

# Investors with Sovereign Immunity in Texas: Considerations for Inclusion in a Subscription-Secured Credit Facility Borrowing Base

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The key question lenders ask in connection with any subscription-secured credit facility is whether there is any impediment to accessing capital commitments to repay the borrower's obligations under the facility. One impediment may be the impact of sovereign immunity on the ability to require an investor to make capital contributions to repay the credit facility. Sovereign immunity is a legal doctrine pursuant to which the state and its agencies (be it local, state or federal) cannot be sued without the state's consent. Whether or not immunity applies to a particular investor depends on its sovereign status and the laws of the applicable jurisdiction with respect to that type of governmental entity. In many U.S. jurisdictions, established case law or statutes exist waiving sovereign immunity in instances where the government is alleged to have breached a contract or is otherwise not functioning in a governmental capacity (i.e., acting as a market participant). In other words, the commonly held position is that when a sovereign enters into a commercial transaction, it should be held as accountable as any private party would be. However, this is not the case with Texas-based sovereign investors ("**Texas Sovereigns**"). Texas Sovereigns have long presented a unique challenge for lenders because, as a general rule, Texas state governmental entities—including Texas-based pension funds—cannot be sued in Texas state courts. Furthermore, even if a Texas Sovereign purports to waive such immunity, immunity generally cannot be waived absent a legislative resolution. In the context of a subscription-secured credit facility, this means that if a Texas Sovereign failed to fund capital to repay the credit facility, lenders would not be able to enforce the Texas Sovereign's obligation to fund its capital commitment.

As a result, lenders historically excluded Texas Sovereigns from the borrowing bases (i.e., the pool of investors against which a lender is willing to lend) of subscription-secured credit facilities. As the market has evolved, however, some lenders have become more comfortable including Texas Sovereigns in a facility borrowing base, often at a lower advance rate and/or in a "hurdle" category (as described below). Whether a lender is likely to include a Texas Sovereign in the borrowing base will typically depend on a number of factors, including:

- **Composition of the Fund.** The overall composition of investors in a private equity fund ("**Fund**") will likely play a significant role in a lender's calculation of whether to include a Texas Sovereign in the borrowing base. Generally, large, commingled Funds with a broad distribution of credit-worthy investors are more likely to obtain borrowing base credit for a Texas Sovereign. The overall size of the Texas Sovereign's capital commitment relative to the size of the Fund, either initially or after implementing concentration limits, will also play a role. The smaller a Texas Sovereign's relative commitment is within a Fund, the greater the likelihood that the lender will be able to recoup any losses from other Fund sources if the Texas Sovereign successfully invokes immunity.
- **Operative Provisions of the Fund's Governing Agreement.** Many Fund governing agreements give the Fund the express ability to make additional capital calls (an overcall) on its investors to cover a deficit caused by another investor's failure to fund its capital

contribution. This right mitigates a lender's risk of nonpayment by expressly authorizing a call on all non-defaulting investors to recover any shortfall created by a Texas Sovereign. Note that while an express right to make an "overcall" is preferred, the absence of such a provision in the Fund's governing agreement does not itself preclude a lender from making successive calls on the investors for repayment.

- **Exposure and Experience.** Lenders that have more experience with Texas Sovereigns are more likely to be comfortable including them in the borrowing base on the basis of an established track record. Conversely, lenders also have restrictions on overall exposure to individual investors which may limit a Texas Sovereign's inclusion if that lender already has significant exposure to that particular sovereign across several other facilities.
- **Relationship and Banking Services.** Lenders that provide unrelated banking services to a Texas Sovereign may have more details into the financial position of such investor, its reputation and track record.
- **Reputational Risk.** Texas Sovereigns have historically argued to Funds and their lenders that if a Texas Sovereign asserted sovereign immunity as a defense to funding a capital contribution, its credibility could be severely damaged, likely resulting in Funds and lenders rejecting such Texas Sovereign from future investments and/or facilities.

Lenders assessing the risk posed by lending against the capital commitment of a Texas Sovereign can employ certain strategies that may further mitigate the Texas Sovereigns' potential defense to funding.

- **Hurdle Conditions.** Before lending against a Texas Sovereign, a lender can wait until such Texas Sovereign has sufficient "skin in the game" by creating a "hurdle condition". Hurdle conditions can include different components but generally require an investor to fund a certain percentage of its capital commitment excluding any returned capital (e.g., 40%) before such investor is eligible for inclusion in the borrowing base. Fund governing agreements generally include severe consequences if an investor defaults on its payment obligations, meaning once an investor funds sufficient capital, a default may be more costly than continuing to make the required contributions.
- **Investor Letters.** In credit facilities where a Texas Sovereign is the only investor or makes up a disproportionate amount of the Fund's commitments, direct negotiations with the Texas Sovereign may be required. In these instances, the Texas Sovereign can execute an investor letter creating contractual privity with the lender. In the investor letter, the Texas Sovereign can agree to certain waivers and agree to proceedings in specific jurisdictions that make a successful claim by the lender more likely.
- **Specified Investors.** Akin to hurdle conditions, some lenders may assign unique advance rates and concentration limits to Texas Sovereigns that differ from the other categories of investors to specifically reflect such lender's appetite for this risk.
- **NAV Covenant.** For facilities with a large concentration of Texas Sovereigns, lenders may incorporate a minimum net asset value covenant. This requirement increases the likelihood that the Fund has sufficient assets to repay the subscription facility if the Texas Sovereigns successfully raise the defense of sovereign immunity.

Whether to lend against a Texas Sovereign in a subscription-secured credit facility is context specific, and there is no market consensus on how to treat these investors. Nevertheless, in light of the factors outlined above, several lenders in the industry are now comfortable with the legal risk presented by the inclusion of Texas Sovereigns in a borrowing base when the right circumstances present themselves.