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FUND FINANCE FRIDAY

LP Sanctions Risk in Fund Finance: Issues for Lenders to Consider

May 13, 2022 | Issue No. 175

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We have been closely monitoring the sanctions landscape over the last few months. Back in March, we covered the sanctions levied by the United States and other jurisdictions in response to Russia's invasion of Ukraine. The sanctions impair Russia's ability to access the international financial system and are designed to have a severe and lasting effect on Russia's ability to fund the war in Ukraine and other such initiatives.

Sanctions are serious business and may result in strict liability, meaning that a financial institution or other lender party can be liable for a sanctions violation even if there is no knowledge of or intent to commit a violation. When it comes to managing risk, most financial institutions consider sanctions risk in terms of the parties with whom they interface directly. For commercial lenders, a focus of sanctions risk assessment and mitigation has been on borrower parties. Banks and other lenders are being cautious when it comes to sanctions compliance and are taking great care when faced with a borrower that has any level of direct or indirect ownership by a sanctioned individual or entity.

In the fund finance arena, we are seeing a nexus to sanctioned limited partners ("LPs") that may not feature in other types of financing arrangements. Numerous individuals and entities that are LPs in various fund borrowers have been blocked for sanctions purposes, either directly, or indirectly by virtue of their beneficially owners being designated under applicable sanctions. In recent weeks, we have seen a number of borrower funds report to their lender that an LP in the fund has become a sanctioned person.

These fund finance-sanctioned LP issues are actual developments, as opposed to theoretical risks. While each sanctions designation and deal structure is nuanced and government guidance specific to sanctions risks in fund finance is limited, we are going to break down some of the major concepts and provide a general rundown of issues that arise when a fund reports to its lenders that an LP has been identified as subject to sanctions.

Sanctions Create Real Risk for Lenders in Financing Transactions

When grappling with sanctions issues in a lending transaction, some borrowers have taken the position that they are the party that bears the risk. It is true that the sanctions risks tend to be more immediate to the fund, but the potential risks to the lender are also very real. In a fund finance transaction, a lender's ability to call capital from a borrower's LPs is one potentially direct touch point with inherent sanctions risk. There is also a risk that a lender instruction to a fund − for example, to call capital, exit an investor, or even to exclude a sanctioned LP from a future capital call − could inadvertently cause a fund to violate sanctions rules, and potentially result in a facilitation violation by the lender. OFAC has not provided detailed public guidance on how lenders should manage fund finance sanctions risks. With this lack of regulatory clarity in mind, parties are being cautious and conservative.

Funds Should Take Immediate Action in Response to an LP Becoming a Sanctioned Person

Under OFAC's 50 Percent Rule, lenders generally are not prohibited from dealing with a borrower fund provided that no OFAC-sanctioned persons own, directly or indirectly, 50% or more of the fund. The holdings of most LPs do not come close to approaching that threshold. But while a lender may be permitted to deal with a fund in which a sanctioned LP holds a small interest, the fund itself must take appropriate measures when dealing directly with its LP.

For example, funds are generally freezing distributions to any sanctioned LP, and freezing funds held in connection with the LP's interest in the fund. Generally, frozen funds are placed into a "blocked account," which the sanctioned person cannot access without an appropriate license from OFAC.

In addition to freezing assets and payments, funds are also considering whether other actions might constitute a prohibited service or other dealing. For example, a fund may consider that excusing a sanctioned LP from a capital call would grant a prohibited benefit to a sanctioned LP; in such a scenario, the fund may opt instead to make the capital call to the sanctioned LP, and immediately place funds received into a blocked account.

Exiting the LP from the Fund May Not Be a Simple Fix

As a general matter, when an investor is identified as being sanctioned, parties are prohibited from dealing both with the sanctioned investor's property and with the sanctioned investor itself. Permitting funds to flow to or from a sanctioned LP without appropriate blocking would almost certainly constitute a violation; signing a new agreement that is countersigned by a sanctioned LP − whether to exit the LP from the fund or for some other purpose − may also be prohibited unless an appropriate license is granted. Obtaining such an OFAC license can be a time-consuming and costly exercise. There is also uncertainty as to whether it would be granted.

In addition, sanctions laws generally would not require a fund to exit an investor that is sanctioned; sanctions laws typically only prohibit new dealings and require blocking and reporting of sanctioned interests. Thus, a fund and its lenders may take the position that exiting a sanctioned investor, rather than simply blocking the investor's property, goes beyond what is required by law and thereby incurs reputational risk for the fund.

Some Fund Finance Lenders Are Moving Forward with Conditional Waivers

Under a typical fund finance credit agreement, the presence of an investor that is a sanctioned person is an exclusion event that results in the LP in question being removed from the borrowing base. Typically, at the time of each draw, a borrower must make a representation that neither it nor any of its investors is a sanctioned person or otherwise subject to sanctions. But when a fund's LP is indeed subject to sanctions, the borrower cannot make that representation and the fund, by operation of contract, is unable to borrow. Lenders and borrowers alike have explored how to address this scenario.

As discussed above, exiting the sanctioned LP from the fund is far from simple. One solution that parties are using is a waiver process. For example, the agent and lender(s) may agree to waive default under the credit agreement due to the borrower's inability to make the required representation as to a particular sanctioned LP. The waiver is granted on the condition that the fund and other parties to the credit agreement commit to taking appropriate, often carefully specified, measures, such as blocking all property related to the sanctioned LP, to ensure that all parties remain in compliance with sanctions laws. These waivers are deal- and party-specific and, depending on the facts and circumstances and the risk tolerance of the various parties, can be fairly complex. Nonetheless, with guidance from counsel, some lenders may determine that such a waiver process provides a reasonable path forward when a borrower's LP becomes subject to sanctions.