INVESTORS' RIGHTS WHEN A FUND OR ITS GENERAL PARTNER GOES BANKRUPT

In today's tumultuous economic environment, what was once unexpected—the bankruptcy of a private equity real estate fund or its general partner—may now be a real possibility for some investors. In prior years, many investors in private equity real estate funds did not pay a great deal of attention to bankruptcy provisions in fund documents, if any specific provisions were included at all. Today, as numerous real estate funds are suffering significant losses, investors must understand what their rights are in the event that a fund or a fund's general partner files for bankruptcy.

As discussed below, in the event of a bankruptcy filing by a real estate fund or a fund's general partner, several provisions of Title 11 of the United States Bankruptcy Code and the Delaware Revised Uniform Limited Partnership Act will determine the rights of the general partner and the fund's limited partners, often in the absence of, or in some cases, contrary to, specific provisions contained in the fund's governing documents.

As a new post–credit crisis generation of funds emerges, we may expect to see more robust bankruptcy provisions in fund documents that will be more heavily negotiated. In addition to addressing concerns about the bankruptcy of a fund or a fund's general partner, investors may want some assurance that their capital contributions and the fund's investments will be protected from the effects of an insolvency within the wider sponsor group. Despite these efforts, however, some bankruptcy courts may continue to find that certain terms of fund documents are not strictly enforceable in a bankruptcy context.

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This article discusses several key issues that may arise in the event that a fund or its general partner files for bankruptcy protection under Chapter 11 or Chapter 7 of the Bankruptcy Code and how these issues may be analyzed by a bankruptcy court.

Investment in a Private Equity Real Estate Fund

Prior to making an investment in a typical real estate fund, an investor will receive a standard set of governing documents that includes a limited partnership agreement, a subscription agreement, and often, a side letter and a management or an advisory agreement. While each document contains its own set of rights and obligations, the documents together govern a fund and the partners in that fund. The following discussion assumes that the fund vehicle is a single Delaware limited partnership and not a series of parallel partnerships or one or more of the many non-U.S. collective investment vehicles that often are used in global or cross-border real estate funds.

The limited partnership agreement is a fund's primary governing document. The partnership agreement sets forth the basic terms of the fund, the rights and obligations of the partners, and the procedures for contributions, distributions, allocations, transfers, and dissolution.

The subscription agreement between an investor and a fund memorializes the investor's capital commitment to the fund. It often also includes investor representations and warranties. A subscription agreement typically does not grant rights to the investor.

In many instances, there also will be a side letter agreement between an investor and a fund's general partner, which often contains provisions that modify the economic terms of the investor's investment and that relate to an investor's internal regulations or policies, as well as fund governance and reporting matters.

Finally, often there will be a management or an advisory agreement between the fund or the fund's general partner and an affiliate of the fund's general partner, pursuant to which the fund pays the advisory or management fee to the affiliate in return for certain services.

A bankruptcy court will look at each document individually but, in certain circumstances, may determine that these multiple documents are the embodiment of a single contract in evaluating the rights of the parties.

Bankruptcy of a Fund or A Fund's Limited Partner

Bankruptcy of a Fund. In a distressed situation, there may be differing views between the general partner and limited partners as to whether the partnership should file for bankruptcy protection. Partnership agreements often are silent as to who has the authority to file (or to object to filing) for bankruptcy protection on behalf of the partnership. In the absence of a specific consent right being granted to the limited partners in the agreement, the power to cause the partnership to file for bankruptcy should be within the general powers of the general partner to manage the affairs of the partnership. In most instances, a bankruptcy filing by the partnership will trigger dissolution provisions in the partnership agreement, calling for the general partner to dissolve the partnership and liquidate its assets in an orderly manner.

Bankruptcy of a Limited Partner. In the case of a bankruptcy of a limited partner, some partnership agreements require the removal of the affected limited partner. In these situations, the remaining limited partners may have the right to purchase the removed limited partner's interest or, in some agreements, to dissolve the partnership entirely. Other partnership agreements make it clear that the bankruptcy of a limited partner will not trigger the partnership's dissolution.

Bankruptcy of a Fund's General Partner

Section 402(a)(4) of the Delaware Limited Partnership Act provides that, unless otherwise provided in the partnership agreement or with the written consent of all partners, the filing of a voluntary petition in bankruptcy or similar reorganization by a general partner or the determination that a general partner is bankrupt or insolvent is a "withdrawal event," and the general partner will cease to be a general partner of the limited partnership. Section 801 of the Limited Partnership Act provides that a limited partnership will dissolve upon a withdrawal event by the general partner unless the partners agree to continue the business of the partnership pursuant to the partnership agreement or the act.

While the Limited Partnership Act may seem fairly straightforward, depending on the terms of the applicable partnership agreement, limited partners may be faced with one or more of the following decisions when a fund's general partner files for bankruptcy.

In many partnership agreements, a bankruptcy filing by a fund's general partner will be deemed a "cause" event, which gives a stated majority of the limited partners the right to elect to remove the general partner. In other situations, where a fund's general partner's bankruptcy is not a cause event, typically a larger stated majority of the limited partners may elect to remove the general partner under a "without cause" provision. In most cases, the partnership agreement also will provide that, upon the bankruptcy of the general partner, the general partner will immediately become a limited partner with

no power, authority, or responsibility to bind the partnership or to make decisions concerning, or to manage or control, the affairs of the partnership.

If the general partner is removed, a stated majority of the limited partners ordinarily may select another person or entity to be admitted to the partnership as a successor general partner, and the successor shall continue the business of the partnership without dissolution. If a successor general partner is not approved by the stated majority of limited partners within a specified period, the partnership will usually dissolve.

Following a general partner's removal, many partnership agreements provide that a stated majority of limited partners may elect to cause the partnership to buy the bankrupt general partner's interest for some agreed-upon value. The determination of this value may differ depending upon whether the removal was for cause or without cause. This buy-out mechanism permits the limited partners, if they desire, to continue the partnership and transfer the general partnership interest to a new general partner following the first general partner's removal.

In other agreements, the general partner's bankruptcy will trigger automatic dissolution of the partnership, without the consent of the limited partners and without the limited partners having any ability to remove and replace the general partner.

While these contractual options may seem straightforward on their face, bankruptcy courts have the power to invalidate or undermine certain terms of a fund's partnership agreement. Several potential issues are described below.

Executory Contracts and the Ipso Facto Rule Under the Bankruptcy Code

Upon the bankruptcy filing of a general partner, a fund's limited partners may seek to enforce the bankruptcy-related provisions set forth in the Delaware Limited Partnership Act and in the partnership agreement. In most jurisdictions, including the Bankruptcy Court for the District of Delaware, partnership agreement provisions such as removal and buyout of the general partner and automatic dissolution will be enforced. In other jurisdictions, however, Section 365 of the Bankruptcy Code may be read to invalidate these key provisions in a partnership agreement.

Partnership agreements generally are considered executory contracts subject to the provisions of Section 365 of the Bankruptcy Code, which governs the enforcement, rejection, and assumption of executory contracts between the debtor and third parties. The Bankruptcy Code, however, does not define the term "executory contract." Most courts follow the "Countryman" definition of executory contract, which provides that "an executory contract is a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach, excusing performance of the other."

Application of the so-called "ipso facto rule" set forth in Section 365(e)(1) of the Bankruptcy Code can prevent termination or modification of the partnership agreement by the non-debtor partner if that modification or termination occurs solely because of a provision conditioned upon the commencement of a bankruptcy case or the insolvency of another partner. The ipso facto rule may therefore be applied by some courts to invalidate provisions in a partnership agreement that automatically dissolve the partnership or call for the removal and buy-out of a general partner solely because of the general partner's insolvency or bankruptcy filing.

Courts interpreting partnership agreements under the Limited Partnership Act, however, likely will conclude that an exception to the ipso facto rule applies to these types of provisions. This exception, found in Section 365(e)(2) of the Bankruptcy Code, provides that an ipso facto clause will be enforceable if applicable law excuses a non-debtor counterparty to such an agreement from accepting performance from the bankruptcy trustee or an assignee. Because the Limited Partnership Act provides that a stated percentage of the interests in the profits of the partnership must agree to continue the business of the partnership to avoid dissolution upon a general partner withdrawal event (and therefore the limited partners do not have to accept performance of the general partner's obligations from the bankruptcy trustee or an assignee), the bankruptcy court in Delaware will likely make an exception to the ipso facto rule for provisions dealing with removal, replacement, and dissolution in a partnership agreement because such provisions are consistent with the Delaware Limited Partnership Act. In other jurisdictions, however, there is a risk that such provisions could be held to be unenforceable.

It is important to note two related issues: First, as many general partners are organized as single purpose entities, it is more likely that it is the parent or other affiliate of the general partner that files for bankruptcy and not the general partner itself, in which case the impact on the limited partners will be the potential diversion from the fund of the time and attention of the larger sponsor organization and, unless "key man" requirements are violated, is something for which most fund documents will not provide a remedy. Second, the exception to the ipso facto rule generally will not be applied with respect to those provisions in management or advisory agreements that provide for automatic termination upon the bankruptcy of the general partner's management affiliate. As

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a result, these agreements likely will stay in place in order to protect the fee income stream to the management affiliate's estate, and the limited partners would need to seek relief in the bankruptcy court to exercise the fund's (or their) rights under those agreements.

Non-Consensual Assignment of Rights And Interests of a General Partner

As discussed above, in most situations following a general partner's bankruptcy, limited partners will seek to enforce the removal and buyout provisions set forth in the partnership agreement so that the limited partners may replace the bankrupt general partner, and those provisions should generally be respected by the bankruptcy court in Delaware. In other circumstances, however, where the decision to remove the general partner or dissolve the partnership has not been made, limited partners may be faced with a situation in which they desire to prevent a debtor general partner from transferring its interest to a third party. While not the norm, this situation could occur, for example, when the interest is being sold out of a debtor general partner's estate or when a single fund in a larger group of funds managed by the same sponsor is in distress and the entire fund management business is being sold or transferred to another sponsor group.

In such situations, most courts will enforce the provisions of Article VII of the Limited Partnership Act and similar provisions in partnership agreements that prohibit assignment without the consent of limited partners, even though Section 365(c) of the Bankruptcy Code provides that a debtor may assume and then assign an executory contract to a third party without the consent of the counterparty. As a result, limited partners may have significant rights under Section 365(c)(1) of the Bankruptcy Code to object to the non-consensual assumption and assignment of a general partner's rights and interests in the partnership. It is important to note, however, that the result of a successful objection may not prevent a transfer of the general partner's economic interest in the partnership but only prevent a transfer of the rights to act as general partner of the partnership, leaving to the remaining partners the decision as to who would act as the general partner.

Similar to the ipso facto rule, typically a bankruptcy court will not enforce restrictions on assignment contained within the partnership agreement itself, unless an exception to this general rule applies. Bankruptcy Code Section 365(c)(1) provides that a trustee or debtor in possession may not assume or assign an executory contract if applicable law excuses the counterparty from accepting performance from or rendering performance to an entity other than the debtor. Traditionally, this exception was fairly narrow and applied most often to personal service contracts. Through broader acceptance by the courts, however, this exception has been applied to other types of agreements, including partnership agreements, by analogizing the general partner's ability to exercise the rights and perform the obligations of a general partner in a partnership (and the limited partner's agreement to accept that performance) to the provision and acceptance of personal services under the personal services contracts traditionally contemplated by this exception.

In cases where the debtor general partner is authorized by a bankruptcy court to sell its general partnership interest but the limited partners refuse to consent to the admission of a successor general partner, the successor general partner may be treated as an assignee of the general partnership interest but not as a general partner. Such assignee is not liable for partnership obligations and is not entitled to exercise other rights of a general partner, but it will be entitled to the economic rights to which the debtor general partner would have been entitled. In addition, a bankruptcy judge in a recent case in Massachusetts made it clear that the bankruptcy of a general partner will not trigger the dissolution of the partnership if there is a successor prepared to purchase the debtor's partnership interest. See *In re Biopure Corporation,* No. 09-16725 (FJB) (Bankr. D. Mass. Sept. 10, 2009) (approving sale and assignment of the economic interest of a general partner in a partnership).

Rejection of Executory Contracts Under Section 365 of the Bankruptcy Code

Because partnership agreements are executory contracts that can be rejected by a debtor in bankruptcy, there is some risk that a bankrupt general partner may exercise its broad power to reject the partnership agreement completely, which could result in a dissolution regardless of whether or not the other partners wish to continue the business of the partnership. Under the Bankruptcy Code, any rejection damages suffered by the limited partners will be discharged, and the limited partners will be entitled to a general unsecured claim in the amount of the rejection damages. Claims of general unsecured creditors are paid, if at all, only after all administrative, priority, and secured claims are satisfied in full. Although debtors have broad power to reject executory contracts, a debtor cannot retain the beneficial aspects of a contract while rejecting the contract's burdens. Under this provision, an executory contract must be rejected in its entirety and may not be rejected in part.

Integration of Fund Documents

As noted above, many limited partners enter into side letters with the general partner as an inducement to subscribe to a fund. Often the side letters include fee breaks and other

benefits that are extremely important to investors. As noted, a debtor cannot retain the beneficial aspects of a contract while rejecting the contract's burdens. If the bankruptcy court finds that the side letter and partnership agreement are the embodiment of a single contract, it is unlikely that the court would permit a general partner to use bankruptcy of itself or of the fund to terminate a side letter entirely or reject certain benefits to the investor contained therein if the partnership agreement is not also terminated. If, however, it finds the documents to be divisible, rejection of the side letter while maintaining the partnership is a risk. In deciding whether contracts are divisible or indivisible, a bankruptcy court looks to state law. Under Delaware law, the parties' intentions determine whether two separately executed agreements are in reality one.

Other Issues

CONSOLIDATION

In recent months, in an attempt to mitigate the risk that a fund's general partner could be dragged into the bankruptcy of another member of the sponsor group by consolidation, some investors have begun asking fund sponsors to structure their entities to ensure that the general partner is a bankruptcy-remote vehicle and to provide the investors with "non-consolidation" legal opinions. The nuances of non-consolidation are beyond the scope of this article, but circumstances that courts generally have taken into account in determining whether to substantively consolidate the assets and liabilities of a debtor and one or more of its affiliated entities in cases under the Bankruptcy Code include whether (a) such entities operate independently of one another, (b) corporate or other applicable organizational formalities are observed in the operation of such entities, (c) the assets of such entities are kept separate and records are kept that permit the segregation of the assets and liabilities of such entities, (d) such entities hold themselves out to the public as separate entities, (e) such entities have maintained separate financial statements, (f) such entities have made intercompany guarantees on loans, (g) such entities share common officers, directors, or employees, (h) the creditors have relied on the financial condition of an entity separately from the financial condition of the entity proposed to be consolidated in extending credit, (i) the consolidation of, or the failure to consolidate, the assets and liabilities of such entities will result in unfairness to creditors, (j) consolidation of such entities will adversely impact the chances of a successful reorganization. Despite taking into account these considerations, however, recent bankruptcy cases involving real estate companies have called into question the strength of the bankruptcy-remote entities that were used as borrowers in several of their debt securitizations.

SUBSCRIPTION-BACKED CREDIT FACILITY/CROSS DEFAULTS

At the beginning of a fund's investment period, a typical fund will enter into a subscription-backed credit facility. The fund's limited partners will agree with the credit facility lender that in the event the fund defaults under the facility, the lender can step into the shoes of the general partner and call capital directly from the limited partners. Once a general partner or a limited partner commences a bankruptcy case, however, any attempts to enforce defaults against the debtor partner or to exercise control over assets of the bankruptcy estate will be stayed by operation of the automatic stay under the Bankruptcy Code. As a result, the automatic stay may prevent a lender from stepping into the shoes of a general partner or drawing on a credit facility if the lender fails to enforce these rights before the partner's bankruptcy filing.

BANKRUPTCY OF UNDERLYING INVESTMENTS

In many instances, particularly where there are no fund-level guarantees relating to individual investments, a fund's general partner will choose to put individual investments into bankruptcy rather than the entire fund. Most current fund documents do not provide the limited partners with any specific rights in such cases. As we are now seeing with respect to requests that general partners be structured to be bankruptcy-remote vehicles, we would expect limited partners in new generation funds to begin to request more rights in these circumstances.

Conclusion

Investors in real estate funds should carefully analyze their fund documents to understand the bankruptcy-related provisions that are included and consult with a bankruptcy professional to fully understand the Bankruptcy Code's likely effect on such provisions given their particular circumstances. ■

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