CADWALADER

Navigating Through November

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Subscription Finance Loan Agreement Series, Part 14: Representations and Warranties

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This article focuses on those representations and warranties that are unique to a subscription/capital call facility and provides some colour. A number of the representations and warranties in these types of facilities are similar if not identical to those in a standard LMA facilities agreement. For the sake of brevity as much as anything else, these "standard" provisions which are common to both are not covered specifically in this article. As you would expect, the primary thinking behind these sections of the subscription/capital call facility (as elsewhere) is on the investors and their commitments to the fund and the continuing ability of the fund to service their debts to the lenders by calling on those commitments (or, in an enforcement scenario, for the lenders to call on the investors directly).

Before getting into the details, a brief aside for the more legally minded: Why do English law facilities agreements include "representations *and* warranties" (and not just one or the other)? This is because there is a fairly fundamental difference between the two in legal terms. A "representation" is a statement of fact or opinion which induces another party to enter into a contract, while a "warranty" is a contractual term, secondary to the main purpose of a contract, which in effect gives the other party to the contract a right to an indemnity if the warranty is not true. Remedies for a breach of "representation" (or, more accurately, a misrepresentation) can include rescission of the contract as well as damages. Remedies for breach of "warranty" are usually limited to damages. The reason they are always included together is, first, that it is sometimes difficult to establish exactly what statement belongs in one category or the other and, second, that it is useful to ensure that the widest range of remedies will be available to the lender if there is a breach. For the rest of this article (and to avoid too much repetition) we have used the term "representations" to cover both "representations and warranties."

All of which leads naturally to a discussion of what issues need to be considered in the representations and warranties section of a subscription/capital call facility. There are three items to consider here in this context.

The first is the question as to which entities within the fund group should provide the representations and warranties. In general, the fund itself will only represent for itself, but the general partner (and/or the manager, if there is one) will often make representations both for itself and for the fund (and sometimes for other parties within the fund group).

Once that is established, the second question is which areas to focus on in terms of what representations are given. Specifically, in a subscription/capital call facility, these will almost always include the following representations: (i) that any financial information provided is true and correct, (ii) that those representing the fund (in particular, the general partner and/or manager) are all those entitled to represent the fund, (iii) that the fund documents (*i.e.*, the LPAs or equivalent, subscription agreements and any side letters) are in full force and effect, (iv) that there are no breaches of those documents and no rights of investors to reduce or refuse to pay when their commitments are requested, (v) that all those documents have been produced to the lender, (vi) that the general partner (or other person) is specifically authorised

to issue drawdown notices to investors, and (vii) that the assets of the fund (and other obligors) are not “plan assets” for the purposes of ERISA. (Note that ERISA is a whole separate can of worms as far as subscription finance/capital call finance goes and will be the subject of its own dedicated article in this series.) Finally, it is also important from a lender’s perspective to include a representation to the effect that any prospectus issued to an investor is accurate in terms of what is stated in that prospectus. Other representations to consider, if there are any possible concerns on this, are representations as to the general partner or manager not being in dispute with investors or facing resistance from investors to paying down commitments in other funds.

And, finally (as with any other facilities agreement), to what extent and when should the representations be repeated? In terms of the "when," this is generally similar to the approach taken on in a standard LMA facility (in that the representations which are being repeated are usually repeated on the date of any utilisation request and on the first day of any interest period). As to what is repeated, again the approach will be similar to the standard LMA approach (where representations are common between the standard LMA and a subscription/capital call facility). The difference is that most if not all of the specific representations referenced above (*i.e.*, those which relate to the fund and the fund’s investors) will and should be repeated.

In the next two articles in this series, we will look at two further sections of a subscription/capital call facility which relate closely to the “representations and warranties” section – namely, those sections devoted to, respectively, (i) covenants and undertakings and (ii) events of default and acceleration. Leaving aside for a moment the legal differences between these three sections, the one thing to say about these for now is that in terms of negotiation and drafting of facility agreements, a point that should always be considered is the extent to which representations and warranties (specifically, those that are repeating) may also be covered in the covenants or undertakings and even in the events of default. These three sections are different (and, to some extent, have different areas of focus). The question is that, if they are covered in these other sections, to what extent do they need to be covered more than once? We will consider this and other specific issues in the following two articles.

Player Profile — Pramit Sheth

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Player Profile

This week we connect with Pramit Sheth, a Managing Director at Kroll Bond Rating Agency, where he manages the Funds group. Pramit has over 13 years of experience in the credit rating industry. Before leading the Funds group, Pramit was a senior analyst in KBRA's CMBS analytical team, where he led ratings analysis on a wide range of complex real estate transactions and helped refine KBRA's rating methodologies in that dynamic market.

Prior to joining KBRA, Pramit was an analyst in the CMBS group at S&P. Earlier in his career, Pramit founded and led a real estate development and construction company. Pramit holds a B.S. in Finance and Information Systems with a minor in Mathematics from the Stern School of Business at New York University.

***FFF*: Pramit, tell us a bit about yourself. How did you end up rating fund products at KBRA?**

KBRA's fund ratings business was growing rapidly in size and complexity, and our CEO saw my team-building skills and my background in complex cash flow analysis as being a great fit.

***FFF*: Can you give our readers an overview of the rated securities business and where it fits into the fund finance landscape?**

Fund finance is only one form of debt issued by an investment vehicle that we see at KBRA. Other transactions include fund investments, collateralized fund interests (platform transactions) and sponsor balance sheet debt. An example of fund investments would be where a limited partner lends to the fund through a note and also invests equity that is subordinate to the note. We refer to this type of transaction as a "Bifurcated LP Interest." Collateralized fund interests include notes secured by realizations from a passive portfolio of fund investments. Sponsor balance sheet transactions are notes that typically provide a fund's sponsor with balance sheet capital for general corporate purposes or for additional co-investments in the underlying funds.

***FFF*: How big is the fund securities market and where do you see it getting to?**

It is hard to estimate the size of the market from the rating agency perspective given that a lot of the transactions are private, but it is safe to say that the market is growing very quickly in size and complexity. As insurance companies continue to seek ways to expand their participation in the alternative space, we believe the growth will continue.

***FFF*: Can you give us some insight into the sponsor motivation for a fund note issuance and an overview of the buyer base?**

In KBRA's experience, sponsor motivation varies from one transaction to another. And this motivation is an important consideration in our rating analysis. Examples include sponsors wanting to expand their subscription or other lending providers beyond traditional banks. Other examples include sponsors wanting to accelerate realizations or fee streams in order to coinvest in opportunities they feel will enhance fund returns. Other examples include more traditional fund leverage or securitization of pre-existing LP positions.

***FFF*: Fund finance has a limited capital markets presence compared with many other bank lending products. What are the challenges for funds in accessing the debt capital markets?**

Depending on the type of debt they are contemplating, funds that have not entered the capital markets before will likely need to beef up their legal teams to design structures that meet capital market preferences, improve their cash flow modeling skills to demonstrate ability to meet debt service requirements under various stress cases, and develop ways to communicate with a different kind of investor base – among other things.

***FFF*: Have you seen anything particularly innovative from issuers and arrangers?**

Yes! The professionals in this space are very intelligent and innovative. Earlier this year, KBRA published ratings on two groundbreaking transactions – one for KKR and one for Blackstone that were each unique and very innovative platform deals. But what they had in common was that they generated enormous global investor interest. Many months later, we continuously speak with other platforms, sponsors, issuers, and bankers about new transactions they are considering as a result of what they learned from those two transactions. It has definitely been interesting to hear about the structural variations that some market players are developing.

***FFF*: What is your sense of the current pipeline for fund securities?**

KBRA's pipeline is large and rapidly growing. We are working with professionals from all sides of the business who are working on numerous bespoke transactions, with a wide variety of collateral types and complex legal structures – all of which plays well to KBRA's strengths. Experience matters at KBRA. We attract and retain senior analysts who often have experience across asset classes and are responsive to market needs.

Engage 2020

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Private equity will be a high-profile 2020 election topic. The U.S. Chamber of Commerce joined the fray this week, releasing an **economic study** of Senator Elizabeth Warren's Stop Wall Street Looting Act (the one that removes the limited liability construct). The Chamber's study concludes that, if enacted, the legislation would result in significant job losses, reduced tax revenues, and diluted investment returns at pension funds and other institutional investors. Next Tuesday, the House Financial Services Committee, under the leadership of Maxine Waters, is set to hold a hearing under the heading, "America for Sale? An Examination of the Practices of Private Funds."

Over the past years, we've confronted recurring misunderstandings and mischaracterizations of fund finance in the press. On the whole, fund lending groups nonetheless have been able to keep a low profile given the private nature of the product and its clean credit track record.

We believe we're entering a new and more challenging political environment – one that may call for a more proactive approach to educating and engaging the media, policymakers and industry organizations on the fundamentals of our product, its utility to funds, and the risk, return and diversification profile it adds to the balance sheet.

Private fund returns largely accrue to individuals as pension holders, insureds, foundation grant recipients, endowment scholarship recipients, teachers or other government employees. Removing private investment options may crowd investors and their ultimate beneficiaries into public equity and fixed income products at a time of record-high valuations, low yields, decelerating fundamentals and rising volatility – the intended beneficiaries of private equity-related legislation may well lose more than they stand to gain.

We believe the 2020 fund finance business plan should give heed to the changing times and include more energy and attention (and maybe dollars) to a deliberate outreach effort – ours will.

More on ILPA's Model LPA

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ILPA's model LPA, published at the end of October, continues to garner publicity as industry participants process the document. Clifford Chance published a note summarizing key terms, available **here**. (The Clifford Chance note was the subject of a *Private Funds CFO* **article** earlier this week.) Separately, law firm Davies Ward Phillips & Vineberg LLP also published a **bulletin** that provides helpful context for the document, noting that it is unlikely to result in a significant shift in fund terms in the near future and is not intended to serve as a precedent document in any sense. As we previously noted, we found the model LPA fund borrowing provisions somewhat unworkable: borrowing is permitted, but standard market terms that facilitate fund borrowing were omitted. Among these were a clear ability to pledge uncalled capital commitments and the collateral account, the waiver of defenses and a grant of third-party beneficiary rights to the lender.

FFA's European Next Generation in Fund Finance London Event Recap

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Macfarlanes hosted the FFA's fifth European Chapter NextGen event, an educational discussion on default and enforcement in fund finance.

Fortunately, defaults and enforcement in our industry are very rare. Given where we are in the current credit cycle, this provided an opportune moment to discuss these issues in a collaborative way.

Attendees from across the fund finance industry were split into 6 teams and discussed one of two fictional distressed fund structures – a capital call fund financing structure and a NAV fund financing structure. Practical next steps were discussed in groups that benefited from the experience of mixed tables of lenders, lawyers, borrowers and offshore lawyers. Groups then shared their findings with the room. Paul Keddie (Restructuring & Insolvency) of Macfarlanes then presented his top tips on fund finance restructurings. The attendees had a vast range of perspectives and ideas which were shared at the interactive event.

The Fund Finance Association Next Generation ("NextGen") initiative, established in 2018, brings together young professionals from funds, banks and law firms within the fund finance market. The NextGen network was founded by Billal Malik (Citi), and previous events have included educational seminars, a speed networking event and industry panels.

Practical top tips for fund finance restructurings
Paul Keddie – Restructuring & Insolvency
MACFARLANES

On the Move — Fund Finance Tidbits

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On the Move

Andrew Waldele has joined Validus Risk Management as an Associate in its Fund Finance Advisory group in London. Andrew joins from Barclays in New York, where he covered Funds and Asset Managers in the International Corporate Bank. He will support Validus partner Sarah Lobbardi, offering independent debt advisory services by providing specialist advice, support and assistance to sponsors seeking to establish, refinance and re-negotiate fund finance facilities. Validus is a leading independent financial services firm specialising in providing financial risk management, fund finance advisory and technology solutions to the alternative investment industry.

Recommended Reading

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"Loan Investor Owl Rock Sells 20% Stake to Fund Expansion": Owl Rock Capital Group, a middle market-focused direct lender, sold a 20% stake in the firm to Dyal Capital. The implied valuation of around $2.5 billion for the three-year-old firm illustrates the meteoric growth in private credit, according to the *Wall Street Journal.* [**WSJ**]

"This Private Equity Firm Now Runs A Political Action Committee": Carlyle Group has formed a PAC. [**Institutional Investor**]

Ernst & Young Global Limited's "2019 Global Alternative Fund Survey": The inflows continue. Allocations to alternatives remain robust. Within the category, investors are raising private equity and real estate exposure at the expense of hedge funds. [**Ernst & Young**]

"Citi Warns of a 'War on Wall Street and Wealth' in the 2020 Election": The financial industry is in the crosshairs. [**Bloomberg**]

Fund Finance Calendar

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Fund Finance Calendar

Upcoming Events in Fund Finance

November 19-22, 2019	SuperInvestor, Amsterdam
December 9-11, 2019	PartnerConnect Texas 2019, Dallas
January 22-23, 2020	PEI CFOs & COOs Forum, New York
February 12-14, 2020	10th Annual Global Fund Finance Symposium, Miami
March 16-18, 2020	PartnerConnect East 2020, Boston

If you have an event that you would like listed on the Fund Finance Friday calendar, please email us at fund-finance-friday@cwt.com.