CADWALADER

FUND FINANCE FRIDAY

Fore!ward

June 9, 2023

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The Belfry, Our Bellwether?

June 9, 2023

By Wes Misson
Partner | Fund Finance

Earlier this week, more than 200 of the top leaders in fund finance met at the first-ever FFA Global Leadership Summit. The two-day mini-conference, in a week where the PGA Tour and Saudi-backed LIV tour shockingly announced a merger, was fittingly held at one of the UK's historic golf venues – the Belfry. Rich in tradition from its four-time Ryder Cup host fame, the Belfry became the inaugural host for what many in fund finance hope will now become a new tradition.

For those who were able to experience it, I know – as a member of the U.S. Advisory Committee – the FFA is eager to get your feedback for future events. Feel free to send us a note to pass along.

For those who were unable to attend, the two days gave ample opportunity for many of the industry's veterans to connect on the most pressing topics of today: rising interest rates, regulatory capital issues, fundraising, the liquidity crunch and lender side supply issues, resulting growth of the NAV market, and the global macro economic environment and what it potentially holds for our industry over the next six months. After all, it seems like a couple of years had passed since the February Global Symposium in Miami. The landscape has shifted significantly and will undoubtedly have a few surprises (good or bad) left for us ahead. Yet, the industry and its participants during this time of extreme volatility have shown incredible resilience in the face of numerous headwinds. Up and to the right at significant speed may no longer be a given, but the pint remains half full as there are good reasons to remain cautiously optimistic.

Lord Mervyn King, the Governor of the Bank of England from 2003-2013, delivered one of the most eloquent talks I have ever heard. Drawing from his experience leading the UK's central bank through the GFC, he gave context for the latest economic crisis and recent bank failures. While economic crises cannot be wholly avoided, the regulatory response can be controlled and prescribed. Instead of employing ad hoc measures on an emergency basis, banks could have contingent liquidity established with central banks in advance of a crisis. Such planning could also potentially eliminate the need for deposit insurance and most certainly would avoid the need for political intervention.

Many thanks to the FFA and all the sponsors for an informative and relationship-rich couple of days with global friends and colleagues! It's a busy time in the UK, as we next look forward to seeing many of you at the seventh annual European Fund Finance Symposium on June 19th.

Make-Whole Clauses: It's All About the Enforceability Question

June 9, 2023

By Renee Fischer
Counsel | Fund Finance

Make-whole clauses (also known as prepayment premiums, call premiums or call protection) are provisions in financing transactions that require the borrower to make a specified payment to the lender if a loan is prepaid before the scheduled maturity. This payment is typically made by the borrower as a lump sum upon early termination and is designed to compensate the lender for the loss of the anticipated yield that lenders expect when providing (or committing to provide) the financing over a specified term.

When drafting make-whole provisions it is important to consider the threshold question of whether the provision would be enforceable under the law of the contract. Under New York law, a make-whole provision generally will be considered tantamount to liquidated damages provisions in contracts. Such liquidated damages provisions may be enforceable in circumstances where actual damages are difficult to calculate, and the premium being paid by the borrower is proportional to the loss incurred by the lender. New York courts will consider whether the lender's damages are difficult to ascertain, and whether the contract's proposed formula for calculating the make-whole or prepayment premium is proportional to the loss suffered by the lender. In contrast, however, New York courts will not enforce liquidated damages provisions that function mainly as a penalty or that are otherwise punitive to the borrower. Make-whole provisions should also clearly state that they are liquidated damages, and should not represent an unreasonable percentage of the principal amount of the loan (courts have varied on what is an unreasonably high percentage). Finally, a New York court also will consider if the make-whole premium actually has been triggered under the terms of the debt instrument. Accordingly, it may be helpful to provide that the payment of prepayment premiums are crystalized prior to the filing of a bankruptcy and that the trigger occurs whether the prepayment is voluntary or involuntary.

Lenders should bear in mind that, in a bankruptcy case, their entitlement to a prepayment premium or make-whole can be challenged. Indeed, make-wholes and prepayment premiums have been the source of much litigation in recent chapter 11 cases. Because section 502(b)(2) of the Bankruptcy Code provides that a claim is disallowed "to the extent that . . . such claims is for unmatured interest," parties have used this to challenge claims for make-wholes and prepayment premiums. Two leading examples of bankruptcy challenges to the enforceability of make-whole clauses are *In re Ultra Petroleum Corp.*, 51 F. 4th 138 (5th Cir. 2022) ("Ultra") and *Wells Fargo Bank N.A. v. The Hertz Corp. (In re The Hertz Corp.)*, Case No. 1:21-ap-50995, Dkt. No. 71 (Bankr. D. Del. Nov. 21, 2022) ("Hertz"), where the courts disallowed lender claims for make-whole premiums, finding that such payments represented payments of unmatured interest under Section 502(b)(2) of the Bankruptcy Code. The court in *Ultra* initially declined to enforce the make-whole payment on the grounds that the payment was unmatured interest. However, over the course of the bankruptcy, as natural gas prices increased following its

bankruptcy filing, Ultra became massively solvent. The court ultimately allowed for payment of the make-whole amount pursuant to the "solvent debtor" exception to Section 502(b)(2), which allows for payment of unmatured interest if the debtor is solvent. In *Hertz*, the court likewise disallowed the lender's claim for the make-whole premium as post-petition interest. However, the Delaware Bankruptcy Judge in *Hertz* certified that decision for direct appeal to the Third Circuit, given that there is a burgeoning circuit split on the enforcement of such provisions. No decision on the appeal has yet been issued.

In light of the complexity of these issues and the potential for disputes over the enforceability of prepayment provisions, lenders negotiating such clauses should carefully consider whether the premium accurately represents the actual damages that would be incurred by the lender upon prepayment, and whether the make-whole premium is reasonable as a percentage of the principal amount of the loan. They also should be mindful of the other criteria that courts have used, both in and outside of the bankruptcy context, to enforce such provisions. We will provide further updates on this evolving area of the law as the case law develops.

Fitch Ratings Finalizes Subscription Finance Rating Criteria and Announces Webinars

June 9, 2023

Fitch Ratings has published its Subscription Finance Rating Criteria and an associated Feedback Report following the receipt of comments on the Exposure Draft published in February. Fitch notes that the final criteria is “substantively in line with the Exposure Draft although certain adjustments and clarifying language were added.” You can read more **here**.

Fitch will be hosting two webinars next week to go over the final methodology and changes from the exposure draft. These webinar pages also include links to the methodology and feedback report (which summarizes comments Fitch received).

U.S./Europe webinar: **https://events.fitchratings.com/fitchfinalizessubscriptionfina**

Asia webinar: **https://events.fitchratings.com/fitchfinalizessubscriptionapac**

Scottish Limited Partnerships – Security Reforms for Funds

June 9, 2023

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Scottish limited partnerships are often used in fund structures. They are very flexible, with little restriction on the terms of their partnership agreements and few specific constitutional requirements. They are quick and easy to set up, with relatively low ongoing administration requirements. They are general business organisations from a G7 country that have been used in many other sectors too since 1907. Most importantly, they have separate legal personality from their partners and tax transparency in the UK and many other jurisdictions. It is therefore very common to see them used as feeder funds, carried interest entities, general partners and performing other fund management functions as well as being used as vehicles directly holding investments of various types.

When funds use subscription line or NAV facilities or co-investment, general partner or other management facilities are put in place, it accordingly becomes necessary to take security interests over various rights related to Scottish limited partnerships that may be part of a given fund structure. As those who have done so will be aware, this can sometimes be less than straightforward, due to the old-fashioned nature of the relevant Scots law of assignation (assignment) and security. These complications should become largely a thing of the past thanks to the passage of the Moveable Transactions (Scotland) Bill (the “Bill”). The Bill was passed by the Scottish Parliament on 4 May 2023 and is expected to come into force in the second half of 2024.

Current security over Scottish commitments and distributions

Security for these types of facilities normally includes either security over commitments of limited partners to advance funds to the Scottish limited partnership, or over distribution rights of partners due from the limited partnership. This security takes the form of an assignation in security by the limited partnership of commitment rights or by the partners of distribution rights, with those rights deriving from the limited partnership agreement. Under current Scots law there are three areas which can cause difficulties in practice when taking such security:

1. an assignation has no proprietary effect until notice has been given to the relevant counterparty.
2. retention of control of the rights assigned by the assignor may undermine the assignation (and thereby the security created); and
3. there are currently serious doubts about the effectiveness of an assignation of rights that do not exist at the time of assignation.

While a number of these issues can arise in relation to security assignations of distribution rights, they arise on a regular basis in relation to security assignations of commitment rights.

Giving notice

While giving notice to limited partners of security assignations of commitments is not normally a problem in principle, the current safest means of giving notice under Scots law is by posting a certified copy of the assignation to the limited partners (to comply with current legislative requirements dating from 1862). Otherwise acknowledgement by limited partners or a high degree of certainty that they have received and are aware of the effect of the notice is required and giving notice by email and through online portals to large numbers of limited partners currently gives rise to administrative headaches. Back-up notices served by post often continue to be used.

Control

An assignee of commitment rights must currently control their exercise otherwise the assignation (and thereby the security created) could be challengeable. Depending on management and lender convenience, drawdown notices may be countersigned by lenders or sent to lenders before issue with an opportunity to divert funds drawn, which may, in turn, require to be paid into a blocked bank account controlled by the lender. These mechanisms can cause some administrative burden.

Future rights

In addition, as commitments from new limited partners and increases in commitments of initial limited partners will not exist at the time an initial security assignation is taken, security assignations normally make provision for supplemental assignations to be taken when new limited partners are admitted or commitments are increased or transferred. This can be complex when a fund has multiple closings and the triggers and their timings can also be missed, leading to technical defaults by funds.

Most of these issues will be addressed when the reforms under the Bill come into force.

The new Scottish regime

The reforms are not unlike a personal property security act, although they do not provide for recharacterisation of transactions and documents rather than notices are filed. The law of assignation of “claims” (*i.e.*, rights) is modernised under the reforms and a new “statutory pledge” is introduced over tangible moveables, intellectual property and further intangibles that may be specified by secondary legislation. The legislation will also create a new online public Register of Assignations and corresponding Register of Statutory Pledges, both operated by Registers of Scotland, the main Scottish public registration entity. While it is anticipated that the

statutory pledge regime will be extended to cover shares and other financial instruments when it comes into force, it may not be applicable in the short term to create security over fund commitment or distribution rights.

Assignations under the new Scottish regime

Given the broad definition of “claim” in the Bill, security assignations of both fund commitment and distribution rights will fall within the ambit of the reforms.

It will be possible under the new regime to dispense with notice to limited partners and other counterparties by instead registering an assignation document online in the new Register of Assignations and for this assignation document to cross refer to relevant data (such as limited partner details). In the alternative, modernised notice provisions in the new legislation will facilitate electronic notice to effect the assignation instead of doing so by registering the assignation document in the Register of Assignations (and notice may in any event be given at any time to ensure that payment to the assignor does not discharge the claim assigned if an assignation document is uploaded). This will address issue 1 (Giving Notice) outlined above.

The Bill also clarifies that an assignation document can assign future claims with effect from them coming into existence and that payment to an assignor will not undermine an assignation. Current mechanisms under which supplemental assignations require to be taken in relation to new partners and increased or transferred commitments will no longer be necessary. Likewise current mechanisms involving lenders in drawdown notices or blocking drawdown receipts accounts will cease to be necessary. This will address issues 2 (Control) and 3 (Future rights) outlined above.

Statutory pledges under the new Scottish regime

As indicated above, the new statutory pledge regime is unlikely initially to be applicable to security over Scottish partnership commitment or distribution rights, although if given partnership interests constitute “securities equivalent to shares in companies” (and thus “financial instruments” for the purposes of the Financial Collateral Arrangements (No.2) Regulations 2003), those partnership interests may be included when, as anticipated, financial instruments are added to the statutory pledges regime when the reforms come into force. Currently, only distribution or other restricted rights under Scottish partnership agreements are assigned in security in order to reduce the risk of the security holder becoming a partner (and in particular a general partner with liability for partnership obligations). It would be useful to clarify that Scottish partnership interests are to be included when shares and other financial instruments are added to the statutory pledge regime so that fixed security can be taken safely over those full interests rather than over more restricted rights.

Conclusions

The reforms under the Bill are very broad, and will greatly simplify a number of areas of Scots finance law, from receivables finance, securitisation, asset finance, real estate finance, technology finance, project finance and many others. While further work is required to ensure the statutory pledge regime also applies in funds finance, the reforms (and in particular the assignation reforms) will be very welcome in simplifying the execution of funds finance transactions involving Scottish limited partnerships, and the Shepherd and Wedderburn team

has been very pleased to have been involved over a number of years in bringing them to fruition.

For further information on the reforms brought about by the Bill, please see the **Shepherd and Wedderburn moveable transactions landing page**.

Fund Finance Tidbits – On the Move

June 9, 2023

Trevor Freeman has joined Axos Bank as senior vice president, managing director and head of fund finance, based in New York. Axos is a new entrant to the fund finance space, and Trevor and his team are working to build a subscription line lending platform there. Trevor was previously at Signature Bank, where he was a managing director and one of the founders of the bank's Fund Banking Division.

Fund Finance Hiring

June 9, 2023

Fund Finance Hiring

Moody's Investors Services is hiring for a Relationship Management role with a focus on the Alternative Asset Management space to assist the U.S. FIG Commercial team. For more information, visit **here**.