CADWALADER

FUND FINANCE FRIDAY

No Commingling Here

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One Is the Loneliest Number

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By Kurt Oosterhouse
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By Eric Starr
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When thinking, talking and writing about subscription credit facilities (a “Facility”), the fund in question usually has a diversified group of investors with a wide range of commitment sizes – those funds are commonly referred to as “commingled” funds. On the other end of the spectrum are funds consisting of just one investor (or just a handful of investors) – those funds are commonly referred to as “SMAs” (Separately Managed Accounts). Why do SMAs exist and why would a lender lend to a “fund of one”?

With respect to why SMAs exist, they exist for a variety of reasons, including strategic investment opportunities, timing inconsistencies between the investor and the manager’s next fund, changes in pricing structure or simply a relationship-building decision between the investor and the manager. Over the last 12 months, one manager in particular saw a resurgence of SMAs since certain investors perceived this period of distress as an investment opportunity. Often, these requests were coming in faster than managers wanted to raise a fund, so SMAs were a popular choice to allow investors to capitalize on the market dislocation.

As to how they function, sometimes SMAs invest alongside a commingled strategy, but that is not universally the case. In other instances, SMAs may afford an investor access to multiple verticals where diversification is sought. Certain investors may prefer to have discretionary authority or approval rights over investment decisions. Alternatively, they may have sensitivities around investing in certain types of assets depending on their broader mandate, asset allocation, or cultural and ethical considerations.

SMAs frequently seek to take advantage of the convenience and utility of a Facility, no different than commingled funds. However, from the lender perspective, loaning money to commingled funds versus SMAs may be best described as “apples and oranges.” As a result, for some lenders, lending to an SMA simply proves too challenging of a request. Why “apples and oranges”? Because when providing a Facility to an SMA, many (if not most) of the “standard” lender protections with respect to evaluating the ability to ultimately collect on uncalled capital are simply not applicable in the context of SMAs.

Similar to a commingled fund, an SMA lender will have exclusion events with respect to the investor(s) to back out risky investors from the borrowing base and/or coverage ratio. However, unlike a commingled fund, since there may be only one investor, other than creating an event of default, from a collateral perspective, removing “the investor” from an SMA Facility fails to

provide any of the collateral protections (or tightened borrowing base or ratio) it would afford in a commingled fund, since the cushion and safety net of overcollateralization and diversity simply doesn't exist. If one investor defaults, the entire investor base has defaulted, and the lender cannot look to the remaining investor to repay the indebtedness owed by the defaulting investor.

That's the risk, but since bankers don't like to lose money, there must be countervailing considerations to explain the fact that SMA Facilities not only routinely get done, but also (as noted above) demand seems to be increasing, especially in the current environment.

For those lenders willing to head down the SMA road, there are unique aspects of lending to an SMA, from both underwriting and documentation perspectives, that must be properly accounted for and considered. From a pure underwriting perspective, lending to an SMA is like making a direct loan to the underlying investor. Thus, regardless of a lender's relationship with the manager (and whether or not the relationship with the manager is a primary motivation for the Facility), the most prominent and obvious underwriting issue is the creditworthiness of the sole investor.

Investors in SMAs are almost exclusively large institutional funds. This reality means that the investor is likely well known to the lender being approached for a facility. In fact, for some lenders, pre-existing relationships and familiarity with the underlying investor is a gating item to consider underwriting an SMA facility. Similarly, lenders find comfort in manager/investor relationships that have considerable, positive history of working together.

Following along with the "positive track record" on a macro level as to the relationship and prior dealings, on a micro level with respect to the particular transaction a positive track record is often also required. This frequently takes the form of requiring some level of capital to have been contributed by the investor prior to the effectiveness of the Facility (for example, 10% of the capital commitment must have been called and received). This requirement is an attempt to ensure the investor has sufficient "skin in the game," making a future failure to fund much less likely. From a pricing standpoint, since the SMA Facility lacks the "standard" protections discussed above, they are typically priced higher than a commingled Facility to a similar sponsor.

As in underwriting, the documentation of an SMA Facility also has quite a few nuances to be considered. The previously common practice of obtaining investor consent letters has largely faded into the annals of subscription finance history. There are many reasons for the elimination of consent letters, not the least of which is the fact that limited partnership agreements and other governing documents have improved with respect to expressly contemplating the existence of and collateral for Facilities. However, in the context of SMAs, this artifact remains alive and well.

For many lenders, the Investor Consent is an absolutely non-negotiable requirement to even consider underwriting an SMA fund for a Facility. Further, in our experience, "best practices" would call for it absent unique circumstances. In response to a request for a consent letter, it's not unusual to hear a response along the lines of either "those aren't market" or "you want what from who?" As a result, it's good to be able to explain the legal foundation to either response. Yes, the investor signed the partnership agreement and, yes, they know about the facility and, yes, they have agreed to have their uncalled capital pledged to the lender. However, an

Investor Consent letter serves the purpose of putting the lender and sole investor in direct "contractual privity" – meaning there is now a document between the lender and the investor where the investor has acknowledged to the lender that it knows about the Facility and the fact that it might be required to fund directly to the lender, etc. at some point. Basically, it creates an estoppel argument for an investor that wants to ignore a lender request as simply a problem between the lender and the fund. In addition, an Investor Consent provides an opportunity to: (i) get the popular lender confirmation that the investor is committed to fund its capital contributions without setoff, counterclaim or defense, (ii) address any side letter issues or (iii) deal with sovereign immunity concerns, which are not infrequent for the types of investors frequenting the SMA space. As noted above, Investor Consents faded, in part, due to a cost (consents from most or all commingled investors) versus benefit (acknowledgement of Facility already contained in partnership agreement) analysis which simply no longer supports their existence. However, that cost versus benefit analysis in the SMA space is decidedly reversed. The benefit of an Investor Consent to a lender willing to take the risks unique to SMA Facilities certainly exceeds the cost of getting a consent from a sole investor. Further, if there is a familiarity between the contracting and advising parties, previously-agreed precedent investor letters can be extremely useful in getting these in place with an almost nonexistent cost.

While not a true Investor Consent, in an SMA Facility, sometimes the SMA Facility is more akin to an SMA of an SMA, meaning that the actual investor in the SMA is a special purpose vehicle created by the (typically) institutional investor. As a result, referencing back to the underwriting discussion, while a lender can gain comfort in the fact that an institutional investor has a track record and assumedly substantial financial resources to support its obligation to fund its uncalled capital, when applied to a special purpose vehicle of the institutional investor, that "track record" thread can look thinner.

In these situations, one tool that has been used to bridge this "comfort gap" is to obtain a support letter from the parent entity of the actual special purpose vehicle investor – since they are the entity that is providing the true creditworthiness to support the credit approval. While not legally enforceable documents, comfort letters, typically: (i) confirm that the parent is in fact the parent company, (ii) acknowledge the investor's commitment and that the commitment is being pledged in connection with the Facility, and (iii) agree that the parent will "cause" the investor to timely fund its obligations (or sometimes agree to ensure the investor is "adequately capitalized"). In some cases, a lender may even require a guaranty from the parent entity – though, not surprisingly, a commitment such as that is a much more difficult request (since it may run against the establishment of the special purpose vehicle in the first place) and is, consequently, rare.

In terms of facility documentation, by comparison to their commingled counterparts, SMAs often see tightened terms. For all the reasons discussed above, there is simply less room for errors or missteps in execution of key aspects of compliance with the documentation. As a result, cure periods for certain events of default are often greatly reduced or, in many cases, simply removed. Further, as referenced above, common exclusion events in a commingled facility (which would simply remove an investor from the borrowing base and/or coverage ratio) are simply immediate events of default in an SMA Facility – if a sole investor in an SMA would need to be excluded from the borrowing base/ratio, *ipso facto*, the Facility simply no longer has a borrowing base or a supportable ratio. For all of these reasons, when lending to a fund-of-one, defaults are more likely to trigger the maturity of the facility.

Ultimately, there are a variety of unique issues facing lenders (and the attorneys that document their deals) when financing an SMA versus a commingled fund. Nevertheless, while those issues can make lending to an SMA more risky, if properly analyzed in the underwriting process and accounted for in the documentation process, those peculiarities and other unique differences can be somewhat mitigated.

FFA Next Gen Event: ‘Into the Unknown’: A Fund Finance Perspective on ‘Letting LIBOR Go’

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By Cassandra Best
Associate | Fund Finance

The U.S. chapter of FFA Next Gen held its second virtual panel session this week, titled “Into the Unknown”: A Fund Finance Perspective on “Letting LIBOR Go.” Over 215 attendees heard from expert panelists Jean MacInnes, Executive Director and Counsel at Mizuho Americas, Jeff Nagle, Partner at Cadwalader, and Tess Virmani, Associate General Counsel and Executive Vice President for Public Policy at LSTA. I appreciated the opportunity to serve as panel moderator. Read on for some key takeaways.

- “LIBOR is like glitter” as it is everywhere!
- The panelists provided a refresher on why LIBOR is going away and what the ARRC (Alternative Rates Reference Committee) is and its role in LIBOR transition.
- When your current benchmark ceases to be available, selecting the replacement rate depends on whether the Credit Agreement includes the “Amendment Approach,” whereby the parties will negotiate and agree to an amendment to provide for the replacement rate, or the “Hardwired Approach,” whereby there is a defined waterfall as to what replacement rate will apply. In the Hardwired Approach, when LIBOR does go away, typically if Term SOFR is available, then the parties will use that, but if not, then the parties will use the next available rate (Daily Simple SOFR, Daily Compounded SOFR, etc.). The intent behind the Hardwired Approach is to agree to the game plan up front before LIBOR goes away. In the Hardwired Approach, a borrower having consent rights to the replacement rate undermines the intent to agree to a replacement rate at the time of signing up the Credit Agreement.
- In 2020, the ARRC and U.S. regulators issued statements in favor of adopting the Hardwired Approach on the basis that (i) the SOFR market has matured in the past few years and there is more information and comfort around the replacement rates, and (ii) millions of Credit Agreement negotiations and amendments will be operationally challenging, especially as we approach the end of 2021.
- In December 2020, the IBA launched a consultation to extend most tenors of US Dollar LIBOR until 2023, which effectively is an 18-month extension to address operational issues. However, just because most tenors of USD LIBOR aren’t going away until 2023, that additional 18 months is intended to provide time to transition legacy deals. U.S. banking regulators have said that no new LIBOR contracts should be entered after December 31, 2021 except in limited circumstances. The clear message is that all parties need to move off LIBOR with all due speed. An upcoming IBA announcement will come out soon with results of this consultation and will likely set benchmark spread adjustments for loans using ARRC fallbacks.

- State of Play on New Loans: LSTA has put out model Credit Agreements that use both Daily Simple SOFR and Daily Compounded SOFR. Banks are very busy putting in place the systems and operational capability for the pricing change. Changing the documentation is just one component of the transition; there is also a lot to do beneath the surface. Some SOFR-based products have been issued in the bilateral market, but it is limited, and we do expect SOFR to hit the syndicated market soon. Furthermore, there is an uptick in the derivatives market. With Sterling LIBOR fading out in Europe next month, it will drive the timeline for multicurrency deals. In the next quarter, we expect an increasing amount of SOFR issuance to hit the market.
- SOFR: "Secured Overnight Financing Rate" is based on the repo rates for U.S. Treasuries. The Fed gathers information about Treasury rates in the market, approximately $1 trillion of daily activity. There is currently a very robust volume of market activity supporting SOFR. The Fed publishes SOFR the next morning. The intent is to implement SOFR as the replacement benchmark for LIBOR but to seek to avoid value transfer for existing deals. Since SOFR is very different from LIBOR and traditionally a lower amount, a spread adjustment is needed to keep things comparable from a pricing perspective; this spread adjustment is different from margin over the benchmark.
- Term SOFR: A forward-looking version of SOFR that can be locked in for a fixed period (similar to 1-month or 3-month LIBOR) and the rate will hold for that period. The market is used to this from LIBOR, but it is looking less likely that we will have a Term SOFR by the timelines necessary to meet regulatory guidelines (it may not be available in 2021). The only way to have a robust Term SOFR is to have a very active SOFR market in derivatives. Many parties in the market are using provisions in hardwired language to "climb up" the waterfall in the event that Term SOFR is not available at the time of transition but becomes available later.
- Multicurrency Facilities: LSTA plans to issue suggested language to provide guidance.
- IBA Announcement: An announcement will be coming out soon with more information about cessation dates. This will also set the spread adjustments for both ISDA and ARRC and will provide much-needed transparency for the economics. The cessation dates will impact numerous Credit Agreements since the dates will effectively start the clock for amendments in transactions that have the Amendment Approach in place.
- Banks' To-Do List: Bankers are extremely busy dealing with LIBOR transition since there is client outreach, banker training, operational transition, pricing, etc. It's a real and major transition that requires extensive training and socialization across multiple stakeholders. The banks have a very large volume of existing loans of all types with LIBOR-based benchmarks. For these reasons, banks also have a huge need to have consistent language to operationalize the processes – this is just too big of an operational challenge to customize – so many banks have migrated to the ARRC-recommended Hardwired Approach language.

The FFA Next Gen team is always looking for new ideas, so please reach out to committee chairs **Jorge Grafal** and **Alexa Schult**.

Leah Edelboim Joins Cadwalader's Fund Finance Practice in New York

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Leah Edelboim has joined Cadwalader's Fund Finance practice as a special counsel in our New York office. She joins from Clifford Chance, where she represented funds and lenders in fund finance transactions for nearly a decade.

Leah has established a national reputation as a rising star in fund finance, having advised funds and lenders in many complex, cross-border, syndicated financings with top-tier sponsors. She has extensive experience in subscription and capital call facilities, as well as numerous NAV and bespoke concentrated-NAV transactions.

"Cadwalader is such a dominant force in the fund finance space, both here in the U.S. and in London," Leah said. "I see this as a great opportunity to work with some of the best fund finance lawyers in the world. I also know many of Cadwalader's clients from being across from them over the years. I am very excited that I will be now be working on their side of the table."

Click here to read the full press release.

Diversity in Fund Finance Volunteers with PENCIL

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By Natasha Puri
Vice President, Financial Institutions North America | Lloyds Bank

Last week, the Diversity in Fund Finance group partnered with **PENCIL,** the NYC-based non-profit whose mission is to provide New York public school students with access to relationships and opportunities with business professionals. In conjunction with PENCIL's internship program, PENCIL provides hundreds of students with 20+ hours of pre-employment career readiness training. These trainings cover a variety of topics that help equip students with crucial skills needed to succeed at their summer internships, such as personal branding, financial literacy, resume editing, networking and mock interviews. Diversity in Fund Finance committee members Bryan Barreras, Partner at Mayer Brown, Chris Davis, Associate at Morrison & Foerster, and Trevor Freeman, Managing Director at Signature Bank, led a financial literacy session for 150+ students where they talked through various topics such as budgeting, saving, investing and responsible credit card use. The students provided great feedback on the session, where they were able to ask questions and even admire Bryan's quarantine beard!

We look forward to continuing to work with PENCIL in their virtual sessions this year. If you are interested in volunteering or getting involved in our Diversity & Inclusion efforts, please reach out to **Michelle Bolingbroke** or **Natasha Puri** to learn more.

Please join our next meeting next Thursday, March 4 at 11:30 a.m. EST.

WFF's #ChooseToChallenge Campaign

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Join Women in Fund Finance’s global #ChooseToChallenge campaign, starting March 8. Enter as an individual, friends and family team, or corporate team for a 10-day push-up and/or meditation challenge. All donations received will go to the Malala Fund, supporting the right to 12 years of free, safe and quality education for every girl. For more details, click **here**.

NAV Lending Provides Solutions for Middle-Aged Funds

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Aberdeen Standard Investments outlined the benefits of a growing trend among middle-aged funds in utilizing NAV lending to fill its liquidity gaps accelerated by the coronavirus pandemic. The coronavirus pandemic caused many middle-aged funds to use their remaining capital to defend portfolio companies' value, leaving them with limited liquidity to continue funding buy-and-build strategies. The lack of liquidity for many middle-aged funds placed them in a precarious position where they are in a crucial period to create value for their investors but lack easy financing alternatives. To obtain the liquidity a fund requires to increase the portfolio's value without further dilution, managers are increasingly utilizing NAV facilities to pursue "tack-on acquisitions" instead of passing up the opportunity. Managers of middle-aged funds are starting to realize that a NAV facility aligns General Partner and Limited Partner goals to support the portfolios and maximize Limited Partners' returns.

As NAV lending continues to develop into a mainstay in the fund financing world, Cadwalader's Fund Finance Group has helped clients utilize NAV lending to achieve their financial needs.

To see Aberdeen Standard Investment's article, click **here**.

Key Players Discuss NAV Trends with Secondaries Investor

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Secondaries Investor recently published an article that contained an interesting and detailed discussion about the movement of the market toward NAV facilities over the course of 2020, with some key market players from Investec, Crestline Investors, 17Capital and Hark Capital participating in the article. The article can be accessed **here**.

Brickfield Article on Seasonal Recruitment

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Brickfield Recruitment's latest article tackles the seasonal nature of recruitment in fund finance (as peak hiring in March approaches), as well as the key issue of timing in recruitment. This article is the first in a two-part series from Brickfield on recruitment processes and relationships.

Readers looking to receive regular updates on talent acquisition trends in fund finance can **follow Brickfield on LinkedIn**. Law firms, banks, funds, alternative lenders and candidates with specific enquiries should contact Rory Smith at Brickfield Recruitment by **email** or by telephone on +44 7800 963 594.

Ireland and Luxembourg Comparative Analysis – The Lawyer

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The Lawyer published an article by Jad Nader (Ogier) and Phil Cody (Arthur Cox) comparing fund finance considerations under the legal frameworks of Ireland and Luxembourg. The **article** details key issues to consider when an Irish or Luxembourg fund is a borrower or other obligor in a fund finance structure, and notes the preferred status of Ireland and Luxembourg as jurisdictions to establish European funds.

On the Move – Alice Wight Joins Walkers in Jersey

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On the Move

Finance lawyer Alice Wight has joined Walkers' leading Banking & Finance team in Jersey, led by Nigel Weston, Alexandra Corner and Jon Le Rossignol.

Alice has two years' experience in the banking & finance team of another Jersey law firm, and advises on all aspects of fund financing matters, including subscription line facilities, NAV and hybrid facilities, as well as co-invest, general partner and manager line facilities.

Alice’s arrival follows that of Senior Counsel Julia Keppe, based in Jersey, another fund finance specialist who trained and qualified with Debevoise & Plimpton LLP, spending more than 10 years in the firm's London and New York offices. These recent hires are part of the firm’s strategic expansion in Europe and supplement the relocation of fund finance specialists Zoë Hallam, who relocated from the Cayman Islands to Guernsey in 2018, and Patrick Ormond and Carl Hey, who relocated from the BVI to London in 2020.

Alice will be part of **Walkers' Global Fund Finance** group that encompasses fund finance specialists from the firm’s offices in Jersey, Guernsey, Ireland, Bermuda, BVI, the Cayman Islands, Dubai, Hong Kong, London and Singapore.

Fraser Hern, Head of Walkers’ Channel Islands business, commented: "Our European and global expansion has continued at pace throughout the past year notwithstanding the challenges created by the global pandemic. We see significant potential for further growth in multiple sectors and business lines, including in fund financing. We have the leading offshore fund finance team globally, and are very focussed on continuing to deepen our capabilities in this space. We are delighted to have Alice join us.”

Fund Finance Hiring

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Fund Finance Hiring

Cadwalader is looking to hire an experienced finance paralegal or NQ to junior-level associate in its Fund Finance group in the London office. Ideally, the candidate would have experience working as borrower or lender side counsel on financing transactions or, if an NQ, have completed at least one training contract seat in finance. The applicant should be a self-starting, highly-motivated individual who enjoys working in a busy team environment. For more information or to suggest candidates, please contact Cadwalader's **London recruitment team**.