



FUND FINANCE FRIDAY

Moving into May

April 28, 2023

Table of Contents:

- **A Lender's Perspective on Special Purpose Entities, Alternative Investment Vehicles and Qualified Borrowers**
- **FFF Sovereign Immunity Series – Part IX**
- **The Risk of De-Reg to the Pledge: Considerations for Lenders When Negotiating Private Funds Act Grace Periods**
- **Inaugural WFF Chicago Event Announced**
- **Cadwalader Welcomes Susan Bumgardner in New York**
- **Welcoming Our New Leveraged Finance & Private Credit Partner: Smridhi Gulati**

A Lender's Perspective on Special Purpose Entities, Alternative Investment Vehicles and Qualified Borrowers

April 28, 2023



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In order for fund credit parties to maintain flexibility for investments and meet the changing requirements of investor requirements (tax, ERISA, etc.), they often need to establish multiple investment vehicles to accommodate those requirements. When putting in place a subscription credit facility, a fund borrower (the “Main Fund”) must remain mindful of how the establishment of alternative or subsidiary entities could impact a lender’s security under the credit facility – namely, direct access to the uncalled capital of the Main Fund’s investors. From a lender’s perspective, in order for it to retain its security interest, there will be covenants requiring the Main Fund and other obligors to ensure that the lender has direct access to the commitments of the Main Fund’s investors and also to ensure that the called capital is paid into an account over which the lender has a security interest. In order for that to occur when using multiple investment vehicles, the primary lender concern surrounds making sure that commitments are not redirected into vehicles outside of the lender’s collateral reach. This article touches on some of the options that a Main Fund borrower has when setting up these additional vehicles together with what a lender needs or expects as a result of each approach.

What is a Special Purpose Entity?

What is a multiple investment vehicle and/or special purpose entity? In credit agreements, the term typically used is special purpose entity (“SPE”), and they are often defined as “an entity that holds portfolio investments of or on behalf of, or which are otherwise beneficially owned directly or indirectly by, or controlled by, a borrower under the subscription credit facility.” As noted above, SPEs are not a creation of the lender, but instead, created by the fund as a means to manage their investment portfolio and the various businesses within that portfolio. SPEs generally do not show up on the Main Fund’s balance sheet and operate as an individual entity. For example, if the Main Fund is buying ABC Manufacturing, this portfolio investment will likely occur via one or more intervening SPEs ultimately owned by the Main Fund – e.g., the Main Fund will not typically own the equity of ABC Manufacturing directly. When used in the credit agreement context, SPEs generally refers to entities below the Main Fund on a structure chart.

What is an Alternative Investment Vehicle?

What is an alternative investment vehicle? In credit agreements, alternative investment vehicles (“AIV”) are often defined as “any entity other than a Main Fund/general partner of the Main Fund under the credit facility that has the right to enforce any capital commitment or to otherwise call, demand or receive any callable capital or capital contribution proceeds.” While AIVs are separate legal entities like SPEs, AIVs are distinguished by having the right to call capital from the investors of the Main Fund. Alternative investment vehicles can be set up for a variety of reasons, including tax, ERISA, etc. For example, a fund may offer to certain tax-exempt or foreign investors the ability to contribute capital to the AIV rather than to the main fund to avoid tax issues resulting from an investment in a particular jurisdiction.

For clarity, there is a subset of AIVs that are often referred to as feeder AIVs (“Feeder AIV”) but are different than the AIVs contemplated above. A Feeder AIV is an investment vehicle that pools capital commitments of investors separately and invests directly (or indirectly) into the Main Fund. When used in the credit agreement context, Feeder AIVs generally refer to entities above the Main Fund on a structure chart. Rather than making investments directly into the SPE portfolio investment, the Feeder AIV “feeds” its capital commitments into the Main Fund vehicle, with the Main Fund ultimately using all of the capital to make the portfolio investments directly. Whether for tax, legal or other regulatory issues, Feeder AIVs often contribute to a “blocker” entity first rather than directly to the Main Fund vehicle, but the main distinguishing factor is that a Feeder AIV does not make portfolio investments of its own.

What is a Parallel Fund?

What is a parallel fund? A Parallel Fund is another entity type that will frequently appear on a fund structure chart. In credit agreements, parallel funds (“Parallel Fund”) aren’t often defined (for the reasons discussed below) but are generally referred to as an investment vehicle that will invest proportionately in portfolio investments at the same time and on the same terms as the main fund vehicle, and will typically share proportionately in expenses. The ability for the Main Fund to offer investors in the Parallel Fund the same terms depends on applicable tax, regulatory and legal concerns. The ultimate goal is for the Parallel Fund to invest “side-by-side” with the Main Fund. When used in the credit agreement context, a Parallel Fund generally refers to entities to the side of the Main Fund (brother/sister entity to the Main Fund) on a structure chart.

AIVs and Parallel Funds can be confused, since they are essentially doing the same thing – *i.e.*, making direct SPE portfolio investments. From the perspective of the source of funds, while an AIV’s funds are typically coming from the same investors in the Main Fund, the funds to a Parallel Fund are coming from a different set of investors. Further, different from an AIV, a Parallel Fund typically invests “parallel” to the Main Fund for the life of the fund, on a pro-rata basis and on the same terms. An AIV isn’t generally established to invest “side-by-side” but rather to make specific investments for tax purposes, regulatory reasons and legal issues. One example of a Parallel Fund is an “employee, friends and family fund” that may have an agreement with the Main Fund that allows for its Parallel Fund to invest “side-by-side” for up to a certain percentage of the overall portfolio investment.

A Lender’s Perspective

Since the lender’s primary focus from a collateral perspective is on direct access to the uncalled capital of the investors in the Main Fund, the requirements imposed by a lender under

a credit facility vary depending upon whether the entity is an SPE, AIV or Parallel Fund.

For the most part, Parallel Funds are irrelevant to a lender and are not governed by a credit agreement, since, from a credit standpoint, they are not entitled to the uncalled capital of the Main Fund and thus are essentially unrelated to the Main Fund. The only exception would be if the Main Fund would be seeking borrowing base credit for a Parallel Fund, which, as well as other issues, would raise multiple questions as to the joint and several nature of the obligations that would need to be addressed.

As noted above, since SPEs mostly fall below the Main Fund on a structure chart and are not directly entitled to the uncalled capital of the Main Fund, they are less regulated by a lender under a credit facility. But that is not to say they are universally ignored, since, depending on the credit profile, some lenders may require that SPEs are subject to additional requirements, such as financial reporting or even a net asset value test with respect to one or more SPE's/portfolio investments owed by the Main Fund.

On the other hand, since an AIV is entitled to the uncalled capital of the Main Fund (the collateral of the Main Fund), an AIV must be joined to a credit facility – or an alternative credit chain must be established via a “cascading pledge” to give the lender direct access to the uncalled capital of the investors to the AIV. For all intents and purposes, if any entity in the structure of the Main Fund has access to the uncalled capital of the investors, that entity will be viewed no differently than the Main Fund. As a result, as a distinct legal entity, an AIV with the ability to call capital will require the same level of diligence as the Main Fund and the same security package as well, which introduces additional cost in the form of regular diligence, UCC filings, legal opinions, etc.

What is a Qualified Borrower?

What is a qualified borrower? While not an AIV or a Parallel Fund, there is another lending structure that can be utilized by a lender and a Main Fund to get funds to an SPE portfolio investment. This avenue avoids having the Main Fund making either an equity investment or interfund loan by the Main Fund to get needed capital to its SPE. In credit agreements, qualified borrowers (“QB”) are often defined as “an entity in which a borrower or another credit party owns a direct or indirect ownership interest, or through which the borrower or another credit party may acquire an investment, the indebtedness of which entity can be guaranteed by such borrower under their constituent documents.” From a credit perspective, the QB structure isn't much different from a lender making a loan to the Main Fund directly. There is still a loan, but the loan is made directly to the SPE/QB of the Main Fund instead of to the Main Fund itself. The loan to the QB is not secured by the assets of the QB or the uncalled capital of the QB (since it doesn't have any uncalled capital), but it is secured by a guaranty of the Main Fund, which is no different than any other loan to the Main Fund, since each loan is secured by the unfunded capital commitments of the investors of the Main Fund and the collateral accounts into which capital is called.

Apart from likely tax benefits for the deductibility of interest expense by the QB (something that wouldn't be available if the capital was provided via a debt or equity contribution by the Main Fund to the QB), the QB alternative allows for capital to be received by a QB without the diligence requirements associated with an AIV. This often allows for a QB to quickly meet its

capital needs for transactions on a short timeline, reducing administrative and organizational burdens on the Main Fund.

While a QB requires less deliverables than an AIV joining a credit facility, there are still organizational and legal costs, since the QB will be required to deliver certain deliverables, such as execution of a promissory note, formation documents, and resolutions authorizing borrowings. However, unlike an AIV, a QB will not be required to deliver a full security package because the lenders are relying on the underlying guaranty from the Main Fund. Apart from the execution efficiencies, QB loans have the added benefit of allowing a QB to borrow pursuant to the same terms (interest rate, etc.) as the Main Fund – which likely would be at a much lower interest rate, since the lenders are relying on the credit support from the Main Fund via the guaranty, not the credit profile of the QB. Further, a QB is usually not subject to financial covenants connected to its financial performance.

Of course, no different than a loan to the Main Fund, borrowings by a QB reduce availability under the credit facility. From a formation document perspective, as a part of the diligence process, the borrowing fund's formation documents may place limitations on the ability to provide blanket guarantees of debt (e.g., the fund's limited partnership agreement might place a direct constraint on giving guaranties or an indirect restriction on guaranties as part of its overall leverage limitations). The limitations may also be in the form of leverage limitation percentages or clean-down periods for any debt of a qualified borrower that is being guaranteed.

Conclusion

Fund borrowers and lenders are constantly trying to accommodate each other's needs to not only provide funds with the structural flexibility to run their business but also give the lenders essentially the same credit support and protections they would have in a "vanilla" fund structure. The alternatives discussed above are just some examples of the type of accommodations that fund borrowers and lenders have worked together to provide the "win/win" that each desires. While the first time through an alternative structure may seem complicated or even overwhelming, rest easy. The market, with respect to multiple investment vehicles, has become quite sophisticated and, as a result, the process has become somewhat routine – so long as the players involved understand that, from a lender's perspective, the point is to get to the same credit support structure as they would see in a "vanilla" fund structure.

FFF Sovereign Immunity Series – Part IX

April 28, 2023



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Fund Finance Friday: U.S. States Sovereign Immunity Series



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Today we release the ninth installment of our Sovereign Immunity Series. In this installment we cover Oklahoma, Oregon, Pennsylvania, Rhode Island and South Carolina to give you a high-level overview of sovereign immunity in each of these states.

As we have mentioned before, this is a complicated legal issue. [Here](#) is a link to the first installment of this series, which gives a good background on sovereign immunity and provides links to previous *Fund Finance Friday* articles on the subject. As a reminder, sovereign immunity refers to a doctrine that renders a sovereign or state immune from civil suits or criminal prosecution and basically means that the government cannot be sued without its consent. Although sovereign immunity has been adopted in the United States Constitution pursuant to the Eleventh Amendment, the extent to which it has been codified into law – and the exceptions to those laws – varies from state to state – hence, our coverage of the issue broken down by state.

This issue most commonly arises in fund finance deals in the context of limited partners that are government entities, such as state pension funds. These investors will often reserve their sovereign immunity in a side letter. However, there is further nuance, as applicable laws and certain principles of equity are applied to determine whether a particular entity is actually immune from suit.

Again, we want to stress that these issues can be quite nuanced and vary deal to deal, so it is important to consult counsel when these issues arise in a transaction. Additionally, please note that the information herein is only summary in nature and a deeper analysis is warranted when evaluating a particular investor.

OKLAHOMA

Oklahoma has waived its sovereign immunity with respect to contract claims. This means that in the presence of a valid contract, a party may bring an action against the state to enforce the terms of that contract. Case law in Oklahoma confirms that “sovereign immunity is not a shield to actions based upon the contractual obligations of a state entity.”^[1]

OREGON

Oregon has also waived its sovereign immunity, but it is more limited, as sovereign immunity is only waived when the state agency is acting “within the scope of its authority.” Therefore, if a contract exceeds the scope of the agency’s authority, a party will not have any right to damages under that contract.^[2] State law puts the burden on those having dealings with the state to ascertain the extent of the state’s authority. In other words, a court will only enforce a contract against the state of Oregon if the state agency was authorized to enter into the contract in the first place.

From a fund finance perspective, most relevant to this discussion are dealings with a state pension fund. In Oregon, the power to invest the funds in the Public Employees Retirement Fund is granted to the Oregon Investment Council (the “Council”).^[3] Likely, contracts in the fund finance context will be entered into by the Council itself. We note that the state statute expressly lists the kind of investments the Council is permitted to make under Oregon law. Further, certain types of investments have been approved by the Attorney General by Opinion. To add another layer, prior to a contract becoming binding on the state, the Attorney General of Oregon must approve all contracts entered into by a state agency that would provide for payment of over \$100,000 unless the Attorney General has exempted that particular type of contract.^[4]

Thus, assuming conformity with state law, the Council can be sued like any other party if the Attorney General has approved the contract.

Thinking about the state as an investor, in order to determine whether a court would enforce a contract against the state, one would need to know (i) whether the investment was of a type approved by statute, (ii) whether it was approved by the Attorney General if it was in excess of \$100,000 (which one would expect it to be) and (iii) if it was approved by opinion. Only once all three elements have been analyzed can one understand whether sovereign immunity has been waived and the state can be sued in a contract claim.

PENNSYLVANIA

Pennsylvania has statutorily waived contractual sovereign immunity, but there are certain rules that must be followed ... and there’s a catch!

Any suit must be initially heard by the Board of Claims, which has exclusive jurisdiction to hear claims brought against the State.^[5] Actions must be brought quickly, as state statute requires

that claims be filed within six months of the date on which the claim accrues.[6] The Board of Claims will determine whether to dismiss the claim or order an award in favor of the claimant. Parties have the right to appeal any orders made by Pennsylvania's Board of Claims by making a filing with the state court within thirty days of the Board of Claims' final order.[7]

Once parties obtain a judgment, however, it may be challenging to enforce the judgment and collect the proceeds. None of the Pennsylvania Rules of Civil Practice regarding the enforcement of money judgments are applicable to a judgment against the Commonwealth.[8] Instead, payment of awards and costs against the Commonwealth are paid from funds appropriated to the involved agency, which could potentially limit recovery.[9]

RHODE ISLAND

Rhode Island has waived contractual sovereign immunity through the State Purchases Act, but state law limits the amount of damages a party may recover against the state.[10] Decisions issued by Rhode Island state court confirm that “the State Purchases Act provides that any person, firm, or corporation having a lawfully authorized written contract with the state ... may bring an action against the state on the contract, including, but not limited to, actions either for breach of contract, enforcement of contract, or both.”[11]

A party may bring an action against the state to enforce a contract so long as the contract was entered into on or after January 1, 1990 and the action is brought within “three (3) years from the date of completion specified in the contract.” Once the claim is brought, the parties are limited to a trial without a jury. Such a cause of action is given priority on the court's calendar, but the amount of damages a party can recover is capped. If the court awards damages in excess of the original contract amount, such excess amount will be limited to an amount equal to the original contract amount.[12]

SOUTH CAROLINA

South Carolina has retained certain sovereign immunity, but the law does not provide for a defense to the enforcement of the state's contractual obligations. There are certain ambiguities in the state statute, but case law has indicated that sovereign immunity does not insulate the state from contractual liabilities. In a key decision on the matter, the court found that “wherever the State of South Carolina pursuant to statutory authority enters into a valid contract, the State implicitly consents to be sued and waives its sovereign immunity to the extent of its contractual obligations.”[13] Courts have found that such statutory authority can generally be found in the legislation creating the government entity.

Note that, if the contract at issue is with respect to services provided under a contract solicited and awarded pursuant to the South Carolina Consolidated Procurement Code, the adjudication of contractual disputes is limited to the procedure which requires administrative review by a chief procurement officer.[14]

Conclusion

In the next installment of our Sovereign Immunity Series, we will discuss the sovereign immunity status of South Dakota, Tennessee and Texas.

- [1] *State ex rel. State Ins. Fund v. JOA, Inc.*, 78 P.3d 534, 537 (Okla. 2003).
- [2] *Harsh Invest. Corp. v. Oregon*, 744 P.2d 588, 590 (Or. 1988).
- [3] Or. Rev. Stat. § 293.701 et seq.
- [4] Or. Rev. Stat. § 291.047.
- [5] 62 Pa.C.S. § 1721-1726.
- [6] 62 Pa.C.S.A. § 1712.1.
- [7] 42 Pa.C.S.A. § 763.
- [8] Pa.R.C.P. No. 3101.
- [9] 62 Pa.C.S.A. § 1726.
- [10] R.I. Gen. Laws § 37-2-1 et seq.
- [11] *Tidewater Realty, LLC v. State*, 2010 R.I. Super. LEXIS 25, *10-11 (R.I. Super. Ct. 2010).
- [12] R.I. Gen. Laws § 37-2-49.
- [13] 249 S.E.2d 900, 903 (S.C. 1978) *overruled on other grounds by McCall v. Batson*, 385 S.E.2d 741, 743 (1985); see also *Hodges v. Rainey*, 533 S.E.2d 578, 585 (S.C. 2000) (“We eliminated the State’s immunity from suit based upon its contractual obligation in 1978 in *Kinsey*”)
- [14] See Section 11-35-4230 of the Procurement Code.

The Risk of De-Reg to the Pledge: Considerations for Lenders When Negotiating Private Funds Act Grace Periods

April 28, 2023



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Much has been written about the introduction of the Cayman Islands Private Funds Act (as revised) (the “PF Act”) and the impact of the PF Act on subscription facilities generally. Here we take a look at the genuine risk of de-registration by the Cayman Islands Monetary Authority (“CIMA”) of an in-scope private equity fund (“Fund”) and practical considerations for a lender when considering any grace period for re-registration. (Please see the end of the article for a quick recap of the PF Act in the context of subscription facilities.)

We are often asked by lenders to provide some insight as to the risk of PF Act de-registration and how long re-registration could take, usually in the context of the discussions around the event of default (“EoD”) grace period for a breach of the covenant requiring a Fund to maintain its PF Act registration (“PF Act Covenant”). Should de-registration trigger an immediate EoD? Should there be a grace period of 5, 15 or 30 days for the Fund to re-register? Lenders generally appreciate that the consequences of de-registration can be significant for the security package, but in negotiations they will want to consider: how likely is de-registration in practice, and how soon can it be rectified?

Why would a Fund be de-registered? Is it a genuine risk?

A Fund can be de-registered by CIMA pursuant to the PF Act if it fails to comply with the requirements set out in therein. As the PF Act includes a suite of requirements to be met by Funds, the scope and severity of what constitutes a breach can be broad, ranging from late payments of fees through to failure to comply with reporting obligations or significant AML breaches. This also means that a de-registration would likely be fairly fact-specific.

Rather than proceeding straight to de-registering a Fund, in practice CIMA would likely (i) notify the Fund of any breach and offer a chance to rectify it, and (ii) utilize various other enforcement options available to it – for example, imposing monetary fines (which can be significant). On this basis, we would expect, save in the case of significant and ongoing non-compliance, the risk of de-registration to be fairly remote, particularly in relation to otherwise well-managed and reputable Funds.

So we have a de-registered fund. How long does it take to be re-registered? Is it possible within the grace periods generally offered?

The timing and process for re-registration will be largely dependent on the reason and circumstances that led to the de-registration. For example, a late payment of fees could potentially be dealt with quickly, whereas a serious AML breach would be a much bigger issue and involve a greater time lag. There will also be various unknowns in the process, such as the current workload of CIMA and if certain compliance aspects are being scrutinized in additional detail at the time. Also relevant will be whether the Fund has a history of breach or non-compliance with CIMA requirements.

When it comes to grace periods, a lender's preference would obviously be that a breach of the PF Act Covenant should trigger an immediate EoD, but often some cure period is given (ranging from 5 through to, in some cases, 30 days). Such a cure period would give the Fund the chance to re-register in that window, if possible, meaning in practice a Fund could potentially be re-registered and avoid the EoD once a minor PF Act breach has been rectified, but a more serious PF Act breach would ultimately trigger the EoD on expiry of the grace period.

In summary, what should a lender be considering?

As a high-level PF Act risk analysis:

- Likelihood of de-registration: fairly unlikely (assuming a reputable and well-managed fund).
- Consequences of de-registration for the security package: very serious.
- Likelihood that Fund can be re-registered quickly: depends on the reason for de-registration, but still fairly unlikely even for a minor breach (given CIMA would have likely taken other enforcement steps prior to de-registration). For a major breach – very unlikely.

A lender might decide that they can live with the risk of a breach of the sort that would likely result in the Fund being re-registered within a satisfactory grace period. Conversely, they might want the flexibility to declare an immediate EoD for any de-registration, regardless of how quickly it might be rectified.

Moving away from the straight PF Act analysis and looking at Fund management more generally, it is also worth considering that if a Fund is being managed in such a way that it has been de-registered by CIMA under the PF Act, then the de-registration is potentially not the only issue and that other (unrelated) defaults may also have occurred under the facility.

Conclusion

When considering cure periods offered for a breach of the PF Act Covenant, lenders will need to consider the likelihood, as well as the seriousness of the consequences of, de-registration. Given that de-registration is in itself a fairly fundamental administrative failing by a Fund, lenders may wish to retain the flexibility of an immediate EoD, but we all appreciate that facilities are negotiated through the lens of the relationship of the parties and the wider commercial context. For now, de-registration by CIMA remains a relatively remote risk, but we will continue to closely monitor CIMA's approach as the regime becomes more established.

PF Act recap

Here is a very quick PF Act recap in the context of a subscription facility.

PF Act summary: Certain private equity funds must be registered with CIMA pursuant to the PF Act within 21 days of accepting capital commitments before such funds can receive capital contributions from investors.

Concern for subscription facilities: If an in-scope private equity fund is not registered pursuant to the PF Act, there is a risk that it might not be able to accept capital contributions to repay a facility (on enforcement or otherwise).

Market approach for subscription facilities: To address this risk, current market position is generally (i) a condition precedent requiring PF Act registration of applicable Funds, (ii) a covenant requiring the Fund to (among other things) maintain its PF Act registration; and (iii) an accompanying EoD, either immediate or with a grace period.

Inaugural WFF Chicago Event Announced

April 28, 2023



Women in Fund Finance (WFF) will host its inaugural WFF Chicago event – part panel discussion, part networking event – on Tuesday, May 16 from 5-7:30 p.m. (CDT) at the offices of Mayer Brown.

The panel discussion will feature the following: Steve Cohen, Managing Director, CIBC; Missy Dolski, Global Head of Capital Markets, Värde Partners; and Amanda Milnes, Senior Principal, Walton Street Capital. The panel's co-moderators will be Ann Richardson-Knox, Partner, Mayer Brown, and Annie Wallis, Partner, Sidley Austin LLP. Additional panelists will be announced.

Registration is open on a first-come, first-served basis.

Cadwalader Welcomes Susan Bumgardner in New York

April 28, 2023



Cadwalader's Fund Finance team has continued its recent expansion with the hire of Susan Bumgardner as an associate in the New York office. Susan is an experienced finance lawyer whose practice focuses on representing lenders in a wide variety of fund finance transactions, including NAV facilities, subscription facilities, hybrid facilities and margin loans.

Welcoming Our New Leveraged Finance & Private Credit Partner: Smridhi Gulati

April 28, 2023



We are pleased to announce that partner Smridhi Gulati has joined our Leveraged Finance & Private Credit team in London.

Smridhi joins Cadwalader from Dechert in the latest in a series of high-profile additions to the practice. London partners Matthew Smith and Bevis Metcalfe joined in 2022, and a four-partner, U.S.-based team – Ronald Lovelace, Patrick Yingling, Jared Zajac and Joseph Polonsky – joined in January. Also recently joining the group in London were ESG Finance and Investment partner Sukhvir Basran and special counsel Andrew Vickers.

Smridhi advises private credit funds, banks, private equity sponsors and corporate borrowers on domestic and international leveraged and acquisition finance transactions. She also has considerable experience in executing and restructuring complex private credit transactions at all levels of the capital structure.

“Private credit is nimble, flexible and innovative and has filled the gap in lending caused largely by regulatory constraints on traditional lenders,” said London managing partner Greg Petrick. “In the wake of the pressure on banks given developments in March, we expect private credit to continue to garner significant market share in credit markets from corporates to real estate borrowers.”

“I am thrilled to be joining the Cadwalader team in London,” Smridhi added. “Cadwalader is committed to building out a dominant private credit practice, and to be able to join forces with Matt and lead that growth together couldn’t be more compelling or exciting for me.”

Read our full news release [here](#).