CADWALADER

Playing in the Minor Key

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Minority Lender Considerations

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Minority lender roles in transactions come up frequently and generally don't warrant specific comment where there is a diverse lender base or established lender relationships, but sometimes the facility holdings are such that one or a small group of lenders can constitute the majority for the purposes of consents and amendments. The amount of focus relative hold amounts and voting power receive from the lender or lenders with the minority position will vary depending on a number of factors, including the type of deal, size of hold, whether the majority lender is a bank or fund lender, the relationship with and reputation of the sponsor, the relationship with the majority lender(s), the identity of the agent and the complexity of the transaction.

Depending on these factors, the minority lender(s) may be comfortable with their position and the alignment of interests among the lender group generally and therefore with the level of control the majority lender has, or they may turn their minds to how they can ensure that they have a say on key decisions.

Ordinarily, protection for lenders on key points comes through the list of all-lender matters in the amendments clause which, in Europe, will cover detrimental changes to pricing, tenor and mandatory prepayment as well as release of security. These provisions will also regulate, as all-lender matters, other key intra-lender concepts such as the pro rata sharing mechanics, enforcement waterfall, matters prescribed as being "all lender" in the applicable provision and rules regarding the application of prepayments.

But in the context of a deal where one or a couple of lenders could constitute the majority, there are certain provisions that the minority lenders may want to consider beyond the standard all-lender matters. This is not to say that all will be relevant in every context. As mentioned above, depending on a number of factors, none or only a few of these may warrant negotiation. There will also be deal-specific considerations (and, indeed, considerations of more general application) beyond those discussed below, which aim to give lenders a flavour of the issues they may want to consider when taking a minority position next to one or a small group of controlling lenders.

It is also worth mentioning at the outset that a large number of deals have a concept of not just majority and all-lender matters but also super-majority matters. Depending on the level, that majority lender is set at (66-2/3% is the traditional level for European deals, but we increasingly see a lower 50% threshold, particularly in NAV and pref deals) the super-majority threshold will be either 66-2/3% or a higher level around 80%. Super-majority levels may be used for decisions relating to the release of security, but sponsors are increasingly seeking to limit the

acceleration right to super-majority rather than simple majority, and so the below considerations apply equally to decisions made under the super-majority regime.

With these different lender thresholds and the competing interests of the sponsor, the majority lender (who may rightly want to protect its own ability to make decisions given its higher exposure levels in the financing) and the minority lenders, there is clearly a balance to be struck and a shift to all-lender decisions for certain matters, which may be unworkable for the sponsor and undesirable to the majority more-highly-exposed lender, may not always be appropriate. One possible solution here is to have a half-way house where day 1 lenders (or a specified number of day 1 lenders) are given a say on certain matters to avoid elevation to full all-lender status.

In the context of the above dynamics, it is also important for a minority lender to pick its battles, looking for provisions key to the economics of the deal and areas where there is misalignment with the majority lender or where a majority lender could prejudice the minority as a distinct class − though the standard LMA-style all-lender matters should deal with most areas of the documentation that fall into the latter category. It is unlikely that either the sponsor or the majority lender will have a lot of tolerance for an over-reaching minority lender looking to take on a prominence in the transaction disproportionate to its exposure, and so a more surgical approach may yield a better result.

With this in mind, below is a summary of some of these key areas to consider.

Consent levels embedded in Agent discretions

Leaving aside the list of all-lender matters in the amendments clause, the finance documents will give the Agent discretion to approve or agree certain matters. Where a consent level is not specified and the matter is not prescribed as an all-lender matter, this will generally mean that the Agent can act on the instructions of the majority lenders in making its determination.

Although there will almost always be important deal-specific agent discretions that lenders all may want a say on, some of the more standard agent discretions we often see at majority-lender level that could warrant elevation to all − or prescribed − lender in the context of a minority-lender financing are decisions as to whether new investors or new assets should be allowed into the borrowing base or NAV calculations (as applicable) as either eligible investors or eligible investments, sweeper clauses in the negative restrictions that allow for indebtedness or security with the consent of the agent, or for the agent to agree to distributions or cash to be moved from secured accounts during a period when the account/distribution block has been triggered.

Another point that is sometimes overlooked are the impaired agent provisions. In European deals, where an agent (or its lender affiliate) is insolvent or fails to make a payment, the agent can be classified as an impaired agent, and the lenders and borrower can then make payments directly, rather than through the agent, in the period until a replacement agent is appointed. Appointment of a replacement agent is generally set at the discretion of the majority lenders where the agent is impaired, but if the agent role is being filled by the lender with the majority position, this may not be appropriate and lenders should consider disenfranchising the affiliated lenders of the impaired agent from the vote.

Cashflows and financial testing

These considerations are generally more pronounced on NAV and pref deals where the distribution cashflows are key to repayment of the facility and where the period after an event of default until repayment can be protracted while assets are sold.

Generally, the financial covenant and cashflow-related definitions will be heavily negotiated, with much attention paid to NAV adjustments, permitted retained amounts, and the timing and impact of detrimental investment events. Mandatory prepayments are often covered as all-lender matters, but where there is a stand-alone financial covenant (as opposed to the LTV-level impacting only on pricing and cash sweep), a minority lender should consider whether changes to the financial covenant or waivers of breach of that covenant are something on which they would like a say.

The financial definitions on which the financial covenant, cash sweep and margin ratchet are based are often omitted from the all-lender matters, and minority lenders may also want to make clear changes to these definitions are all − or prescribed − lender matters. Depending on the formulation of the amendments provision, there may be some protection for these definitions as, at least in the European LMA formulation, the casting of the all-lender matters clause is wide (being any amendment, waiver or consent that has "the effect of changing or which relates to" the list of enumerated matters). Given this breadth, if the financial covenant, cash sweep or margin ratchet are listed in the all-lender matters, there may be some protection for the financial definitions, as a change to those definitions could be argued to have the effect of changing or varying the covenant/ratchet itself. Despite this, given the focus these definitions receive in the negotiations, lenders may prefer to have these definitions specifically listed and to be clear that agent discretions need to be exercised on an all or prescribed lender basis.

Another point that plays out more usually in NAV and pref deals is agreeing any cure plan. Generally, this will be a majority-lender decision, and moving from this position may be hard for the sponsor and the majority lender as they will both want comfort that a cure plan to reduce the facility outstandings is agreed efficiently, without lenders with less skin in the game being able to disrupt the process. This is an area where minority lenders may take a view that there is sufficient commonality of interest between the minority and the majority lender position to allow the majority to make the determination that the plan is one that will deliver the desired outcome. It may also be that minority lenders are concerned that other minority lenders may block a worthwhile plan and frustrate the cure process. But minority lenders could consider shoring up their position by requiring that the plan is shared with them during the consultation period between the majority lender and the sponsor so they have visibility as to the likely direction of the plan or by enhancing their say if the cure process involves a further plan if the initial one fails to result in disposals to pay off the facility in full.

Information flow

In circumstances where the agent is also the majority lender, there can be a concern that information may not flow to the minority lender(s) at the same time as the majority lender is made aware of it. To an extent, this is an unavoidable issue on any transaction, and lenders don't generally regulate the unofficial correspondence and "heads up" discussions between a borrower and the lenders in the lender group. There are two points for minority lenders to take comfort from and consider in this context. The first is that European agency provisions will

generally have a positive obligation on the agent to provide any documents it receives from the obligors to all lenders promptly, and minority lenders should check that this provision is present in their deal. If there is a particular concern about the entity having the agent role, then minority lenders could also ensure that the timing for key decisions is based off the date on which that information is provided to all lenders, rather than the date on which it is provided to the agent. An example of this might be the “snooze” provision in the amendments clause, where lenders can rightly say that the “snooze” timing should only start once they have received the amendment request and not when the request is provided to the agent.

Disenfranchisement

The final consideration for this list is whether lender transfers to sponsor affiliates are permitted and, if they are, whether the sponsor is then disenfranchised from voting. To give this some context, the concern here is that the majority lender may be taken out by a transfer to the sponsor, leaving the sponsor with voting control on a large number of matters while the minority have no voice. Again, this is probably a more pronounced concern in the context of a NAV or pref financing where the exit route is not as clear-cut as a subscription facility. The LMA documentation provides various regimes to assist with this issue in their leveraged form, and these solutions can be applied equally to a fund finance facility. Options include blocking transfers to sponsor affiliates completely or, if permitted, disenfranchising the sponsor affiliate from voting. Another option may be to treat the sponsor transfer as a repayment of the debt (though this somewhat offends against the pro rata repayment concept) or to have a put right on transfers to a sponsor, such that if a majority lender wants to transfer to a sponsor, the sponsor must also be willing to accept a transfer from any other lender. The circumstances of a deal will dictate which of these options is most appropriate − there is certainly no “one size fits all.”

Ultimately, taking on a minority position in a deal with a cornerstone lender or lenders will require some thought, but with a considered and measured approach, it should be possible to achieve the right balance for the sponsor, the cornerstone lender and the minority lender.

Fund Finance: Sanctions

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Following on from the *Fund Finance Friday* articles of **March 11** and **May 13**, which looked at the sudden escalation of sanctions measures following Russia's invasion of Ukraine and the associated issues being considered by lenders in the fund finance space, this article focuses on the current state of play in the Cayman Islands and some of the questions which Cayman Islands funds are facing in practice.

The Cayman Islands sanctions framework

Whilst sanctions can be imposed domestically in the Cayman Islands, in practice, the financial sanctions in force in the Cayman Islands are essentially those in force in the United Kingdom. It is the UK's policy to ensure that British Overseas Territories like the Cayman Islands are legally and practically enabled to implement United Nations and UK sanctions in order to ensure compliance with international obligations. This is principally achieved via the extension of the UK sanctions measures to the Cayman Islands, with certain modifications.

Whilst other non-UK sanctions regimes, such as those of the United States and the European Union, do not apply in the Cayman Islands as a matter of law, those regimes can have far-reaching, extra-territorial impact and may still be applicable. Therefore, many Cayman Islands funds choose to monitor and comply with non-UK sanctions in practice, particularly the U.S. regime administered by the Office of Foreign Assets Control ("OFAC"). This may be required in situations where there is jurisdictional overlap between the various regimes due to a fund's structuring and underlying operations. These can be difficult waters to navigate and, in particular, there are some areas where the UK/Cayman Islands regime differs from the U.S./EU sanctions regimes.

Aggregation of the holdings of separate sanctioned investors

One such area is with aggregation − that is, where a fund has more than one sanctioned investor/limited partner, neither of whom individually "own or control" the fund for the purposes of the relevant legislation.[1] The Cayman Islands follow the UK position here, with the Office of Financial Sanctions Implementation ("OFSI") having recently updated its guidance to clarify that, when making an assessment on ownership and control, OFSI would not automatically aggregate sanctioned persons' holdings in a fund; there must be evidence of a joint arrangement between those parties, or evidence that a sanctioned person controls the fund for the purposes of the relevant sanctions legislation.[2] Notably, this is different from the U.S. and EU sanctions regimes, both of which do aggregate the ownership interests of multiple sanctioned persons in a fund to determine whether the ownership threshold has been met.

Actions required

The Cayman Islands anti-money laundering and countering financing of terrorism regime requires that applicable sanctions lists must be checked frequently to identify whether a fund maintains any accounts or holds any funds or economic resources for designated persons or entities, whether directly or indirectly. The fund must look through to the ultimate beneficial owners of their direct clients/investors. In practice, this "scrubbing" of sanctions lists is often conducted via a third-party service provider or as part of the compliance function within larger or more sophisticated fund managers.

Where a sanctions hit occurs, the fund is required to:

- **Freeze:** freeze any accounts, other funds or economic resources (which terms are defined extremely broadly) that are owned or controlled by designated persons or entities;
- **No dealing:** refrain from dealing (also defined extremely broadly) with the funds or assets, or from making those funds or assets available (directly or indirectly) to, or for the benefit of, the designated person or entities, unless an appropriate license is held;
- **Report:** report any findings to the Cayman Islands Financial Reporting Authority (the "FRA") as soon as practicable by completing and submitting a compliance reporting form in the prescribed form;[3] and
- **SAR:** consider whether a suspicious activity report ("SAR") also needs to be made to the FRA.[4]

What is an asset freeze?

In the context of a fund, an asset freeze means that the fund may not process any redemption, withdrawal or transfer of, or make any distributions in respect of, the frozen interest; nor may the fund accept any additional subscriptions from or make capital calls on the relevant investor. In addition, the fund must not otherwise alter, move or allow the designated person to access or receive the benefit of the investment. Additional complexities may arise in practice, dependent upon the precise terms of an investment fund, in determining how far an "asset freeze" may extend and what actions, such as payment of fees, may be permitted at the fund level. However, where a designated person holds a minority interest in a fund, the impact on day-to-day activities can be expected to be minimal.

Impact on subscription credit facilities

Most credit agreements will also include express representations and restrictive covenants which require the borrower to actively monitor for sanctions risk at the investor level, where the possibility arises of controlling persons or individual officers or employees becoming sanctioned. While the sanctions language is often subject to negotiation with the input of specialist counsel, the term “sanctions” is typically broadly defined to include all economic or financial sanctions imposed, administered or enforced by any governmental authority with jurisdiction over the borrower or its affiliates, including OFAC in the case of U.S. sanctions, and OFSI in the case of UK and Cayman Islands sanctions.

The exact wording of any such sanctions provisions must be considered on a case-by-case basis. The sanctions provisions may not necessarily be breached solely by reason of an individual non-controlling/minority investor in a fund becoming subject to sanctions. However, where an investor in the fund is sanctioned, the borrower will need to take active steps to ensure it remains compliant with these contractual provisions, which may lead to challenges in practice. Most notably, a typical sanctions covenant will strictly prohibit any proceeds of a sanctioned transaction being used to repay advances under the facility, and will prohibit any proceeds of the facility being made available (directly or indirectly) to any sanctioned person.

In any event, both lender and borrower need to remain mindful that, under a typical credit agreement, an investor (including those holding a minority interest) becoming sanctioned is likely to, at minimum, result in that investor being excluded from the borrowing base (by becoming an “excluded investor” or pursuant to an analogous definition). In turn, that may trigger a prepayment requirement if the borrowing base is exceeded.

General license to alleviate the position

That being said, there are reasons why a Cayman Islands fund would want to cause a designated person to exit the structure, including whether due to the nature of the other investors in the vehicle and reputational or perception issues, or because of the impact under existing facility terms. Currently, a mandatory transfer cannot be achieved without a license specific to that vehicle and the licensing process is, at this stage, uncertain and time-consuming.

However, talks are underway between the FRA and the UK authorities regarding the grant of a general license which would allow Cayman Islands funds to effect mandatory redemptions or withdrawals of frozen investors and place the proceeds into a blocked account. If issued, such a license will provide operators and managers of funds with frozen investors (including funds with majority frozen investors, which are themselves then subject to sanctions) with a way forward to improve the position of the fund (and its remaining investors) and remediate any technical breaches of credit facility terms.

It is expected that any such license would be closed-ended, requiring impacted funds to take action within a certain window of time. Therefore, it is essential for fund sponsors and their counsel to stay abreast of this development.

[1] Under The Russia (Sanctions) (EU Exit) Regulations 2019, an entity is “owned or controlled, directly or indirectly” by another person if:

- the person holds (directly or indirectly) more than 50% of the shares or voting rights in an entity;
- the person has the right (directly or indirectly) to appoint or remove a majority of the board of directors of the entity; or
- it is reasonable to expect that the person would (if they chose to) be able, in significant respects, by whatever means and whether directly or indirectly, to achieve the result that the affairs of the entity are conducted in accordance with their wishes.

[2] Paragraph 4.1.4, **OFSI General Guidance - UK Financial Sanctions**.

[3] Available at the FRA’s website **here**.

[4] It should be noted that suspicious activity is reported to the FRA in a different format from sanctions-related reporting; the FRA’s prescribed SAR form is available at the FRA’s website **here**.

Cadwalader Webinar Series: A Practical Guide to Capital Relief Trades for U.S. Banks

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CADWALADER

Webinar Series

CAPITAL RELIEF TRADES

Cadwalader's financial services team is hosting the first of a four-part series focused on capital relief trades, where attorneys will discuss the nuts and bolts of these transactions, which a growing number of U.S. banks are exploring to optimize regulatory capital and manage credit risk, including capital benefits, structural considerations and other legal and regulatory issues. The first installment, on Wednesday, June 22 at 1 p.m., will feature partners Jed Miller, Daniel Meade and Ivan Loncar on the topic: "CRT Overview and Regulatory Capital Basics." Please register **here**.

Wildgen ‘Fund Finance Experts Talks’ Highlights Sustainable Finance and the APAC Market

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Luxembourg-based law firm Wildgen published its fourth episode of "Fund Finance Experts Talks" this week, featuring host Michael Mbayi and industry leader Sally Little, Head of Financial Institutions Sector Lending APAC at ING in Singapore. Michael and Sally discuss the timely topic of sustainable finance and understanding the client's sustainable finance objectives, as well as the similarities and differences of the United Kingdom and APAC region fund finance markets. Specifically, Sally highlights LP sentiments, single managed accounts, advance rates, and confidentiality protocols in the expanding APAC market. Sally also provides guidance for growing as a key leader in a fund finance institution. The video and podcast are accessible **here.**

WFF European Networking Brunch

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If you are in London for the FFA European Symposium, be sure to **RSVP** to join Women in Fund Finance for a networking brunch on June 29 that promises to deliver exceptional connection and conversation.

RBS Report on the Science Based Targets Initiative

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With ESG considerations becoming increasingly prevalent in Fund Finance transactions, RBS International surveyed 125 influencers across the Alternatives Funds space to understand how the Science Based Targets initiative can be used to help provide a shared framework for the industry. The report's conclusions can be accessed **here**.

Iron Road Partners Analytical Note on Cost Allocations

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This week Iron Road Partners published an Analytical Note on the cost allocation of fund finance commitment fees and related charges, such as unused fees, between a commingled fund and applicable co-investors. The note is available **here**.