

FUND FINANCE FRIDAY

On the Side

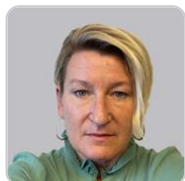
February 3, 2023 | Issue No. 209

Table of Contents:

- **Regulatory Focus on Investor Side Letters**
- **FFF Sovereign Immunity Series – Part V**
- **Out of the PF Act Club and Into the Cold: When Would a Cayman Private Fund Be De-Registered?**
- **Irish Investment Limited Partnerships – Updates on the Revamped Regime and Comparison to Non-Irish Limited Partnership Structures**
- **RBS Predicts Fund Finance Trends for 2023**
- **KBRA: ‘NAVigating the Resilience of NAV Loans’**
- **Private Debt Investor’s ‘LP Perspectives 2023 Study’**
- **Walkers ‘We Talk Banking & Finance’ Podcast Featuring FFA’s Jeff Johnston**
- **SJL Jimenez Luns – ‘A Look at Fund Finance in Luxembourg 2022’**
- **Fund Finance Hiring**
- **Cadwalader Welcomes New Team Focused on Leveraged Finance, Private Credit and Special Situations**

Regulatory Focus on Investor Side Letters

February 3, 2023 | Issue No. 209



By Renee Fischer
Counsel | Fund Finance

Side letters are an important component of most fund finance deals. They are reviewed by lenders in connection with due diligence reviews (i) for subscription line facilities to determine the rights and obligations of investors in respect of capital commitment collateral and (ii) for NAV facilities to determine the liquidity and information rights attached to equity interest collateral. The SEC is expected to revert shortly on a proposed rule published last year that, if adopted, could impact the substance of side letters. That proposal received extensive feedback from fund managers, investors, industry groups and other market participants. Below we have discussed certain aspects of the proposed rule. We note that this is merely a proposed rule, and the contours of what will be included in the final rule are unclear.

Side letters are a common way of formalizing bilateral negotiated arrangements between a private fund and its investors, where investors seek to modify the rights and entitlements generally applicable to investors pursuant to the fund's constituent documents. Side letters can address a myriad of issues but often include provisions reducing investment management or performance fees, granting fee rebates, providing excuses for funding capital, granting preferential liquidity and redemption terms (e.g., waiving lock-up provisions or offering shorter redemption notice periods) or providing for enhanced transparency and reporting. In the private fund space, side letters have been a hotly debated topic for decades. By entering into side letters with preferential terms, fund managers worry about breaching fiduciary duties obliging them to treat their clients fairly. Historically, to mitigate the risk of such claims, fund managers have included in offering materials or constituent documents of the funds they manage disclosure language noting that the fund and/or manager may enter into side letters that result in different investment terms applying to certain investors.

On February 9, 2022 the SEC proposed a number of significant new and amended rules under the Investment Advisers Act of 1940 focusing on private fund advisers. The public comment period for the proposal closed on June 13, 2022, and the SEC is expected to take final action on the rule in early 2023. The proposed rules are designed to enhance transparency and prohibit conflicts of interest. The rules cover a lot of ground and include enhanced quarterly reporting and annual audit requirements, prohibitions on certain fees and expenses, prohibition on certain provisions seeking indemnification, limited liability or clawback of carried interest net of taxes, prohibition on borrowing from private fund clients, and certain requirements for adviser-led secondaries. Among the proposed rules is a prohibition on investment advisers offering certain types of preferential liquidity and preferential information rights to a sub-set of investors if such differences would be expected to have a material, negative effect on certain investors. The proposal would also require investment advisers to disclose in detail other types of preferential terms being given to a subset of investors.

The preferential treatment rule, if adopted, could force private fund advisers to re-evaluate their practices, including the practice of having differing liquidity and information terms apply to fund investors. It could also prompt them to reconsider the level and type of disclosure they provide with respect to variance in investment terms.

Market participants have also raised concerns that the rule may create challenges for both fund advisers and investors. For example:

- Side letters are an essential tool used by institutional investors to ensure compliance with statutory, regulatory or governance protections. There is no carve-out under the proposed rule for investors that need to negotiate preferential withdrawal rights in order to comply with regulatory or statutory requirements.
- Certain investors (e.g., many public pension plans) may need the flexibility to divest when required to comply with internal portfolio concentration or other risk limits. Having different liquidity or transfer rights allow them to invest in less liquid investments in a manner that complies with such internal limits.
- Side letters are often used to incentivize seed or anchor investors to provide capital to support investment while the fund adviser continues to raise capital from external investors. This is particularly important for smaller and newly formed advisers and may create a significant barrier to entry into the market.
- The prohibition on preferential treatment regarding information rights could chill investments in private funds, and may have broader social impact. Not only will enhanced transparency impact investors who require a look-through analysis for their own risk management purposes or to meet their obligations under state or local law, but the prohibition could have broader implications for investors' general due diligence. The proposed rule could limit access to information by investors looking to promote diversity, equity and inclusion and/or environmental, social and governance investing.

Institutional advisers have raised objections that the proposed rule effectively regulates negotiations between private fund sponsors and private fund investors, and that such regulation is unnecessary as private fund investors tend to be highly sophisticated and well represented. Numerous comments from large, institutional, industry groups and law firms cited concerns that the lack of clarity as to what constitutes "preferential treatment," "reasonable belief" or "material, negative effect" make the proposed rule overbroad and difficult to implement, and likely to have a chilling effect on investors in private funds, including large, institutional investors. In addition, they have argued that the proposed rules, as written, could restrict competition, cause industry consolidation, deter new, entrepreneurial advisers from entering the market and limit an investor's ability to adequately due diligence its investment opportunities in private funds.

The final rule may differ materially from the proposed rule. Stay tuned for further updates once the final rule is published.

FFF Sovereign Immunity Series – Part V

February 3, 2023 | Issue No. 209



By Danyeale Chung
Partner | Fund Finance



By Michael Johnson
Associate | Fund Finance

We are back today to continue along with our tasting menu of state sovereign immunity. In our fifth installment in the series, we will visit Massachusetts, Michigan, Minnesota, Mississippi and Missouri. If you are new to the *FFF Sovereign Immunity Series*, the [first installment](#) in this series provides helpful background as well as links to additional *Fund Finance Friday* articles that cover sovereign immunity in general.

We are now in the thick of things, having analyzed sovereign immunity statutes and case law for roughly half of the states. As we mentioned in our previous installments [here](#), [here](#), [here](#) and [here](#), sovereign immunity is a complex topic warranting thorough examination on a state-by-state basis.

Let's dive in...

MASSACHUSETTS

Massachusetts has abolished contractual sovereign immunity by statute. M.G.L.A. 258 § 12 states, in relevant part, that claims against the Commonwealth may be enforced in the superior court. Relevant case law has interpreted the waiver of sovereign immunity as primarily applicable in action of contracts against the Commonwealth of Massachusetts.^[1]

MICHIGAN

Michigan does not have immunity from suit in actions arising out of contracts to which it is a party. In fact, the courts of Michigan have stated (somewhat emphatically) that “[Michigan] never had and does not have immunity from suit in actions arising out of contracts to which it is a party.”^[2] Plus one for the home team.

While the State of Michigan does not create a sovereign immunity issue per se, Michigan governmental investors and certain public investors have recently been receiving increased attention by our team and clients alike. Article IX, Section 18 of the Constitution of the State of Michigan provides that “[t]he credit of the state shall not be granted to, nor in aid of any person, association or corporation, public or private, except as authorized in this constitution.”^[3] Certain Michigan public and governmental investors tend to include a provision in their side letters relating to the Michigan Attorney General’s interpretation of this Section. The side letter may

provide that such investor cannot agree with the fund or the fund's lender to directly honor any request from such lender, including any requirement to fund capital contributions.

These side letter provisions can vary a great degree, while seemingly looking quite similar on their face. It is important for lenders and their lawyers alike to pay close attention to the particular language included in each side letter for these investors on a deal-by-deal basis to ensure the facility documentation adequately addresses any risks posed by such side letters.

MINNESOTA

Minnesota has waived sovereign immunity for certain contracts via statute.^[4] The statute makes specific reference to controversies arising out of a contract for work, services, the delivery of goods, debt obligations of the state incurred under article XI of the Minnesota Constitution, or revenue obligations of a retirement fund incurred under section 356B.10 entered into by a state agency through established procedure.

Even though fund finance facilities do not fall explicitly into any of the specifically enumerated categories above, Minnesota case law provides "Generally, sovereign immunity does not apply to contractual obligations."^[5]

MISSISSIPPI

Mississippi has waived sovereign immunity for express contracts, though not for implied terms of a contract. The courts in Mississippi have held that, "Sovereign immunity does not bar actions against the state or its political subdivisions brought on a breach of contract theory."^[6]

MISSOURI

Missouri does not recognize contractual sovereign immunity. Courts in Missouri have consistently held that sovereign immunity does not apply to breach of contract claims.^[7]

CONCLUSION

Since sovereign immunity and related issues can be nuanced and vary by investor, it is extremely important to consult counsel when sovereign immunity issues may be present in your deal. The Cadwalader team stands ready to assist. In our next installment, we will visit Montana, Nebraska, Nevada, New Hampshire and New Jersey. Please stay tuned.

^[1] *Mass Elec. Co. v. Athol One, Inc.*, 462 N.E.2d 1370, 1371 (Mass. 1984)

^[2] See *Davidson v. State*, 201 N.W.2d 296, 298 (Mich. Ct. App. 1972) (citing *Zynda v. Aeronautics Comm'n*, 125 N.W.2d 858 (Mich. 1964))

^[3] Const 1963, art 9, Sec 18

^[4] Minn. Stat. § 3.751.

^[5] *McDonough v. City of Rosemount*, 503 N.W.2d 493, 497; *City of Minneapolis v. Ames & Fischer Co. II, LLP*, 724 N.W.2d 749, 756 (Minn. App. 2006).

[6] *Churchill vs. Pearl River Basin Dev. Dist.*, 619 So.2d 900, 903 (Miss. 1993). See also *Cig Contractors v. Miss. State. Bldg. Comm'n*, 399 So.2d 1352 (Miss. 1981) stating “[W]here the state has lawfully entered into a business contract with an individual, the obligations and duties of the contract should be mutually binding an reciprocal.”

[7] *Kunzie v. Olivette*, 184 S.W.3d 570 (Mo. 2006); See also *Kublely v. Brooks*, 141 S.W.3d 21 (Mo. 2004); see also *Dicarolo Construction v. State*, 485 S.W.2d 52 (Mo. 1972).

Out of the PF Act Club and Into the Cold: When Would a Cayman Private Fund Be De-Registered?

February 3, 2023 | Issue No. 209



By Michael O'Connor
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As the Fontainebleau once again prepares for an influx of fund finance professionals to its restaurants and nightclubs, we got to thinking about another kind of club (those funds registered with CIMA under the Private Funds Act) and what it might take for one of those funds to have the equivalent of a Dwayne “The Rock” Johnson-sized bouncer come and take them out of that club (CIMA being the relevant 300lb bouncer here!).

Throughout all of the discussions from 2020 up until the present day, in relation to the Cayman Islands PF Act one of the common questions from lenders looking to analyse their risk was: *“What does a de-registration of a private fund by CIMA look like and when could it happen?”*

As with all questions relating to how and when a regulator might take action there is rarely an easy or conclusive answer, but this note attempts to provide some guidance on the issue based on our extensive experience advising clients in more heavily regulated sectors (such as the banking, (re)insurance and investment management/advisory sectors) regarding CIMA scrutiny and enforcement actions.

Prudential Regulation in Cayman – A (Very) Short History

One of the well-understood themes about Cayman funds (both hedge funds and private funds) is that the regulator (CIMA) has always taken a prudent but unintrusive approach to registration, regulation and de-registration of Cayman funds. This very much continues to be the case, but the global tide of increased regulation has also landed on Cayman’s shores in the past years and shows no sign of retreating. Accordingly, the likelihood of reviews by the regulator of funds and corresponding administrative fines or regulatory actions occurring has increased significantly in the past five years. While the PF Act remains a relatively new addition to the regulatory landscape and private funds have not yet featured in the more involved reviews by CIMA, if CIMA’s interactions with other sectors over the past few years is to be used

as a litmus test then it is safe to say that private funds will face increased focus in coming years regarding compliance with their continuing obligations under the PF Act.*

Why Does All of This Matter to Fund Finance Lenders?

As anyone who has had a Cayman fund in the middle of one of their deals over the past few years will be aware, Cayman private funds that are in-scope of the PF Act are required to be registered with CIMA in order to accept capital contributions. Given the ability to call for capital contributions from LPs is the core pillar of a lender's collateral package in a subscription finance deal, any regulatory issue that may render a call for capital contributions technically difficult or illegal (such as CIMA de-registering a fund for non-compliance and the fund then being unable to accept capital contributions) is of course pertinent to the lender's risk. As a result of this, almost all credit agreements with a Cayman nexus now contain an affirmative covenant of the borrowers to maintain the registration of the applicable Cayman funds together with a linked event of default if de-registration occurs while such a fund remains in-scope of the PF Act.

When Would CIMA De-register a Private Fund?

As noted above, there are no hard or fast rules for this, but the PF Act does specifically empower CIMA to cancel the registration of private funds that are failing to comply with the PF Act. In practise, however, the reality is that before de-registration by CIMA of a private fund would occur there would likely be an opportunity for such a fund to right the ship as, assuming CIMA follow the same process they do in other sectors, they would likely first issue a "breach notice" to the GP of the fund setting out the compliance failures and the timeline in which such failures must be corrected. Accordingly, in most scenarios in our experience, it would require a sustained pattern of non-compliance and/or failure to engage with CIMA in respect of breach notices before de-registration occurred. The easiest examples to give of issues that might lead to de-registration are: (i) failure to pay annual fees to CIMA over multiple years; and (ii) failure to file annual audited accounts or returns with CIMA on time or over a number of years. These are just the most obvious examples, however, and with the expansion of regulatory obligations for private funds that the PF Act introduced, it is entirely foreseeable that in the future other areas of focus may become as important to the regulator and as such be factors in a potential de-registration action.

Conclusion

The global tide of increased regulatory oversight of private funds has not missed the Cayman Islands, and we expect to see this theme continue in the coming years. While the PF Act is still a relatively new addition to the Cayman landscape and regulatory actions by CIMA to de-register a private fund are not something that is likely to be a common occurrence for now, the future focus of any regulator is hard to predict, and so we continue to advise our clients on the importance of comprehensive ongoing covenants in credit agreements regarding PF Act compliance.

**As a result of the increased regulatory scrutiny in other sectors (and predicted increased scrutiny in the private funds world) one of the more interesting developments to observe locally in Cayman over the past few years has been the proliferation of a new species to Cayman (being the regulatory lawyer). A decade ago the idea of a regulatory lawyer would have been*

about as useful as a Cayman ERISA or tax specialist, whereas now most large firms have at least one attorney focused solely on this area (at Conyers, we now have an entire group comprised of regulatory lawyers and compliance professionals who focus solely on advising our clients on these issues!).

Irish Investment Limited Partnerships – Updates on the Revamped Regime and Comparison to Non-Irish Limited Partnership Structures

February 3, 2023 | Issue No. 209



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We are often asked by clients and non-Irish law firms in the context of fund finance transactions about using fund structures established under the revamped Irish Investment Limited Partnership (“ILP”) regime, and, in particular, how ILPs compare to similar structures in other jurisdictions such as Lux SCSps and Cayman ELPs. We have set out a brief (and hopefully helpful) summary of these matters below.

Background to the revamped ILP Regime

The Irish regime for ILPs was re-designed in early 2021 to ensure that the ILP offers the features expected by managers employing credit, private equity, venture capital and real asset strategies, following successful engagement between industry, the Irish Department of Finance, the Irish Revenue Commissioners and the Central Bank of Ireland (the “Central Bank”). The significance of the re-designed ILP regime has been discussed by Matheson in a previous *Fund Finance Friday* article, which can be found [here](#). An overview of the key features of ILPs is also set out below.

Why the ILP is proving increasingly attractive to market participants

Ireland is an increasingly popular fund domicile for managers, with managers identifying regulatory conditions (including the speed to market afforded by the Central Bank’s 24-hour authorisation), legal and tax frameworks, and business conditions (such as ease of doing business, service culture and local expertise) as key reasons for this trend. 17 of the top 20

global managers (and over 560 managers in total) have fund operations in Ireland, and 40% of the world's alternative investment funds ("AIFs") are administered in Ireland.

More specifically, ILPs offer an Irish limited partner fund structure to managers and other market participants who already deal with limited partnerships in other jurisdictions.

What the increase in popularity of ILPs means for fund finance practitioners

Fund finance practitioners will need to have a solid understanding of the ILP regime in transaction structuring and execution, including with respect to ILP document due diligence, credit support packages and reflecting ILP structures in primary documentation.

The above would, of course, be the case for any fund structure (albeit in relation to the respective regimes of such structures). As such, in practical terms the differences between a financing involving an ILP and an Irish Collective Asset-management vehicle ("ICAV") or a variable capital investment company will not be drastic for non-Irish fund finance practitioners, with the key distinction being that the transaction will involve limited partnership agreements as opposed to subscription agreements.

ILPs in comparison to Lux SCSps and Cayman ELPs

As mentioned above, ILPs are increasingly aligned to limited partnership structures commonly used in other jurisdictions. A comparison of the key structural features of ILPs, Lux SCSps and Cayman ELPs is set out in the table below:

	Irish ILP	Lux SCSp	Cayman ELP
Constituted by Limited Partnership Agreement	✓	✓	✓
GP can be non-local	✓	X	✓
LP liability limited / white list of acceptable LP activities	✓	✓	✓
Umbrella structure with segregated liability	✓	X ^[1]	X
Unregulated GP	✓	✓	✓
Not subject to legal constraints and formalities applicable to corporations	✓	✓	✓
Broad range of LP default provisions	✓	✓	✓
No local annual tax	✓	X ^[2]	✓
No legal personality	✓	✓	✓
Access to EU AIFMD passport (if AIFM is EU)	✓	✓	X
Flexible return of capital provisions	✓	✓	✓
Re-domiciliation available	✓	✓	✓
Tax transparent	✓	✓	✓
Identity of LPs confidential	✓	✓	✓
Flexible LPA amendment	✓	✓	✓
Regulated	✓	X ^[3]	X

1. A Lux SCSp can be an umbrella and regulated, but only if it obtains RAIF status.
2. A Lux SCSp may be subject to Municipal Business Tax, if it carries out a “commercial activity” or Lux GP owns 5% or more of the SCSp.
3. A Lux SCSp can be an umbrella and regulated, but only if it obtains RAIF status.

Overview of the key features of ILPs

Structural Features

- ILPs are regulated AIFs, authorised by the Central Bank and constituted by a limited partnership agreement (“LPA”) with few mandatory provisions.
- An ILP has no separate legal personality, and the general partner (“GP”) is responsible for the management, control and operation of the ILP.

- The GP does not require a separate authorisation from the Central Bank and is not subject to any minimum capital requirements. Directors of the GP (or, where the GP is a partnership, the directors of the general partner of that partnership) must, however, comply with the Central Bank’s Fitness and Probity regime and be approved in advance by the Central Bank.
- The GP can be a corporate entity or partnership, domiciled inside or outside of Ireland.
- Limited partners (“LPs”) can be corporates, natural persons or partnerships. There is no upper limit on the number of LPs that can participate in an ILP and no minimum number either (single investor ILPs are permitted).
- Generally speaking, ILPs have no regulatory limits on leverage (save for loan origination funds). There is no requirement to spread risk – it is possible to have a single asset ILP.

LP Liability

- In general, each LP’s liability is limited to the amount of its capital contribution or commitment to the ILP unless the LP participates in the conduct of the business of an ILP. The ILP Act specifies certain activities (the “white list”) which will be deemed not to constitute participation by an LP in the business of an ILP.

EU Marketing Passport

- Where managed by an EU alternative investment fund manager (“AIFM”), ILPs can be marketed throughout the EU to “professional investors” within the meaning of MiFID II using the AIFMD marketing passport. Where managed by a non-EU AIFM or a registered AIFM, there is no AIFM marketing passport available and it can only be marketed under national private placement rules, where applicable.

Tax

An ILP is transparent for Irish tax purposes. No Irish stamp duty applies to the transfer, exchange or redemption of units in ILPs. An exemption from Irish VAT applies to management and administration services. Ireland has implemented the reverse hybrid rule (“RHR”) under ATAD in a flexible way, such that RHR issues do not arise in the case of tax-exempt investors, investors in nil tax jurisdictions or investors resident in jurisdictions which have a territorial basis of tax. In addition, investors are not automatically considered to be acting together, so an ILP can be established with a small number of investors without triggering any adverse RHR implications. There is also a RHR exemption for widely held and diversified ILPs.

Matheson’s Fund Finance Team

Matheson has advised both lenders and managers in relation to some of the first ILP fund finance transactions to have taken place in the market, and is well placed to advise clients and non-Irish law firms in relation to transactions involving ILPs, or indeed, on any other Irish fund finance transactions. For further information about Matheson’s Fund Finance practice, please see [here](#).

The article was co-authored by [Alan Keating](#), [Donal O’Donovan](#), [Finnbahr Boyle](#), Sherilyn Deane and [Turlough Galvin](#) of the Finance and Capital Markets Department at Matheson, alongside

Michelle Ridge of the Asset Management and Investment Funds Group at Matheson. For further information, please contact any one of them or your usual Matheson contact.

RBS Predicts Fund Finance Trends for 2023

February 3, 2023 | Issue No. 209

While rising interest rates and other market data lead us to believe there will be a slowdown in fundraising, this challenging market could make opportunities in the secondary market more attractive. To cope with today's market volatility, lenders are capitalizing on smaller facilities with more flexibility to react to the different borrower profile they're seeing. Borrowers, on the other hand, are taking a more proactive approach by looking at other creative solutions, such as bespoke sub lines, hybrids and NAV lines, and even continuing step-profile fundraising to get new vehicles off the ground. Read more of what RBS believes 2023 might hold in store [here](#).

KBRA: 'NAVigating the Resilience of NAV Loans'

February 3, 2023 | Issue No. 209

KBRA has produced a report, "NAVigating the Resilience of NAV Loans," that discusses the rise of NAV loans in the private equity industry, some contributing tailwinds to this recent growth, their anticipated performance amid headwinds, and KBRA's own NAV loan exposure. The report is available [here](#) (free login required.)

Private Debt Investor's 'LP Perspectives 2023 Study'

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Check out *Private Debt Investor's* "LP Perspectives 2023 Study" for a deep dive into current investor sentiment. The annual investor [survey](#) covers topics ranging from investment strategies, allocation concerns, views on emerging managers, ESG and even the LIBOR transition.

Walkers 'We Talk Banking & Finance' Podcast Featuring FFA's Jeff Johnston

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With the Global Fund Finance Symposium in Miami less than a week away, Walkers' Julia Keppe and Alice Wight talk to Fund Finance Association Chair Jeff Johnston about what to expect from the year's biggest event for the Fund Finance sector. Tune in [here](#).

SJL Jimenez Lunz – ‘A Look at Fund Finance in Luxembourg 2022’

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Partner Antoine Fortier Grethen of Lux law firm SJL Jimenez Lunz shared his insights in a new [article](#) on the Lux fund finance market in 2022, including trends and developments and the impact of recent legislative changes.

Fund Finance Hiring

February 3, 2023 | Issue No. 209

Fund Finance Hiring

SVB is looking to hire a Fund Finance Portfolio Manager, Vice President II. For more info, visit [here](#).

Cadwalader Welcomes New Team Focused on Leveraged Finance, Private Credit and Special Situations

February 3, 2023 | Issue No. 209



**(L-R) Ronald Lovelace, Joseph Polonsky,
Patrick Yingling and Jared Zajac**

We are delighted to announce the arrival of partners Ronald Lovelace, Patrick Yingling, Jared Zajac and Joseph Polonsky, substantially enhancing the firm’s leveraged finance, private credit and special situations capabilities. The team joins from King & Spalding and will be resident in our Charlotte office.

This represents another step – along with the recent hire of financial restructuring partner Mike Rupe and the addition of Matthew Smith and Bevis Metcalfe in London – in building out a market-leading middle-market leveraged finance, private credit and special situations practice. The new team will expand the firm’s ability to provide counsel on creditor-side restructuring and special situations work and will expand our existing capabilities in, among other areas, asset based lending, warehouse finance and NAV lending.

Ron joins the firm as Head of Leveraged Finance. He focuses on leveraged finance and other syndicated lending transactions, with significant middle-market acquisition finance and robust workout and special situations experience. He is recognized as a leading finance lawyer in North Carolina by *Chambers USA*, which describes his “strong reputation for his handling of acquisition finance, working capital finance and wider asset-based lending transactions on behalf of lenders and borrowers [with] additional expertise in restructuring and workout matters.”

Patrick focuses on leveraged finance and other syndicated lending transactions. He advises financial institutions, other lenders and borrowers on a wide range of financing transactions, including syndicated credit facilities on both a leveraged and investment-grade basis, first-

lien/second-lien arrangements, acquisition financings, recapitalizations and cross-border facilities.

Jared represents financial institutions, investment funds, lenders, and borrowers in leveraged finance, acquisition financings, first- and second-lien financings, syndicated credit facilities, and debtor-in-possession (“DIP”) financings. He also has an extensive financial restructuring background, having spent a number of years at Proskauer Rose advising on bankruptcy and restructuring engagements, with particular experience advising on DIP financings.

Joey advises banks, private credit funds and other financial institutions that provide companies with the liquidity necessary to make acquisitions, refinance existing debt, make dividends to equity holders, and restructure their balance sheets. He works closely with public companies, large-cap companies, sponsor-backed companies and privately held companies on how to structure complicated financings and debt & equity restructurings, including for first-lien and second-lien financings, asset-backed financings, unitranche financings, FILO financings, unsecured financings, and DIP financings.