Capital Call Agreements As Credit Enhancement

by Joel F. Brown and Randall L. Klein

The capital call agreement is a popular device, especially in tight credit markets, for accommodating the divergent goals of secured lenders, their borrowers and shareholders. Sometimes called a support agreement or make-whole agreement, the essence of a capital call agreement is simply an agreement by an investor to make certain investments in an entity, typically in this context a borrower. This formulation understates a number of important and sometimes complex business and legal considerations that must be addressed in order to craft a meaningful and legally enforceable document. This article will outline and analyze these considerations, and will also present a number of relevant drafting recommendations.

It may be helpful to briefly discuss credit situations in which capital call agreements are commonly used. In new transactions, capital call agreements may be used to bridge opposing requirements and goals of shareholders and lenders. For example, a lender may require financial projections that demonstrate total leverage below 3.0 to 1.0 in one year's time. One way to achieve this result would be for the borrower to decrease its initial borrowings and increase its reliance on equity financing. While satisfying the lender's concern, this strategy would decrease returns on shareholders' equity. As a means of maximizing return on equity, the shareholders might agree at deal inception to commit future additional funds in their company, if necessary, to satisfy the lender's future target leverage ratio.

Capital call agreements are also useful devices when lender and shareholder underwriting criteria differ. For example, in a credit facility that contemplates future acquisitions, shareholders might expect their lender to advance funds against a multiple of earnings on a pre-corporate overhead basis. In theory, that overhead will be disproportionately high in early years, but should become significantly less material over time as acquisitions are booked. The lender, however, may wish to underwrite the transaction more conservatively by advancing against actual earnings, net of overhead. In this scenario, a lender might become comfortable lending against the more aggressive pre-corporate overhead basis in exchange for a capital call agreement that would require increased future equity contributions in the absence of improved cash flow through the consummation of future acquisitions.

Capital call agreements are also increasingly popular devices in loan restructurings and workouts. The willingness of a key shareholder to pledge future funds may be a significant determinant for a lender deciding whether to grant a forbearance in the face of existing defaults. In this context, the capital call agreement also serves as its own self-effecting future restructuring. For example, rather than

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force all major transaction parties back to negotiations if a workout fails, a lender may require a capital call agreement at the inception of the workout, thereby triggering a prenegotiated second-stage workout.

Contrasts with other credit enhancements

Capital call agreements as credit enhancements should be compared to and contrasted with other common credit-enhancement devices, such as letters of credit and guaranties. Some of the important legal differences among these instruments and documents are discussed below.

Letters of credit typically, though not necessarily, issued by banks are highly valued by beneficiaries due to the reserve requirements and regulated status of bank issuers. The law and practices governing letters of credit are also generally favorable to beneficiaries, inasmuch as they tightly limit the grounds on which an issuer may dishonor a draw on a properly issued letter of credit. Letters of credit establish tri-party legal relations among the issuer, the applicant and the beneficiary. The issuer of the letter of credit has no direct interest in or recourse to the beneficiary as a consequence of a draw by the beneficiary. Instead, the issuer's recourse is to the letter of credit applicant, which enters into a reimbursement agreement with the issuer. The reimbursement obligation is often collateralized.

A guaranty creates a direct legal relationship between the guarantor and the recipient of the guaranty. The honoring of a guaranty by a guarantor creates an equitable right of subrogation in favor of the guarantor — that is, the guarantor's right to assume the claims of the recipient of the guaranty as a creditor of the beneficiary. For example, an investor executing a guaranty in favor of a lender would, upon payment under the guaranty, have certain rights to enforce the lender's loan documents against the beneficiary/borrower to the extent of payment on the guaranty. Lenders customarily require guarantors either to waive or deeply subordinate this right of subrogation. From the investor's perspective, this legal right of subrogation, conferring upon the investor only a contingent interest in the beneficiary as a creditor, is the sole common law compensation for the investor entering into the guaranty. In other words, the investor will not be entitled to an increased equity interest in the beneficiary merely by performing under the guaranty, although the guarantor may separately acquire a contingent equity interest in the beneficiary as a fee for the issuance of the guaranty.

Guarantors, also called "sureties," are generally referred to as being favored at law. This means that the law governing suretyship, which is common law rather than statutory law, has evolved over many years to be protective of the interests of sureties, and has created many grounds for excusing surety performance because of (among other things) changed circumstances following the date of execution of the guaranty. For instance, if a borrower and lender agree to release collateral without obtaining the guarantor's consent, the change in the underlying credit without the guarantor's consent may excuse the guarantor from some or even all of its obligations under the guaranty. As a result of this risk of guarantor discharge, many commercial lenders draft sophisticated guaranties containing extensive waivers and releases of all these common law protections.

By way of contrast, capital call agreements are generally governed by the common law of contracts. In a capital call agreement, the investor (the obligor under the capital call agreement) bargains to receive some form of instrument or security in the beneficiary upon performing under the capital call agreement by making an investment in the beneficiary. This investment may take the form of debt or equity or a hybrid thereof. The investor should not be entitled to any common law right of subrogation as against any third-party beneficiaries of the capital call agreement, where capital call agreements are used as credit enhancements. In other words, an investor that has agreed to invest funds in a borrower, even where such funds are earmarked to repay indebtedness of the borrower for borrowed money, has no right to assume an interest in the lender's loan documents upon performance. Instead, the investor bargains in advance with the borrower for its consideration in exchange for the capital call agreement.

The capital call investor also should not be entitled to suretyship defenses. Courts have developed these defenses to protect guarantors against having to honor their guaranties in situations where, as noted above, the terms of the debt guaranteed are modified without the guarantor's consent. Unlike a guaranty, the investor in a capital call agreement is not obligated to pay the debt of another entity. Rather, it contracts to make its own investments in that entity. The investor could, if it chooses, negotiate the

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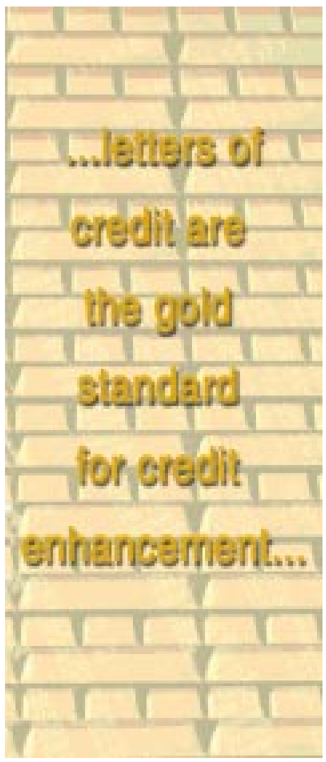
capital call agreement to excuse or otherwise adjust future investment commitments in light of changed circumstances. That said, to the extent that a capital call agreement is constructed as a pure credit enhancement, with the proceeds of all investments being earmarked for a lender, a court could conceivably construe a capital call agreement as the functional equivalent of a guaranty, at least from the perspective of affording the investor the equivalent suretyship protections. Moreover, as discussed below, certain bankruptcy law considerations may prompt lenders to insist upon the contingent right to be paid directly by the investor in the event that the capital call agreement is, for any reason, unenforceable directly by the borrower. This contingent right, creating direct legal relationships between the investor and the lender, moves the capital call agreement more in the direction of a guaranty, thereby raising potential suretyship defenses for the investor. Lenders should preempt such defenses by adding to their capital call agreements suretyship waivers of the type customarily found in guaranties.



Enforceability in bankruptcy

A lender's legal relationship to the form of credit enhancement, as outlined above, takes on heightened significance in the context of a borrower's bankruptcy. From this perspective, letters of credit are the gold standard for credit enhancement because of the independence principle, which generally protects the rights of the beneficiary of the letter of credit from the consequences of the borrower's insolvency, and affords the beneficiary a direct legal right to enforce its claim for payment against the issuer. Guaranties, while not as preferable as letters of credit because of the litigation risk associated with suretyship defenses, also generally permit direct enforcement notwithstanding a borrower's bankruptcy. Note that, in contrast to letters of credit and guaranties, capital call agreements run directly in favor of the borrower, not the lender. Therefore, the threshold questions are whether and to what extent the lender's rights against the capital call provider may be affected by a bankruptcy case commenced by or against the borrower.

These questions are answered in part by a specific provision of the Bankruptcy Code with which many lenders and their lawyers are familiar, albeit in a different context. It is commonly understood that a borrower seeking bankruptcy protection cannot compel a lender to continue to make advances postpetition pursuant to a prepetition commitment or a committed prepetition facility. Section 365(c)(2) of the Bankruptcy Code provides:

> The [debtor] may not assume or assign any executory contract...if...such contract is a contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor, or to issue a security of the debtor.

Considering the terms of a capital call agreement, one can easily see the enforceability challenge presented by Section 365(c)(2). In its most fundamental form, the capital call agreement gives the borrower the right to obtain funds from an investor in exchange for debt or equity securities — a contract, in other words, either "to make a loan" or to "issue a security of the debtor." If bankruptcy of the borrower intervenes, the investor is able to argue that the contract is governed by Section 365(c)(2) and therefore not capable of enforcement by the debtor.

The consequence of a successful investor challenge under Section 365(c)(2) is disastrous for the lender whose rights are derivative of its borrower's. Here, the main difference between capital call agreements on the one hand and letters of credit and guarantees, on the other, is most acute — the lender has the direct right to enforce letters of credit and guaranties unaffected by Section 365(c)(2) of the Bankruptcy Code. To respond to the risk posed by a challenge under Section 365(c)(2), three related provisions should be added to a capital call agreement. First, the lender must be named as a third-party beneficiary entitled to the benefits provided by the agreement. There does not appear to be any published decision directly on point; however, third-party beneficiary status may provide the lender with a safeguard in the event of a challenge under Section 365(c)(2). The Bankruptcy Code rights of "assumption" or "rejection" of an "executory contract" are not magical powers that destroy prepetition contracts: rejection constitutes breach by a debtor, resulting in a prepetition claim for damages; assumption merely enables a debtor to enjoy the benefits (and burdens) of a contract postpetition. Certainly, a prepetition loan agreement, complete with grants of security interests and other rights, does not disappear simply because the debtor does not have the right to advances postpetition. Similarly, if the investor has consented to a third-party's reliance, the fact that the debtor cannot compel performance should not disrupt the lender's contract rights. In other words, Section 365(c)(2) only speaks to the debtor's rights and is silent as to whether a third-party beneficiary can compel performance.[1]

Second, the capital call agreement should contain an express waiver by the investor of the defenses provided by Section 365(c)(2). As discussed more extensively in the

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next section, the Uniform Commercial Code authorizes the assignment of payment rights created under capital call agreements from borrower to lender. Although no case law is directly on point, if a capital call investor expressly waives the right to assert the protections of Section 365(c)(2), the lender as assignee of a payment right — and not as a debtor in bankruptcy — should argue that it takes its assignment rights free of any challenges under Section 365(c)(2).

Unfortunately, given the lack of clear authority that third-party beneficiary status is sufficient to survive a bankruptcy enforceability challenge, as well as the absence of authority concerning the right to waive the protections under Section 365(c)(2), a third provision should be added to the capital call agreement, providing for the lender's contingent right to be paid directly by the investor if the capital call agreement is, for any reason, not enforceable or enforced directly by the borrower. It is this aspect of the capital call agreement — a springing claim directly enforceable by the lender against the investor — that most closely resembles a guarantee and, therefore, supports inclusion of the suretyship waivers described above.

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Priority matters

Related to the right of enforcement is the lender's right to priority in the investor's cash when paid to the borrower. If the borrower (or lender as third-party beneficiary) enforces the capital call agreement prior to bankruptcy, or if the lender is able to compel performance post-petition directly or as a third-party beneficiary, it is equally important that the funds paid be made available to the lender free of claims by the borrower's other creditors. This is the hallmark of an enforceable first-priority security interest: putting the borrower's property out of the reach of its general creditors for the benefit of the lender.

Revised Article 9 of the Uniform Commercial Code, now effective in all states, gives lenders the tools to create a first-priority security interest in investor obligations under a capital call agreement. Under the UCC, a borrower's contractual right to receive funds from its investor should be classified as a general intangible as well as a "payment intangible," defined as a general intangible under which the account debtor's principal obligation is a monetary obligation.[2] A lender may receive a perfected security interest in this general intangible by entering into a security agreement with the borrower that describes the general intangible as collateral, and by filing an appropriate UCC financing statement that does the same. In the case of a customary "blanket" security agreement and related UCC financing statement filing, the lender will pick up this collateral as a matter of course.

The UCC provides an additional benefit in the case of security interests covering certain general intangibles. An investor party to a capital call agreement should be classified under the UCC as an "account debtor" of the borrower: a person obligated on a general intangible.[3] As authorized by UCC Sec. 9-406(a), the capital call agreement should contain a notification to the investor authenticated by the borrower (as assignor of a payment intangible) and by the lender (as assignee of a payment intangible) that the payment intangible arising under the capital call agreement has been assigned to, and that payment is to be made to, the lender. The legal effect of this notification under the UCC is that payment by the investor to the borrower of amounts owing under the capital call agreement does not discharge the investor's obligation to pay the same amount directly to the lender.

The preceding sections have addressed issues pertaining to the enforceability and priority of claims arising under capital call agreements. Successful navigation of these issues, however, does not ensure a valuable credit enhancement. Fundamental due diligence regarding the investor's identity and the means by which the investor contractually binds itself, and careful construction of the operative capital call provisions are also equally important components of a well designed document. The following sections address these topics in more detail.

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Know thy investor

In middle-market financings, the majority of capital call agreements give rise to unsecured investor obligations. Therefore, in stark contrast to the typical credit decision involving a borrower, where collateral value is a dominant credit consideration, a capital call agreement is typically not supported by investor collateral. Instead, a lender must be satisfied, both from a business and legal perspective, that the investor has the financial wherewithal to honor its obligations. These concerns are practically identical to those faced by a lender receiving a guaranty.

An important precondition to establishing investor solvency is establishing investor identity. In institutional equity-sponsored transactions, the identity of "the investor"

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may be more challenging than initially imagined. A seemingly monolithic deal sponsor may, upon investigation, in actuality be a number of inter-related legal entities, only some of which control purse strings. Many institutional funds also do not have immediate access to meaningful amounts of cash, but instead act as conduits for their fund investors, who are generally obligated, upon call, to invest in such funds. Recipients of capital call agreements from these institutions must therefore realize that they are making a credit decision based indirectly on the financial strength of often numerous far-flung fund investors, whose identities may be impractical or impossible to establish within the normal course of a transaction.

With precise investor identity having been established, the recipient of a capital call agreement may next choose to investigate the financial resources of the investor. The appropriate tools here should be familiar to any credit analyst: cash flow statements, balance sheets, bank and brokerage account statements and tax returns. The amount and sophistication of information solicited will, of course, be determined by the materiality of the capital call to the deal, and the lender's overall comfort with the investor's track record. In some transactions, an investor may resist lender credit inquiries on the grounds of protecting fund investor confidentiality. Other investors, especially more established institutional investors, may find direct credit inquiries by lenders (as compared to credit inquiries regarding their borrowers) to be distasteful or even offensive, and lending officers in such situations will need to balance their desire for credit information against the prospect of alienating fund investors.

Since capital call agreements contemplate future investments on the part of the investor, the recipient of such an agreement should implement methods for establishing ongoing creditworthiness of the investor. The preferred method is to collateralize the capital call agreement obligations, such as through the issuance of a letter of credit in favor of the beneficiary of the agreement or the posting of cash collateral. However, an investor may not always be willing to offer collateral to secure capital call obligations, and in such situations the beneficiary of the agreement will need to establish methods for confirming investor creditworthiness on an ongoing basis. The capital call agreement may be drafted to assist this process. First, the agreement should include agreements by the investor to deliver to the beneficiary periodic financial statements and other relevant information, so that the beneficiary may closely monitor investor solvency. The parties may also choose to negotiate certain net worth or net income floors, below which the beneficiary (and its lender) would have the immediate right to demand full investment under the agreement. Finally, a beneficiary may choose to include in the capital call agreement, where applicable, representations by the investor that the investor's funding sources (such as limited partners in the context of an investment limited partnership) are committed, subject only to call by the investor, to contribute funds in the investor sufficient to satisfy all capital call obligations, and that the investor has also reserved funds under its organizational documents to permit it to satisfy its capital call obligations.

Contracting with the investor

Assuming a satisfactory resolution of the issues concerning investor identity and adequacy of financial resources, the recipient of a capital call agreement will next need to analyze the rights of the investor to enter into a binding contract of the type presented by a capital call agreement. The key questions presented are:

(i) do the investor's basic organizational documents (in the case of a business entity investor, as opposed to an individual investor) authorize the investment? (ii) are there any laws that prohibit or otherwise adversely restrict the investor from making this investment? and (iii) is the investor party to any other agreements which prohibit or adversely restrict the investor from making this investment?

These same due diligence questions will be asked by lender's counsel with respect to the borrower's ability to incur the underlying debt. Appropriate responses, however, may be much more challenging to obtain and analyze in the case of the investor than with respect to the borrower. Several factors lead to this result. First, most corporate borrowers have simple charter documentation, which is almost always compatible with the routine events of incurring debt and granting liens to secure such debt. Borrower's counsel also typically expects a full review of a borrower's charter by lender's counsel, will conduct its own review in tandem and will make any necessary modifications to existing documentation as part of the closing process. Moreover, in many cases, especially in the acquisition context, a borrower's organizational documen-

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tation will be newly minted specifically for the subject transaction, thereby giving counsel a prime opportunity to review and comment on these materials before they become effective.

By way of contrast, investor organizational documentation, especially in the case of institutional investors, can be very complex, and many investors will seek to restrict access to such materials on the grounds of protecting fund investor confidentiality. Borrower's counsel often will not be familiar with these materials, as such counsel typically represents the investor's targets, not the investor itself, and lender's counsel cannot expect any meaningful opportunity to modify such organizational materials, which will usually have been "frozen" into place long before the current investment.

Similar complexities typically will arise in connection with questions concerning provisions of law or contracts that restrict the investor's investment decision. Borrower's counsel often will be less familiar with the legal matters pertaining to the investor as compared to the borrower. Borrower's and lender's counsel both routinely review a borrower's material contracts, and will solicit consents where needed to accommodate a financing and, where applicable, a related acquisition. The same access typically is not given in the case of an investor's existing contracts, which are often considered confidential and not appropriate for lender review.

Underscoring all of these matters, moreover, is an oft-expressed investor sentiment that lender's counsel has no proper business in conducting investor legal due diligence. This view derives, in part, from the typical positioning of a capital call in a deal structure. Specifically, the capital call is often the product of investor concession (at least from the investor's perspective), and many investors will bristle at having to submit to the costs, inconveniences and delays sometimes associated with proper legal due diligence, especially where such diligence seeks to disclose the investor's internal organization and other material business relations. From the lender's perspective, such diligence is a fundamental prerequisite to knowing that the investor's "concession" is meaningful and legally enforceable, though the lender can expect this rationale to be met with the investor's claims that the lender's efforts to conduct due diligence evince a lack of trust.

There are ways to short-cut investor legal due diligence without forgoing all meaningful protections. First, a lender may rely to a small degree on representations and warranties contained in the capital call agreement that address fundamental contractual matters. However, such representations and warranties are best viewed as complements to, not substitutions for, due diligence. Moreover, a lender will want to know of a potential legal or contractual conflict before getting into a deal, rather than at some critical time when remedies may be limited value. Contractual representations are often poor tools for ferreting out real problems. Lenders may increase their coverage by requiring an appropriate opinion of investor's counsel that cover core legal due diligence matters. So long as lender's counsel has no independent reason to believe such opinions to be false, lender's counsel may accept customary closing opinions from investor's counsel without the independent need to review underlying documentation. The authors have found the request for such "blind" opinions of counsel to be generally acceptable by investors.

What is the investment and how is it made?

There is no legally mandated or default form of investment required pursuant to a capital call agreement. Instead, the form needs to be carefully drafted by the parties. Additional consideration must be given to the legal flow of investment proceeds, as compared to the actual cash transfers.

The form of investment required under a capital call agreement may take on characteristics of a debt investment, equity investment or any form of hybrid instrument. The capital call agreement should address issues relating to each form of investment. To the extent the investment has equity characteristics, the capital call agreement should specify whether the security to be issued is common stock or preferred, and, if the latter, the particular attributes of the preferred that will be permitted by the lender. If preferred securities are required by the investor, the beneficiary should consider requiring the investor to execute a subordination agreement in favor of the beneficiary, so as to prohibit cash dividend payments to the investor under certain situations. Subordination issues are also present where the form of investment is a debt instrument or otherwise has a debt-like component. Whenever subordination matters are presented, the capital call agreement should define the acceptable terms of subordination (such as by referring to pre-existing subordinated debt issuances, or by attaching an acceptable form of subordination agreement as an exhibit). Failure to establish ground rules for subordination could cause significant future delays, even where an investment is clearly required, as the parties may dispute the terms of acceptable subordination.

The capital call agreement should also distinguish the legal flow of investments from the actual cash transfers, and carefully delineate each. The legal flow of investment takes on most significance where the borrower is owned entirely by a holding company, a common deal structure used to accommodate a variety of shareholder and lender concerns and goals. Where a holding company structure exists, the parties must consider whether the investment is made into the holding company, then by the holding company into the borrower, or instead whether the investment is made directly by the investor into the borrower. The difference may have important legal differences. For example, a debt investment made by an investor into a holding company, which is then contributed as equity capital by the holding company to the borrower, will confer certain structural subordination benefits to a lender to the borrower.[4] An equity investment made into a holding company, then by the holding company to the borrower, may avoid any dilution to the shareholdings pledged by the holding company to the lender. Therefore, in addition to specifying the form of investment, the capital call agreement should establish the legal means by which the investment flows into the borrower.

Tracing the legal flow of funds is important to establish the existence or non-existence, as the case may be, of a variety of ancillary legal relationships and consequences, some of which are described above. Tracing the actual flow of funds also is important to expedite the delivery of cash by the investor to the ultimate beneficiary, the lender in the context of this article. Absent clear guidelines in the capital call agreement or other controlling document, the investor may, for example, choose to satisfy its capital call obligations by sending a check to the borrower. The borrower may then waste several days before depositing the check into one of its accounts, only then cutting a check to the lender. Even where these transfers are made by wire transfer, the existence of cash parked in a borrower account for one or more days may cause significant risk to a lender, risk that the funds are diverted for another borrower purpose, or risk of an intervening borrower bankruptcy which may delay or prevent the lender from reaching the cash.

A well-constructed capital call agreement can significantly reduce or eliminate these risks. The agreement should contain express payment authorizations and directions designed to collapse any number of interim transfers into one key transfer, from investor to beneficiary.[5] To illustrate, as a legal matter an investor may be required under a capital call agreement to make certain equity investments in a holding company, with the holding company making concurrent and equivalent equity investments in its operating subsidiary, and the operating subsidiary in turn using the equity proceeds to repay outstanding indebtedness owed to the lender-beneficiary. Without disturbing the legal consequences of these various actions, the capital call agreement may nonetheless reduce the actual transfers into one movement of funds from investor to lender.

How is the investment triggered?

The capital call agreement should be drafted to set forth clear, unambiguous conditions under which an investment is required. The agreement should also be sensitive to exigencies that may intentionally or unintentionally arise over time and which could circumvent plain business expectations. Consider, for example, a capital call agreement that requires an equity sponsor to make a significant equity investment if year-end total leverage exceeds 3.5 to 1.0, with leverage calculated based on borrower prepared financial statements. Consider what would happen if, in the face of significant business downturns, the sponsor directed management to hold back delivery of financial statements. While this act may constitute an additional default under governing credit documentation, the failure of a condition precedent in the capital call agreement — the production of required financial statements — could, depending on specific drafting language, suspend the requirement of the investor to satisfy a capital call commitment. Consider, too, what would happen if the borrower became a debtor in bankruptcy, or commenced liquidation, prior to year-end. As a safeguard, the investment should be accelerated upon a voluntary or involuntary bankruptcy filing by the bor-

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rower. Failure to anticipate such events within the context of the capital call agreement could have unintended and materially adverse consequences from the lender's perspective. In sum, forethought and creativity are necessities in crafting a document such as the capital call agreement where meaningful performance is always a future event. ▲

Endnotes

[1] *See generally*, William L. Harvey, *Financial Keep-Well Agreements: When Comfort Becomes Discomfort,* 115 Banking L. J. 1061 (1998), citing a contrary position, *SCA Tax Exempt Fund Limited Partnership v. Kahn,* 974 F.2d 1339, 1992 WL 219025 (6th Cir. (Tenn.)), in which the Sixth Circuit held, among other things, that a lender's third party beneficiary status under a "Limited Operating Deficit Guaranty" merely served to establish, at least in part, that the contract at issue was a contract of the borrower, not the lender, thereby implicating Section 365(c)(2).

[2] *See* UCC Sec. 9-102(a)(42) and UCC Sec. 9-102(a)(61).

[3] *See* UCC Sec. 9-102(a)(3).

[4] For instance, by becoming a creditor of the holding company rather than the borrower, the investor will be deprived of any claim, even on an unsecured basis, against the assets of the borrower. Further, if the holding company's equity interests in the borrower are pledged to the lender, and if the borrower is generally prohibited from making distributions to the holding company, the investor should have no meaningful ability to be repaid prior to satisfaction of the lender's claims.

[5] Note that this payment authorization and direction complements the assignment to the lender of payment intangibles under the capital call agreement pursuant to UCC Section 9-406(a).