

The Commercial Activity Exception Stands Strong

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Summary

Foreign sovereign investors continue to have significant investment in private equity in the United States and abroad. As with U.S. sovereign investors, foreign sovereign investors require special attention when analyzing a lender's ability to enforce the obligation of such foreign sovereign investor to fund capital calls. In the United States, the commercial activity exception (28 U.S.C. § 1605(a)(2)) to the Foreign Sovereign Immunities Act ("FSIA") is a fundamental provision for subscription line credit facility lenders, as it ensures that foreign sovereign investors remain liable to their obligation to fund capital calls despite any claims of sovereign immunity. Recent concerns over foreign sovereigns contracting out of a similar commercial activity exception under English law raised the question as to whether foreign parties may also do so in the United States. Unlike under the State Immunity Act 1978 ("SIA"), the FSIA contains no explicit language permitting parties to contract around this exception. Even if foreign sovereign investors assert that the commercial activity exception shall not apply to their investments, for example via a side letter provision, their attempts at retaining sovereign immunity should be unenforceable on grounds of a conflicting statutory provision.

U.S. vs. English Law

Similar to the commercial activity exception in the United States, *Section 3(1)(a)* of the SIA states that a state entity is not immune from proceedings relating to (a) a commercial transaction entered into by that state entity, or (b) an obligation of a state entity which by virtue of a contract (whether a commercial transaction or not) falls to be performed wholly or partly in in the United Kingdom. However, *Section 3(2)* of the SIA permits parties to agree in writing that *Section 3(1)(a)* of the SIA will not apply. Certain foreign investors have incorporated language into their side letters whereby they submit to English law and utilize *Section 3(2)* to retain sovereign immunity from suit and/or enforcement.¹

The FSIA governs the circumstances under which a foreign state, as well as its political subdivisions, agencies, and instrumentalities, may be immune from suit in the United States. The FSIA contains several enumerated exceptions, including the commercial activity exception (with no express language permitting parties to contract around this exception). Without this exception, which denies immunity for sovereign entities engaging in commercial activity inside of or with a direct effect in the United States, lenders would likely face significant challenges to obtaining legal recourse against these parties. The commercial activity exception provides lenders in the fund finance industry assurance that foreign investors are unable to claim immunity to suit in the United States in the event, for example, they fail to fund their capital commitments.

A Freedom of Contract Argument?

Foreign investors engaging in commercial activity may attempt to advance a freedom of contract argument in favor of sovereign immunity. It is true that in many circumstances, courts prefer honoring voluntary contractual agreements. Parties may willingly contract to shorten the time in

which suit may be brought, relieve themselves of responsibility for business losses, or otherwise waive liability. In many cases, waivers of liability will be upheld unless a statutory provision forbids such contract. Although in these circumstances it is permissible to limit one's statutory rights or benefits, parties are still bound by any countervailing public policy or express statutory provision.

Courts in the United States have a history of upholding contracts waiving sovereign immunity. Domestic entities such as tribal nations or government agencies may waive sovereign immunity through "sue and be sued" clauses or other provisions. In this way, parties may agree to limit or contract out of legal protection entirely. However, parties are usually restricted from contractually expanding any legal right. For example, although a contract may shorten the applicable statute of limitations as discussed above, parties may not typically contractually extend the limitation period.² Therefore, case law on matters unrelated to sovereign immunity suggests that courts would be unwilling to enforce a contract for sovereign immunity rights where it otherwise is statutorily prohibited.

When faced with the commercial activity exception in the United States, courts mainly focus on whether the foreign sovereign's conduct qualifies as commercial activity. This judicial scrutiny reconfirms that foreign sovereign immunity is not an absolute right.³ As recently as April of 2023, the court in a high-profile case in California, *Jones v. PGA Tour, Inc.*, rejected a foreign sovereign investment fund's claim of immunity.⁴ There, the court held that although it "provides great deference to foreign sovereign states and the diplomatic work of their officials conducted in the United States for the benefit of the sovereign," the FSIA does not "immunize the expenditure of billions of dollars in the United States to launch a "Disruptor" golf league." The court's willingness to apply the commercial activity exception, albeit outside the fund finance context, should provide a sense of comfort to lenders.

Conclusion

With *Section 3(2)* of the SIA in mind, lenders should note the possibility of investors submitting to jurisdiction in England and counsel must stay on the lookout for investors who seek to make use of this contractual workaround. Despite these potential concerns and the lack of direct case law clarifying the issue, defendants still bear the burden of proving their sovereign immunity rights.⁵ So long as the commercial activity exception of the FSIA remains in place and no contrary statutory amendment arises, a foreign sovereign investor should be unable to raise a sovereign immunity defense to a suit brought against it for failing to meet its commitment obligation. However, even though lenders have reason to feel comfortable relying on the FSIA, if an investor has a side letter provision attempting to contract around its obligations to make capital contributions it is always good practice to try to determine why the investor asked for that provision so lenders can understand the investor's intentions before underwriting its commitment.

Summer Associate Brianna Joyce contributed to this article. Brianna is not yet licensed to practice law.

¹ It is important that any retention or waiver of immunity under English law specify the type of immunity it is purporting to retain/waive. This is because there are two types of immunity under English law; immunity from suit and immunity from enforcement. Immunity from suit concerns whether a court has authority to adjudicate a dispute involving a state entity, and immunity from enforcement concerns whether any judgement arising from such adjudication can be enforced against a state entity. A retention/waiver of one type of immunity does not necessarily imply a

retention/waiver of the other type of immunity.

² *Shaw v. Aetna Life Ins. Co.*, 395 A.2d 384, 386 (Del. Super. Ct. 1978).

³ *Franchise Tax Bd. v. Hyatt*, 139 S. Ct. 1485, 1501 (2019) (citing *The Santissima Trinidad*, 20 U.S. (7 Wheat.) 283 (1822)).

⁴ *Jones v. PGA Tour, Inc.*, No. 22-cv-04486-BLF, 2023 U.S. Dist. LEXIS 61129, at *25 (N.D. Cal. 2023).

⁵ *Exp. Grp. v. Reef Indus.*, 54 F.3d 1466, 1470 (9th Cir. 1995).