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FUND FINANCE FRIDAY

Mine Your Dragonglass

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With President Trump announcing that both Winter *and Sanctions* are Coming full-on Game of Thrones-style, it is time to tune back in for the next season.

The November 5 reimposition of U.S. sanctions on Iran combined with the Khashoggi tragedy at the Saudi Arabia consulate in Istanbul has fund finance lenders asking about potential sanctions' impact on their portfolios. While the implementation of sanctions on a private equity fund investor raises a host of potential issues, here we highlight the impact for a lender’s borrowing base.

Sanctions are not one size fits all. In the U.S., sanctions generally either target countries or regimes whose actions or policies are determined to constitute an unusual and extraordinary threat to the national security, foreign policy, or economy of the U.S., or target specific individuals or entities involved in or contributing to activity determined to constitute such a threat (such as narcotics trafficking, weapons proliferation, and terrorism). Currently, more than two dozen different sanctions programs are in place, most of which are administered by the U.S. Treasury Department’s Office of Foreign Assets Control (known as “OFAC”). While many of the more longstanding sanctions were passed as law by Congress, more recently, sanctions have been more commonly imposed (and undone and then reimposed) by Executive Order. For those, the President has substantial flexibility in the specific terms dictated. Sanctions can be targeted at specific individuals, organizations, a government, an industry or industry sector or all residents of an entire nation state. Sanctions can vary in degree, from prohibiting any commerce at all, to prohibiting certain financial transactions, to only prohibiting military-related commerce. There can also be grandfathering, phase-in periods, and an exception approval (or “license”) process. Thus, the impact of an investor becoming subject to sanctions, of course, depends on the specific terms of the actual sanctions implemented and the business or locale in which a fund invests.

If an investor were to become a "Sanctioned Person" or otherwise subject to a sanctions program that specifically and immediately prohibited all transactions and no exception or license were available, the fund likely would need to isolate that investor from the rest of the investor pool, cease making distributions, and cease accepting capital contributions from that investor. The fund would also be well-advised to seek immediate guidance from OFAC. In some subscription facilities, the fund’s knowledge that an existing investor has become the subject of sanctions could be an event of default, requiring the lender and fund to agree to waive the event of default or otherwise resolve. In addition, under most subscription facilities, this would almost certainly trigger an exclusion event from the borrowing base.

Even where a particular facility does not expressly remove a sanctioned investor from a coverage ratio or the like, the lender and the borrower would likely need to come together to resolve. A lender may not be able to foreclose on a sanctioned investor's capital commitment without the lender itself potentially violating sanctions, and a lender cannot lend against uncalled capital which has become illegal to call. There is, of course, the additional potential that the lender has already advanced against the sanctioned investor's uncalled capital, in which the exclusion of such investor could create a borrowing base deficiency. In this circumstance, hopefully the lender's transaction structuring has included sufficient overcollateralization to permit the borrowing base deficiency to be repaid via overcalls on the remaining limited partners. The investment acquired with the related loan proceeds could provide another potential source of repayment as well. As we learned in Game of Thrones, a Lannister always pays his debts.

From a practical perspective, while we could see Cersei sanctioning the Dothraki in 2019, we think it unlikely that the U.S. would impose fund finance impactful sanctions on a sovereign wealth fund sponsored by Saudi Arabia. A sovereign wealth fund is distinguishable from both the nation itself and the individuals allegedly responsible for the horrific actions in Istanbul. The degree of commerce between the U.S. and Saudi Arabia, the benefits to the U.S. from foreign passive investments, and the need for allies in the Middle East all suggest that further sanctions, if any, arising out of the events in Istanbul would be highly targeted and unlikely to be broad enough to pick up a sovereign wealth fund's capital commitment to an unaffiliated fund. Additionally, the November 15 sanctions issued by OFAC targeted specific individuals allegedly involved in the Khashoggi murder, giving additional practical comfort that sanctions that could impact a subscription facility are not likely. We do not see a trial by combat with the Mountain for the fund finance markets this year.

In an upcoming edition, we will address the implications for the snap back of the Iranian sanctions.