CADWALADER

FUND FINANCE FRIDAY

Springing into Q2

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FFF Sovereign Immunity Series – Part VIII: England & Wales

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By Samantha Hutchinson
Partner | Fund Finance

By Laurence Sappa Cohen
Associate

By Jonathan Byrne-Leitch
Associate

For our eighth installment in the *FFF Sovereign Immunity Series*, we consider the doctrine of sovereign immunity in England & Wales.

We begin with our usual disclaimer that sovereign immunity is a complex legal and tax issue, and it is vital that legal advice is sought when considering its implications. This article provides a high-level summary of the doctrine under the laws of England & Wales (or, in the case of taxation, the United Kingdom) and each sovereign entity's status must be analysed on a case-by-case basis.

Sovereign immunity under English law

Sovereign immunity is the principle that a state (whether the sovereign, the government, a department of the government or any separate entity acting under sovereign authority) can claim immunity from enforcement action on the grounds that the counterparty does not have jurisdiction over it. In other words, a state actor should not be judged by the laws of another state.

Under English law, different rules determine whether (i) a dispute involving a state entity can be adjudicated and (ii) the judgment arising from that adjudication can be enforced.

Immunity from adjudication

The general principle is that the UK courts have no jurisdiction to adjudicate disputes against sovereign entities unless one or more of the following exceptions applies:

- the state entity has submitted to the jurisdiction of the English courts (*e.g.*, by prior written agreement or by submitting to the jurisdiction after a claim has been brought);
- the proceedings relate to a contractual obligation on the state that is to be performed wholly or substantially in the UK;

- the state entity has agreed to submit to arbitration (*e.g.*, through an arbitration provision in a contract); or
- the proceedings relate to a commercial transaction entered into by the state entity (*e.g.*, a financing transaction).

Immunity from enforcement

Under English law, a party can be prevented from obtaining an injunction against a state entity and enforcing any judgment or arbitration award against the property of such entity. This principle, again, is subject to certain exceptions, as follows:

- the state entity provides its written consent to any relief or process (*e.g.*, an explicit waiver of immunity as to enforcement); and
- with specific reference to judgments or arbitration awards, such judgments or awards may be enforced against property that is in use or intended for use for commercial purposes.

While this article focuses on the English law approach to sovereign immunity, a lender should consider the jurisdiction in which proceedings are brought, as well as the governing law elected by the parties in their agreements. In addition, the rules of all the jurisdictions where that sovereign entity has significant assets or where courts may have jurisdiction over it may also be relevant.

Concern for lenders under subscription credit facilities

When a state-linked investor (such as a sovereign wealth fund or governmental pension plan) subscribes to a fund, they may also enter into a side letter with the general partner and/or manager of the fund. The side letter will often vary the general terms of the fund's limited partnership agreement (LPA) and may contain a provision under which the investor claims rights to immunity from adjudication and/or enforcement.

As part of the security package, a lender under a subscription credit facility will typically take an assignment of the borrower/general partner/manager's rights under the LPA to call and receive capital from investors and enforce all rights in respect thereof. In an enforcement scenario, therefore, a security agent (or the lender in a bilateral facility) may look to directly or via a receiver step into the shoes of the borrower/general partner/manager and issue capital call notices to investors directly. If an investor fails to comply with such capital call notice and the security agent/lender chooses to take enforcement action in respect of that investor, it will first need to obtain a judgment against that investor for a failure to comply with its obligations under the LPA. If that investor has entered into a side letter claiming sovereign immunity, the terms of that provision will need to be carefully analysed in order to determine its impact on both the ability to obtain a judgment against that investor as well as the enforceability of that claim against the investor/its assets.

Key considerations

In all subscription credit facilities, lender's counsel should review the applicable LPA(s), subscription agreements and side letters in order to advise as to whether immunity is relevant to an investor. We set out below some of the key considerations that we would expect as part of the review, noting again that this analysis is in respect of the position under English law only:

- **Does the LPA contain a waiver of immunity?** If the answer to this question is yes and an investor has not separately agreed in a side letter to retain its rights to immunity, then in many jurisdictions this will operate as an effective waiver of sovereign immunity rights. If the LPA does not contain any such waiver, an investor may still have implicitly waived its immunity by virtue of the exceptions described above.
- **Does the waiver of immunity in the LPA apply in respect of "adjudication" and "enforcement"?** If an investor waives its immunity in respect of "adjudication" (*i.e.*, immunity from a judgment being issued against it following a failure to fund a capital call) and "enforcement" (*i.e.*, following the obtaining of a judgment, the enforcement of that judgment against the assets of the investor), this should operate to permit a security agent/lender to bring a claim and enforce its judgment against the assets of an investor. However, if the waiver does not apply with respect to both "adjudication" and "enforcement," a security agent/lender may be able to obtain a judgment against an investor but unable to enforce against all or any of its assets.
- **Has an investor expressly reserved its rights to immunity from "adjudication" and/or "enforcement" in a side letter?** If a side letter does not contain any such provision, the position will depend on any waiver in the LPA, as well as whether the exceptions referred to above apply. If a side letter does contain an immunity provision, consider whether the provision also contains mitigating language. In some cases, an immunity clause will be accompanied by language clarifying that the reservation of immunity is not intended to limit the investor's obligations to fund its commitments under the LPA. Such language should provide comfort to lenders, as it will make it more difficult for an investor to refuse to fund commitments if there is a clear agreement to comply with its obligations under the LPA. Mitigating language can, however, provide varying levels of comfort depending on its precise wording and, as mentioned above, it is vital that legal advice is sought in each instance.

It is worth noting that even where an investor has retained its immunity rights in this type of situation, failure to comply with a capital call would likely cause that investor severe reputational damage, particularly given the vast usage of subscription facilities across the private markets globally.

Sovereign immunity from UK direct taxation

Sovereign immunity from UK direct taxation reflects an international law principle that one sovereign state should not seek to apply its law to another sovereign state. This doctrine has been developed in the UK by case law and HM Revenue & Customs (HMRC) practice.

This means that, broadly, sovereign persons are exempt from UK direct taxes (*i.e.*, income tax, capital gains tax and corporation tax) on all UK-source income and gains from their commercial activities. Therefore, UK-source interest payable to a sovereign immune person should be exempt from UK withholding tax.

Additionally, under the UK tax legislation, eligible sovereign investors are treated as "Qualifying Investors" (for the purposes of the real estate investment trust (REIT) regime and the qualifying asset holding company (QAHC) regime) and as "Qualifying Institutional Investors" (for the purposes of the substantial shareholding exemption from corporation tax on chargeable gains). The aim is to encourage certain institutional investors to invest into the UK by allowing them to benefit from these tax regimes, while permitting sovereign investors to invest alongside them.

HMRC is responsible for assessing the availability of sovereign immunity. Decisions are made on a case-by-case by reference to the particular applicant's circumstances.

In July 2022, the UK government launched a consultation to "modernise and improve the tax treatment it provides to foreign sovereign investors, such as heads of state and sovereign wealth funds." However, the UK government announced at the Budget 2023 that the position was reversed. In other words, the UK government decided that there will be no change to the current exemption, and that it will continue to operate as it does now.

Conclusion

Care must be taken during the diligence process to understand which investors in a fund have elected to retain sovereign immunity rights and exactly which rights those are. Lenders should consider (i) the terms, including the governing law, of the LPA, subscription agreements and side letters, (ii) the type of investor and their identity and (iii) the jurisdiction in which that investor is incorporated.

Lender's counsel should review all applicable constituent documents to determine whether there is a waiver or any mitigating language and, in the latter case, the extent to which it provides comfort around the investor's obligations under the LPA.

Depending on the commercial agreement between a lender and the fund, a lender may be able to take advantage of certain protections, including removing investors from the borrowing base or conducting a more detailed analysis of the investors in question. A lender may take further comfort from a sovereign investor's track record of funding and the commercial risk associated with failing to fund a capital call.

It is welcoming that the UK government decided to retain the relatively generous rules for sovereign immunity from UK direct taxation. Funds that are within the QAHC regime or the REIT regime or that intend to benefit from the UK substantial shareholding exemption can be assured that eligible sovereign investors will continue to be treated as "Qualifying Investors" or "Qualifying Institutional Investors," as applicable. A sovereign immune lender can continue to have their UK-source interest exempt from UK withholding tax (and other UK direct taxes). However, as mentioned above, decisions on the availability of sovereign immunity are made by HMRC on a case-by-case basis, so care must be taken to determine a sovereign investor's tax status.

LIBOR Transition Update: Synthetic LIBOR Is Here

April 14, 2023

By Leah Edelboim
Partner | Fund Finance

By Jeffrey Nagle
Partner | Finance

Back in March of 2021, we covered a number of developments pertaining to the end of LIBOR that came out of certain announcements made early that month by the Intercontinental Exchange Benchmark Administration (the “IBA”), which is the administrator of LIBOR. In those announcements, the IBA stated that it would cease publication of certain LIBOR settings on certain dates. In those same announcements, the IBA noted that its regulator, the UK Financial Conduct Authority (the “FCA”), could potentially require the IBA to publish certain LIBOR tenors on a synthetic basis.

Recently, as has been long signaled, the FCA announced that it would indeed require IBA to publish an unrepresentative synthetic USD LIBOR for 1-, 3- and 6-month tenors for an additional year, which is expected to be further extended through September 30, 2024. It has come at a time when we continue to be in the thick of LIBOR transition amendments in our fund finance deals, as June 30, 2023 − the last date of publication of representative USD LIBOR − is quickly approaching. Given this dynamic, the FCA announcement has created some confusion in the fund finance market – and in the broader loan markets. Here we explain the dynamics at work and what it means for fund finance deals.

What is Synthetic USD LIBOR and why was it published?

Synthetic LIBOR as a benchmark will be calculated on the basis of CME Term SOFR plus the standard ARRC/ISDA spread adjustments for 1-month, 3-month, and 6-month tenors. This means that synthetic LIBOR is the same rate that is used for deals that have standard ARRC hardwired fallback language, as well as for deals that transition pursuant to the LIBOR Act, which is discussed below.

The FCA’s intention in requiring the IBA to publish synthetic LIBOR is to give the parties to certain contracts described below additional time to transition their deal documents, or for these deals to mature according to their terms.

Synthetic LIBOR has been put in place to be used for legacy contracts that have no other means of transitioning. These contracts are largely agreements that are governed by non-U.S. law that reference USD LIBOR and lack any fallback or transition mechanism. As we discuss below, U.S. deals that fit certain criteria would be transitioned pursuant to their terms or, pursuant to the LIBOR Act, rather than using synthetic USD LIBOR.

What does this mean for the fund finance market?

In the fund finance corner of the loan market, synthetic LIBOR is not expected to affect the vast majority of deals for a couple of reasons.

First, most of our deals do not have very long tenors and, as such, the documentation is generally up to date and the deals that have not yet been remediated at least contemplate the end of LIBOR with some version of ARRC-recommended benchmark transition language (there have been several iterations over the years). These deals will specifically say that LIBOR ceasing to be representative (*i.e.*, publication of synthetic LIBOR) would constitute a benchmark transition event. On June 30, 2023, LIBOR will no longer be representative. This means that any deal document that has ARRC or ARRC-like language will transition because there is a trigger in the loan agreement for the instance where LIBOR is not representative.

Second, the result under contracts that do not contain any ARRC or ARRC-like language will depend on the language of the deal documents themselves. LIBOR-based loan agreements that pre-date any ARRC transition language still typically contemplate unavailability of "LIBOR."

Whether publication of synthetic LIBOR means that "LIBOR" is "unavailable" will depend on the specific language in a document. Most formulations of the definition of "LIBOR" include language that could make it challenging, from a contractual perspective, to argue that synthetic LIBOR is an available "LIBOR." In these circumstances, it is important to analyze closely, in coordination with your legal counsel, whether the publication of synthetic LIBOR constitutes a transition event.

What about the LIBOR Act?

The LIBOR Act has been similarly confusing to market participants. On March 15, 2022, the Adjustable Interest Rate (LIBOR) Act was signed into law. This federal law provides a means for transitioning legacy contracts that either lack or have insufficient provisions to address the end of LIBOR. Given that it is a federal law, the LIBOR Act and the regulations promulgated pursuant to the law supersede any state or local laws related to the same subject matter. This helps to create greater certainty and uniformity in the market for the contracts to which it applies.

The deals to which the LIBOR Act most readily apply are deals governed by U.S. law with no fallback language. The law serves to provide a means for these challenging legacy contracts to transition to a replacement benchmark. The law also contains a means by which certain conforming and operational changes related to the replacement benchmark can be made without the need for consent by the parties to the agreement.

What fund finance market participants most need to know here is that because most fund finance deals, even from many years ago, contain fallbacks to non-LIBOR rates (*e.g.*, prime or federal funds), these contracts would be <u>out of scope</u> for the primary transition provisions of the LIBOR Act. Market participants should not rely on the LIBOR Act except under certain, expected to be limited, circumstances.

What else do I need to do?

Keep in mind that even if you have an agreement with hardwired fallback, while June 30, 2023 will be a benchmark transition event under the terms of the deal, you will almost always need a conforming changes amendment. The credit agreement contemplates what the benchmark will be but it lacks, among other things, certain definitions and operative provisions pertaining to the benchmark transition. The amendment for these provisions does not typically require affirmative or negative consent by the borrower or syndicate members, but rather the agent or lender has the authority to send out the changes.

Keep going!

The bottom line is that synthetic LIBOR and the LIBOR Act are not primarily intended for deals like the ones we see in the fund finance market. There is, unfortunately, no magic bullet to this benchmark transition. And June 30th is quickly approaching! So keep those transition amendments going and, if you have any questions about your deal documents, contact your friendly Cadwalader lawyer. We are here to help.

KBRA Assesses Subscription Facilities in Light of Market Challenges

April 14, 2023

Kroll Bond Rating Agency (KBRA) examines its portfolio of rated subscriptions facilities in a report published this week. The report reviews KBRA's $11.3 billion of rated debt portfolio spanning over 40 funds and over 30 asset managers in light of the litany of challenges in 2023, including a potential recession, weakening private investment valuations, and challenged fund performance.

Find the full report here: ***Funds: Subscription Facilities in Focus***.

PEI Digs into Continuation Fund Finance

April 14, 2023

Significant growth in continuation funds is creating opportunities for specialized fund financing vehicles, according to a recent report by PEI. Single-transaction, commitment-backed facilities, hybrids, and NAV deals have all found specialized applications. But while the current investment landscape supports the need for financing, the optimal configuration of asset-level, fund-level, and investor-level financing can be a bit of a puzzle.

More on that in ***Hybrids and NAV loans offer unique uses in continuation funds***.

Fund Finance Webinar to Focus on 'Mastering Secondaries'

April 14, 2023

"Mastering Secondaries" will be the theme of the next installment of the Fund Finance webinar series hosted by Michael Mbayi of Pinsent Masons Luxembourg on Thursday, April 20 at 4 p.m. (CET).

Joining Michael, who hosts this webinar series, will be the following:

- Samantha Hutchinson, Partner, Cadwalader, Wickersham & Taft LLP
- Stuart Ingledew, Fund Solutions, Investec
- Leon Stephenson, Partner, Reed Smith LLP
- James York, Head of Investor Backed & GP Financing, NatWest Markets Plc
- David Young, Partner, Pinsent Masons

Michael and the panelists will discuss the structuring of secondaries transactions and the fund finance solutions available in this context and for the secondary funds. There will be a fund finance market update as well.

Register **here**.

Fund Finance Hiring

April 14, 2023

Fund Finance Hiring

State Street is looking for an Assistant Vice President, Fund Finance in Boston and a Vice President, Credit Services in Boston or Charlotte.

- The Assistant Vice President will be responsible for, among other responsibilities, due diligence process and underwriting of capital call credit facilities to private equity funds; the presentation and defense of credit recommendations; maintenance of up-to-date approvals, risk ratings as well as credit and legal files; addressing requests for information from Enterprise Risk Management, internal audit and bank examiners; and working with Loan Operations and customers as appropriate to facilitate operational aspects of credit relationship. Click **here** for additional information.
- The Vice President role will include, among other responsibilities, growing and managing a portfolio of fund level credit facilities to alternative investments funds; working closely with Alts Sales and Relationship Management teams to identify and develop cross-sell opportunities and ensure client retention; managing due diligence process and underwriting of subscription credit facilities, including legal documentation; presenting and liaising with respective deal committees and stakeholders internally such as operations, legal, risk management, etc.; networking within the fund finance and alternative investment management industries to promote and strengthen State Street's reputation; and providing effective portfolio oversight and management reporting in accordance with State Street risk framework. Click **here** for additional information.

Avardi Partners, a leading fund finance advisory practice, is looking to hire multiple candidates in London, from analyst to vice president. If you have up to eight years of experience in fund finance and are interested in joining our fast-growing firm, please get in touch. To apply, please visit **here**.

Intesa Sanpaolo IMI CIB is looking for a VP role to join the Fund Financing desk at Intesa Sanpaolo Bank Luxembourg. The candidate will be responsible for the structuring and execution of FF deals, together with a fast-growing team. Visit **here** for more information and to apply.