the guarantor steps into the shoes of the lender (technically becomes subrogated to the rights of the lender) with respect to all of the rights and remedies of the lender. The subrogation issue can be particularly troubling if the guaranty runs toward the senior creditor and the transaction involves a layer of subordinated debt. In such a case, by honoring its guaranty of the senior debt, the guarantor (the owner) could leapfrog the subordinated lender on the balance sheet.

Rights of subrogation and common law defenses are not applicable to the obligor under a capital call agreement, which is governed by the law of contracts. The obligor under a capital call agreement essentially has the rights and defenses specified in the capital call agreement–no more, no less.

Nevertheless, private equity fund groups, and most other owners, prefer liquidity support or capital call agreements over guaranties because they would rather inject equity into portfolio company borrowers

(and get a better equity position) than pay on a guaranty.

Of course, from the lender's standpoint, capital call agreements are not as valuable as a letter of credit. They are, however, distinctly more preferable from the standpoint of the investor or owner. Letters of credit are rarely issued by financial institutions unless supported by hard collateral, often cash. From an investor's standpoint, if it must use cash or other hard assets to support a letter of credit pledged to secure the borrower's debt, then it may as well directly invest the funds in the borrower, similar to an investor's reluctance to provide a guaranty.

***Legal Issues in Drafting Capital Call Agreements/Practical Tips***

- Section 365(c)(2) of the Bankruptcy Code prohibits a debtor (borrower) from assuming or assigning any contract which requires a party to make a loan to, or an investment in, the debtor (borrower). This would seem to say that capital call agreements are useless when the borrower files for reorganization under Chapter 11, the time when such agreement is most needed. The problem is overcome by making the lender a third-party beneficiary to the capital call agreement and by making the investor (owner) waive any benefit of Section 365 of the Bankruptcy Code. As a further protection, a well-drafted capital call agreement should give the lender the right to demand that the amounts due under the capital call agreement be paid directly to the lender to reduce the borrower's obligations. This last provision, however, may cause a court to characterize the capital call agreement as a guaranty.

- A lender must ensure that the capital call agreement permits the lender to demand that the owner (investor) make the required investment. Otherwise, the borrower, controlled by the investor, may simply fail to enforce its contractual rights. When possible, lenders should have the right to make the capital call directly, for the benefit of the borrower, or to require the capital call to be made automatically upon certain triggering events (such as the failure to meet a final covenant or meet a net availability test).

- The lender and its counsel must ensure that the obligor under a capital call agreement has the actual power and authority to enter into the agreement. The owner (investor) in many deals is a fund controlled by an equity sponsor. In such a case, this can be accomplished by making sure that (a) the fund has the irrevocable contractual right to call capital from the fund's limited partners, (b) there is an adequate unrestricted capital reserve in the fund, and (c) the general partner's right to call capital from the limited partners is assignable to the senior lenders, if possible. In every case, the lender and its counsel should review a fund's organizational documents to ensure that no prohibition on the fund delivering a capital call agreement is in effect. Prudent lenders should also obtain an opinion from the fund's counsel that the execution of the capital call agreement, and performance by the fund of its duties under the capital call agreement, have been duly authorized by the appropriate fund authorities and do not contravene any such organizational document. Lenders may meet objections from sponsor groups that fund organizational documents are private and subject to confidentiality restrictions. In such event, lenders at a minimum should insist on receiving appropriate opinions of counsel. Also, lenders and their counsel should conduct due diligence to ensure that the fund or investor does not have a history of failing to honor capital call agreements or guaranties.

***Credit Issues***

Like a guaranty, a capital call agreement, no matter how well-drafted and no matter how enforceable, is still only of use if the underlying obligor (investor) is credit worthy. Lenders must do their own business due diligence to ensure that is the case. Often, the first step in conducting this due diligence is ascertaining who exactly the underlying obligor is and what are its assets. Equity sponsors often manage a whole series of separate funds, each of which is a distinct legal entity. A lender must be certain that the party entering into the capital call agreement is the party it anticipates, and that such entity has adequate uncommitted and available funds to meet any of its obligations. A lender should also obtain financial statements from the obligor, both on the date of the agreement and on an ongoing basis. Further, the capital call agreement may contain financial covenants which would give the lender the right to trigger the capital call if the fund's financial condition deteriorates.

Once a lender is able to get a business understanding on a capital call agreement, the lender and its counsel need to focus on both the due diligence and legal drafting to ensure the capital will be available to the borrower when called. To the extent that investors are seeking "escape clauses" from performing capital call obligations, lenders must be willing to stand behind the often controversial decision to insist on well-drafted legal documents. The consequence of a poorly drafted capital call agreement could be the failure to realize upon the benefits of the capital call.

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