GUIDE

Subscription credit facilities - An offshore lawyer's perspective

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The involvement of offshore advisers on a fund finance transaction is derived entirely from the fact that one of the entities involved in the transaction (e.g. the fund vehicle or an alternative investment vehicle) is formed in one of the offshore jurisdictions. Accordingly, the focus of local counsel is on the law as it affects the relevant vehicle. For example, does the relevant entity have the authority and legal capacity to enter into and perform its obligations under the relevant finance documents as a matter of local law and under its constitutional documents, and do the relevant documents create valid, binding and enforceable security in the relevant jurisdiction? Inevitably, a lender will look to obtain a 'clean' legal opinion from local counsel to confirm this is the case before lending.

As such, the role of offshore counsel differs somewhat from that undertaken by the principal counsel to the parties. While the latter will concern themselves with negotiating the main deal documentation to protect their respective clients' positions and with ensuring that the terms of the documents reflect the commercial understanding between the parties, the role of offshore counsel is essentially twofold: firstly, focusing on the fund borrower itself, its ability to enter into the deal and ensuring it follows the correct procedures in doing so, and secondly, ensuring that legal considerations arising out of the law of the fund's jurisdiction of formation are adequately addressed.

Fund documentation and due diligence

Given that the primary focus of local counsel is on the borrower entity formed in the relevant offshore jurisdiction, it follows that a key part of the role is to carefully review the constitutional documents of the relevant entity. In the context of a private equity fund constituted as a Cayman Islands exempted limited partnership, this will be the limited partnership agreement (LPA).

In particular, counsel will review the LPA to ensure that it permits the fund to avail itself of the relevant credit facility and for the fund and the general partner (GP) to grant security over the unfunded capital commitments of the limited partners. In addition, counsel will look for, amongst other things, language giving the GP the power to make capital calls to fund bank financing obligations (including after expiration of the investment period), the ability to grant a power of attorney to support the security package and any provisions which may impose restrictions on borrowing (e.g. relating to duration or purpose). As noted above, counsel will ultimately be expected to issue a 'clean' opinion to the effect that the transactions contemplated by the deal documents do not breach the LPA and so will look for anything which may affect the ability to provide this.

It is now common for LPAs to include provisions expressly permitting the fund to enter into subscription facilities and to grant security over those unfunded capital commitments, but there may be other restrictions or conditions which must be met. For example, advisory committee consent may be required, or there may be restrictions on the maturity or amount (typically expressed as a percentage of aggregate capital commitments) of any permitted indebtedness. In these situations, offshore counsel will raise the restrictions with their instructing counsel or client in order to ensure that appropriate steps are taken or protections built into the documents.

The terms of investor side letters can also impact the deal in a number of ways. Although it is unlikely that the terms of a given side letter will operate to prevent a fund ever entering into a subscription facility, they can operate to dilute the value of the investor's commitment as part of the security package.

The ways in which they can do so are almost unlimited. We have seen examples of side letters providing that an investor is only obliged to fund capital calls made by the GP, rather than by any delegate or attorney; that default remedies under the LPA may only be exercised by the GP; that investors be given extended grace periods to cure funding defaults or before the fund or the GP can exercise default remedies; or granting investors additional excuse provisions in certain circumstances. We have also seen side letter terms to the effect that investors need not provide any financial information for the benefit of a financing lender unless such information is already publicly available. In these circumstances the usual course of action for the lender is to exclude the relevant investor from the facility's borrowing base.

When reviewing the structure, a lender's counsel should also be alive to the potential for leakage if the LPA permits the general partner to set up alternative investment vehicles (AIVs), blockers or parallel funds. Such provisions can allow the general partner to divert investor commitments to these other vehicles. In our experience, the biggest private equity sponsors tend to be very 'AIV heavy' in their fund structures.

If the LPA contains such provisions, lenders will want to ensure it also permits the GP to grant security over the undrawn investor commitments to any such vehicles, and the facility documentation should include covenants obliging the fund and the GP to ensure that any investor commitments to these vehicles are added to the security package. The lender will typically expect any legal opinion to also be extended to these AIVs (which are usually also established in offshore jurisdictions).

Finance documents: issues to note

Rather than focusing on the commercial aspects of the transaction documents (which, as noted above, is more the purview of principal counsel), offshore counsel will instead concern themselves principally with aspects of the documentation which may be impacted by local law.

Most offshore jurisdictions are sensitive to the demands of their principal user bases, including the private equity industry, and aim to meet those demands with user-friendly and practical legislation: the Cayman Islands, for example, overhauled its Exempted Limited Partnership Act (as amended) in response to industry feedback.

Because of this, offshore fund vehicles tend to be flexible and their governing legislation accommodating of common industry practice, and it should rarely be necessary for offshore counsel to make substantial comments on a draft loan agreement or security document. The review will mainly concentrate on ensuring that appropriate representations and events of default are included and that customary conditions precedent documents are included and correctly described.

Notification of assignment of call rights: 'perfection' and priority

The typical security package will include rights under the fund's LPA, which will be governed by the law of the jurisdiction where the fund is formed and/or registered. Accordingly, offshore counsel will need to satisfy themselves that any relevant legal requirements for the creation and perfection of this security are satisfied.

For example, lenders and fund sponsors who use Cayman Islands fund structures will know that, in order to secure the priority of the lender's security interest over capital call rights under the LPA, it is necessary to notify investors that those rights have been assigned as part of the security package.

The timing for the dispatch of such notices can frequently be a point of negotiation between lenders eager to safeguard the priority of their security and GPs who are reluctant to disturb investors unnecessarily. Lenders will generally want GPs to send notices upon closing or within three to five business days following closing, and to provide lenders with evidence of delivery (since the notice is only effective when received by an investor, rather than upon dispatch), whereas GPs may prefer to send notices at a later date, such as in a quarterly report or upon default. Ultimately, this will be determined by the negotiating position of the parties.

A lender faced with a GP adopting such a negotiating position might derive some comfort from remembering two things. Firstly, although the sending of notices is frequently described as a 'perfection'

requirement, from a Cayman Islands law perspective it is not technically so, in the sense that a valid security interest will still have been created at signing even if no notices are sent. Secondly, the 'priority' of the lender's security interest is its priority only as against competing interests in the secured assets. A validly created security interest over capital call rights will still have priority over the claims of a liquidator or unsecured creditor of the fund, even if no notices have been sent, and covenants in the main credit agreement prohibiting additional indebtedness and negative pledges in the security documents should ensure that, as a practical matter, the risk of a competing creditor claiming a security interest over the call rights is minimal.

A GP can take comfort that the investors do not need to acknowledge the notice in order for it to be effective. However, the lender should receive evidence that the notice has been effectively delivered to investors. Notices are commonly delivered via email or via the fund's online secure investor portal. Either approach is acceptable from a Cayman Islands legal perspective provided that such method is permitted under the notice provisions in the fund documentation. Where notices are sent electronically, it is customary for the lender to receive a copy of the signed notice, copies of the emails attaching the notice or alerting the investors to the portal upload, and confirmation that there were no delivery failures.

Offshore legal opinions

The offshore legal opinion(s) should address both the capacity of the fund to enter into the transaction documents and the enforceability of those transaction documents against it.

It has long been market standard in any kind of US law driven fund finance lending transaction for borrower's offshore counsel to give opinions to the effect that the borrower is duly formed and registered and in good standing, that it has taken all necessary action under its constitutional documents to authorise its entry into, and to perform its obligations under, the transaction documents, and that the obligations of the fund under those transaction documents are legal, valid, binding and enforceable. It should be noted that in UK, European and Asian fund finance transactions the responsibility for opinions is split between borrower's and lender's offshore counsel whereby borrower's offshore counsel issues a capacity and authority opinion on the transaction documents with lender's offshore counsel covering enforceability of the Cayman Islands law governed security documents they have prepared.

In addition to these 'standard' opinions, there are a number of additional aspects deriving from the particular features of subscription credit facilities which lenders are increasingly requiring to be addressed in any offshore legal opinion, including that the fund's entry into the finance documents does not conflict with the fund LPA, there is no requirement for the finance party to be licensed in the Cayman Islands, nor is there a requirement for the finance party to be resident in the Cayman Islands and the payment obligations owed by the fund to the finance party will rank equally and rateably with its other unsecured and unsubordinated payment obligations (*pari passu*).

Given the importance of the capital call rights to the quality of the credit, lenders will want the offshore opinion to confirm not only that a valid security interest has been created over those rights and that the secured party will have recourse to those assets in priority to any third party (including a liquidator or unsecured creditor of the fund), but also that priority as against competing interests is secured by sending notice of the assignment to the limited partners, and specifically that the form of notice prepared for this purpose (typically included as an exhibit to the credit agreement or security document) will be sufficient to achieve this.

In addition, lenders are now frequently requesting the borrower's offshore counsel (who, in most cases, will have acted on the formation of the borrower vehicle and so will have had input into the drafting of the LPA) to confirm in their opinions that the obligations of the limited partners under the LPA to contribute capital when called are legal, valid, binding and enforceable.

It is also becoming increasingly prevalent in certain markets, such as Asia, for a borrower's offshore counsel to be asked to confirm that the fund's obligations under the transaction documents do not conflict with or breach the terms of any side letter. As noted above, this may not be possible in all circumstances.

Contacts

A full list of contacts specialising in Cayman Islands law can be found here.

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