Global Legal Insights

Fund Finance

2019

Third Edition

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global legal group

FUND FINANCE association

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Fund finance: An offshore perspective

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Overview

"*Fund financing is one of the fastest-growing areas of the syndicated loan market…*"[1]

As previous versions of this book have so eloquently demonstrated, the investment funds world (and by extension, the market in lending to those funds) is truly international.[2] From a macro perspective, nothing has changed in that respect in the last 12 months, and investor/allocator appetite for alternative investment products continues to grow and take on a more international flavour. In their October 2018 presentation to the Fund Finance Association, Preqin confirmed that total private equity assets under management stand at US$5.2trn, with over 40% of that figure being non-US.[3]

In our view, it is, therefore, inevitable that the demand for vehicles located in 'offshore' jurisdictions or international financial centres such as the Cayman Islands, the British Virgin Islands, Bermuda, Jersey and Guernsey, whose predominant business is servicing the alternative investment funds industry, will continue to be strong in the short to medium term. This is supported by statistics published by the General Registrar in the Cayman Islands.[4] As at 1 November 2018, the number of active limited partnerships (still very much the global vehicle of choice for private equity funds) in the Cayman Islands was at an all-time high of over 25,000 active, registered limited partnerships.

Against this backdrop, it is not surprising that the size of the fund finance market[5] is also growing and, as such, the role that offshore jurisdictions and advisors play remains a significant part of the landscape.

Most offshore jurisdictions operating in this area have legal systems which are derived from English common law[6] and benefit from stable governments which embrace transparency as well as the implementation of, and compliance with, international laws and regulations. The fund finance industry is very important to offshore jurisdictions, which are generally amenable to quick implementation of legal and regulatory changes driven by or serving market trends and requirements.

Although there are many thriving offshore jurisdictions, the Cayman Islands is the offshore jurisdiction of choice for North American and, increasingly, Asian investment managers, and therefore borrowers in the Cayman Islands account for some of the largest subscription finance facilities in the market.

For this reason, when discussing legal issues, we will base many of our examples in this chapter on the Cayman Islands regime. However, most of the issues discussed will apply to the offshore market as a whole.

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In this chapter, we will discuss: some of the basic reasons why managers, allocators and lenders alike continue to use offshore structures; developments and trends in the fund finance market from an offshore perspective; the key issues that any transaction involving an offshore element should cover; and some ideas for future innovation.

Why offshore?

Most seasoned participants in this market will rarely ask themselves this question. However, with more and more entrants to the market on the lending side (both bank and non-bank), and with the size of the market growing, credit/risk teams within lending institutions often want some sort of explanation to the rationale and size of their offshore exposure.

In his article on the use of offshore structures, AIMA's head of tax affairs, Paul Hale, summed up well the rationale for the use of offshore centres in investment fund structures:[7]

Tax-neutral, not tax-free

Investment funds in the key offshore centres are not generally subject to any form of direct taxation on their profits. This means that the fund itself doesn't incur tax in its home jurisdiction. In addition, jurisdictions such as the US give pension funds and endowments tax-exempt status and thereby encourage the use of tax-neutral structures for investment purposes. Other investors in offshore funds will use them in the knowledge that they will remain liable as a tax matter on their gains when they bring those gains back 'onshore', but the offshore fund vehicle remains a tax-efficient way to invest.

Regulatory burden

Although some fund managers may now feel that regulatory 'mission creep' has increased offshore to be almost on a par with that existing onshore, the reality is that regulatory regimes of international financial centres such as the Cayman Islands are still more friendly to the professional investment funds industry. And as such, they may feel such regimes do not dictate the investment strategies and risk-management tools that funds may use – in contrast to onshore regimes, such as the UCITS regime, in Europe.

Privacy, not secrecy

Equity ownership of structures offshore remains private, which is still an important consideration for many investors in alternative products. However, that does not mean that this information is secret. Tax and crime reporting regimes such as the OECD's Common Reporting Standard, means that the identities and financial details of beneficial owners (such as investors in offshore alternative investment funds) are shared with tax authorities in the investors' home countries. Additionally, all of the British Overseas Territories and Crown Dependencies are in the process of establishing, or have established, beneficial ownership register regimes from which details can be provided to crime agencies on request.

Highest standards of anti-money laundering and global transparency

Regulators in the leading offshore centres have regulatory and supervisory regimes that have been comprehensively and positively assessed by other global regulators from the point of view of investor protection and systemic risk monitoring, and have co-operation agreements in place with regulators in many jurisdictions. These anti-money laundering regimes are among the most stringent in the world; these jurisdictions tend not to have large domestic financial services markets, so the focus is on the use of the jurisdiction by international clients.

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Investor/creditor-friendly

The main offshore financial centres have legal and regulatory regimes which are both investor- and creditor-friendly. In the context of fund finance, lenders to funds should take comfort in the fact that were a default to lead to enforcement action, provided that the deal and the collateral packages are structured correctly in the first place, courts will be willing to assist lenders within an established insolvency regime. Contrast this to debtor-friendly jurisdictions, such as the US.

Familiarity and clarity and service levels

Finally, much of the desire for fund sponsors and lenders alike to use, and continue to use, offshore financial centres can be attributed to familiarity and clarity as to the legal and regulatory consequences of doing deals, and the availability of top quality legal and financial advisors in these jurisdictions. All of this helps to keep servicing and set-up fees at consistent levels in an extremely competitive market.

Offshore issues

Developments and trends in the nature of lending

As noted above, the global fundraising and capital allocation remains buoyant. "Standard"[8] capital call secured facilities[9] continue to represent the bulk of the fund finance lending that is seen offshore.

Although often discussed, hybrid facilities, where a subscription line transitions into an asset-based line or is accompanied by an asset-based collateral package, still remain in a minority, while more relationship-based lending such as 'GP facilities', where a lender might lend to a general partner/fund manager and their principals, taking security against limited partnership interests in underlying funds, are also occasionally seen.

Committed facilities continue to make up a large proportion of the market, with a significant minority of certain lenders and borrowers favouring uncommitted facilities. Syndication, particularly at the larger end of the facility market, is also more common now than it was, say, five years ago.

Constitutional certainty

For borrowers and lenders alike, the power, capacity and authority of the borrower to enter into the credit facility, and to grant security over the collateral being sought by the lender, are fundamental issues. As a result, it is very important for borrowers and lenders to engage with experienced offshore counsel who are familiar with market expectations and norms, to help make transactions as efficient as possible.

On the whole, it remains onshore legal counsel who will conduct the more detailed reviews of fund subscription documentation and side letters alongside the in-house lender due diligence team. Offshore counsel will take responsibility for the review of the constitutional documents of the offshore fund[10] and, where relevant, the offshore general partner (**GP**). Use of corporate and even unit trust vehicles is not unheard of for private equity fund vehicles, and similar financing and collateral arrangements can be provided for those structures.

The fund's limited partnership agreement (**LPA**) will always be governed by the laws of the jurisdiction where the fund is formed, whereas investor subscription agreements and side letters are typically governed by a different governing law (such as New York law). In and of itself, these potential conflicts can introduce an element of uncertainty when it

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comes to analysis and construing potential conflicts-of-law issues and routes to enforcement for a lender, and it is up to onshore and offshore counsel to the lender to effectively negotiate the points. Issues such as this should be addressed at the outset, despite the temptation to try and rush through a closing without considering these conflicts, or at least factoring them into pricing or the lending decision.

More sophisticated constitutional documents

Thankfully, the form and content of LPAs is now much more sophisticated than it was in the early 2000s, particularly as regards their disclosure and treatment of arrangements to cater for the increased popularity of subscription finance facilities, and it is now common to see explicit language in LPAs referring to and authorising such facilities. Lenders and borrowers also have much clearer expectations of the terms they want to see included in the documentation, and this is something which is now considered from the outset at the time of setting up an offshore entity. This is due in large part to the fund formation and finance teams at leading law firms operating in this space being joined-up in their thinking when it comes to structuring funds, and is another reason why sponsors should seek to use experienced counsel where possible.

As a result of this improvement in terms, lenders will prefer to see certain explicit provisions in the offshore LPA whereby an investor will waive rights regarding set-off, counterclaim and defence as regards the investor's obligations to meet capital calls, outside of any claims they may have separately as against a GP or a fund itself.

Generally, investors will commit to funding investments or repay fund expenses when called upon to do so by the GP, pursuant to the terms of the LPA; this is a contractual obligation of the investors to fund an uncalled capital commitment, and the fund has the right to call for uncalled capital from its investors. The subscription line facility is based on this contractual relationship between the fund and its investors and the key collateral element is the assignment to the lender, by way of security, of the fund's right to call capital from the investors (which is an intangible asset), and its existence and assignment are governed by the laws of the Cayman Islands.

The thorny issue of notice

For most offshore jurisdictions, there is no true perfection of a security assignment of capital call rights such as practitioners familiar with the North American market, in particular, would expect in the form of a UCC filing. Other chapters will deal with country-specific issues, but in general, lenders to offshore funds will still want to see some form of notice given to investors in a fund in order to establish their priority as regards any subsequent assignment of those rights, as was established in the English case of *Dearle v Hall* (1828) 3 Russ 1.

The form of notice is becoming more standard, and will typically mirror the wording of the transaction documents so that the investors are given clear and complete details of the security that has been granted by the fund and GP to a lender. Given the growth of the market, investors have also become more accustomed to receiving such notices, making GPs less reticent to send them. One area of improvement that could certainly be made would be for fund formation counsel to pay closer attention to notice provisions in LPAs, which form the basis of any discussion about how notices can be sent and deemed to be received, to provide wider scope for GPs to use online portals and email notices.

The fundamental importance of the investor notice in fund finance transactions in most offshore jurisdictions has been highlighted by well-publicised events in the fund finance industry in 2018. Academic debate has raised interesting questions about the content of

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notices and the implied protection for a lender that serving the notice on investors may grant by way of an 'estoppel' argument over subsequent changes to investor commitment terms. In recent years, a trend has been for borrowers to ask lenders to agree ever-more brief notices (given that the only case law we have is almost 200 years old without any requirements as to content, no-one can have any truly 'correct' answer in negotiations). However, with certain additional disclosure regarding the fund or the GP's covenants to a lender not to change the terms of their contractual agreements with investors without consent from all parties, including the lender, even though the GP and fund would be in breach of their agreements with the lender, it is possible that an investor with notice of such covenants would be estopped from relying on any subsequent amendment to their commitment terms.

<u>Importance of understanding differences</u>

In light of these issues, it is interesting to note that, for example, under US law, the law provides certainty that unless otherwise provided in the partnership agreement, the obligation of a partner to make a contribution or return money or other property paid or distributed may only be compromised by consent of all the partners. This does still allow for side letters to change the terms of the partnership agreement; however, the law further provides that notwithstanding the compromise, a creditor of a limited partnership who extends credit, after entering into a partnership agreement or an amendment thereto which, in either case, reflects the obligation, and before the amendment thereof to reflect the compromise, may enforce the original obligation to the extent that, in extending credit, the creditor reasonably relied on the obligation of a partner to make a contribution or return.[11] Effectively, any subsequent changes are considered void.

In many offshore jurisdictions, there is no such similar statutory protection, which means that the lender in a subscription finance facility would be obliged to issue proceedings against a GP or fund for a breach of the facility agreement or security agreement, but it might be preferable to at least consider the content of investor notices in this regard. Common law in the UK includes examples, albeit quite outdated and certainly not necessarily binding in offshore courts, of notice of assignment to the debtor being considered necessary to prevent a subsequent modification of the contract without the consent of the assignee of the contractual rights.[12]

<u>Legal opinion</u>

The legal opinion (**LO**) is a key document of the subscription finance transaction and although somewhat standardised across the offshore market through multiple deals and experience, it remains a point of negotiation and perfection between the law firms involved. It is interesting to note that the responsibility for preparing the legal opinion on a subscription finance transaction tends to vary, depending on the lender's market. In UK and European-led transactions, it is customary for lender's legal counsel to prepare the LO in respect of the entities granting security, whereas in the US it is borrower's legal counsel who is responsible for preparing these legal opinions.

The LO will provide legal confirmation to the lender that, pursuant to the laws of the offshore jurisdiction: the borrowing entities involved have the power and authority to enter into the transaction; that they are validly existing and in good standing under the laws of the Cayman Islands; and that the security interest created over the *chose in action* is enforceable and will be recognised by the courts of the offshore jurisdiction as such, despite the transaction documents generally being governed by other laws than those of the offshore jurisdiction.

The relationship between offshore counsel for the parties is important to note here, as a familiar and proactive relationship can make the difference between a smooth and

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successful transaction and a long, tedious negotiation process – which, in turn, will increase the costs for the parties involved.

Onshore/offshore counsel relationship

Roles of onshore and offshore counsel are complementary, and differ mainly in the purpose and essence of the legal advice provided. Onshore counsel will invariably lead the transaction and be responsible for drafting and negotiating the terms of the various facility documents (and also security documents, unless the relevant offshore jurisdiction requires a local law security document) and therefore their advice, in major part, is key to ensuring that the commercial aspects of the transaction work from a legal perspective, and that the transaction documentation protects their respective clients' interests. Inevitably, as a result, they carry more of the technical burden in transaction drafting.

Offshore counsel, on the other hand, are largely unconcerned with the commercial aspects of the transaction (aside from determining relative bargaining powers!) and are mainly concerned with ensuring the legal validity of any offshore provisions in the transaction documentation, and in particular with the view of confirming that the fund borrower and/or guarantor has the legal capacity under the terms of its constitutional documents to provide the commercially agreed collateral package, and ensuring that any local legal considerations (e.g. the form or registration of security) are properly covered in the transaction documents. Offshore counsel's role is to efficiently review and comment on the transaction documents from a local law perspective, liaise with its counterpart, and follow the lead of onshore counsel in respect of timing.

In our experience, a close relationship with onshore instructing counsel is essential in providing a smooth and tailored service to the clients, and a good understanding and collaborative relationship with offshore counterparts is also invaluable in this context. This enables experienced offshore counsel to have a detailed understanding of the relevant onshore law firm's documentation and dynamics. This helps with efficiency, timing and, ultimately, cost.

Innovate or die?

Standardisation of documents or processes

In our view, there is a strong argument in favour of simplifying the documentation governing fund finance transactions despite the innovations of lending arrangements and structural complexity of these deals. Some reticence is expected in this respect, seeing as preparing and reviewing the documentation is the bread and butter of finance and banking lawyers. However, a certain level of standardisation has undeniably already taken place within existing cross-border relationships, and will continue to do so over the next few years.

While we freely acknowledge that the content and drafting of the facility agreement does not lend itself at all well to standardised processes, we would argue that a more global agreement as to what is expected from an offshore perspective; in particular, in respect of the LPA, the LO and the investor notices, would significantly improve efficiency and certainty by avoiding repetitive commenting on identical documents. A full high-level review of each individual offshore vehicle's constitutional documents (and in particular, specific subscription arrangements and side letters with investors) will never be replaced, of course, but simplifying some of the transaction documents in this way would definitely be an improvement.

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Registration of security interests

Some offshore jurisdictions, including the British Virgin Islands, Jersey and Guernsey, allow/provide for security interests over capital call rights to be registered in a register for security interests which is searchable.

Despite its market-leading position, the Cayman Islands has yet to introduce any form of public or private registration of a security interest granted over an intangible asset such as capital call rights of a partnership (contrast the requirement for a Cayman Islands company to maintain a register of charges in respect of any security granted over its assets). However, a partnership must maintain a register of security interests that have been granted by an investor over its partnership interest in a register of security interests, which should be open for inspection by all persons during business hours. Could introducing security interest registers more broadly as a method of perfection be used as a way of replacing the much-contested investor notice, and provide more certainty in the protection of lenders?

Greater transparency/self-regulation

Lenders have eagerly entered into fund financing in recent years, attracted by strong returns and the apparent low risk of lending to funds, with the collateral effectively being the creditworthiness of the limited partners in funds; traditionally, high-net-worth individuals, pension and insurance funds and sovereign wealth funds. However, a lot of investors now have a very large funding line exposure and managers are able to delay or even avoid calling on investors' commitments, which artificially inflates the funds' returns.

There have been some calls in the investor community for the introduction of self-regulation to the fund finance industry, following concerns over the internal rate of return (**IRR**) of investment funds being overstated by artificially raising the apparent performance of the fund without actual returns earned by investors, particularly in the early stages of a fund's life. Instead of basing the IRR of a fund on the date an investor's capital is called into action, the Institutional Limited Partners Association (**ILPA**) has issued guidelines calling for IRR data to be reported from the time a manager starts to use a bank loan, and for GPs to publish returns on a leveraged and an unleveraged basis.

Some say that carry/hurdle rates are currently being met as a result of the distortion created by subscription lines of credit bolstering the IRR. It means that assessing managers' investment performance has become difficult; there is no data on which funds are using subscription lines, what type/structure and scale of subscription line, and which are not. ILPA also opposes cross-collateralisation in favour of limiting subscription facilities to 180 days, instead of allowing extensions of up to a year or more, as is often the case now. The industry should be mindful of protecting investors' interests, since they are ultimately the ones covering bank loan fees and other unexpected costs; the ILPA guidelines have certainly opened the dialogue on these issues.

In our experience, most experienced investors are aware of the risks, and many favour greater transparency and disclosure on the use of subscription lines. Investor liquidity is an important issue to consider; were there to be a systemic event in the banking industry such as we witnessed in 2008, dominant investors could potentially be called on to repay substantial credit lines across a wide range of funds and lending institutions.

Is the future bright?

Without a doubt, many leading lenders in this space can confirm that the fund finance industry is booming, and every expectation is that the use of fund finance facilities of all

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flavours will very likely continue to prosper, in line with the growth of private equity funds.

As can be seen from the Preqin survey, private equity fundraising remains very successful, and continuous growth has been witnessed over the past few years. There is a direct correlation between the successful fundraising achieved by sponsors in the private equity market, and the increase in lending to funds. GPs now view fund finance as the norm and with non-bank lenders becoming more common, lenders in this space operate in a highly competitive environment, and find themselves being required to provide more flexible and favourable terms to funds.

The flourishing market has equally impacted the size of the facilities, with more and more transactions exceeding the US$1 billion mark and several facilities of up to US$4-5 billion. Despite the fierce competition and growth of the market, lenders are maintaining their credit requirements, particularly with larger funds, and are requiring multi-bank club arrangements. In light of all of this, standardisation of offshore documentation and improvements in security processes may prove essential to survive in the market, although expert quality service will continue to prevail in favour of package value deals.

We are lucky to have a strong community of lending institutions, sponsors, investment funds, managers and other service providers supported by the fund finance association (**FFA**) which encourages dialogue, discussion and improvement across the industry. The regular international conferences, training and meetings organised by the FFA are invaluable in maintaining industry standards and effectively safeguarding against potential detrimental issues by creating a forum of expertise and growth.

* * *

Endnotes

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4. Cayman Islands General Registry | An official website of the Cayman Government (2018). Partnerships Statistics. [online] Available at: https://www.ciregistry.ky/partnerships-register/partnerships-statistics/ [Accessed 4 Nov. 2018].
5. As an industry we don't seem to be able to agree on a consistent taxonomy, so in this chapter, we use the term *fund finance* to describe all types of lending to private funds, which includes subscription finance/capital call facilities.
6. Luxembourg being a notable exception, if you consider Luxembourg an 'offshore' jurisdiction!
7. Hale, P. (2018). *The truth about offshore alternative investment funds* [online] Aima.org. Available at: https://www.aima.org/article/the-truth-about-offshore-alternative-investment-funds.html [Accessed 4 Nov. 2018].

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8. Use of this term within earshot of a banker specialising in capital call finance can cause considerable angst…
9. Other chapters in this book will include numerous descriptions of what such a facility is, but in essence it is where a lender extends a facility to a fund borrower, and the security that the lender takes is a security assignment of the uncalled capital commitments of investors in the fund and the right to make capital calls.
10. As noted in the introduction, globally the vehicle of choice for private equity transactions is the limited partnership.
11. Delaware Revised Uniform Limited Partnership Act 17-502(b).
12. *Brice v Bannister* (1878) 3 QBD 569.

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