

CADWALADER

Top 10 Items to Consider When Structuring Your ESG Facility

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By **Wes Misson**
Partner | Fund Finance

ESG-focused investment funds raised a record amount last year – estimated at more than \$50 billion in new investor money. This trend is expected to not only continue but accelerate over the next few years. Some commentators have even noted that eventually, there may be no distinction at all between traditional investing and ESG investing as the latter cements its standing as the new normal for our modern-day society.

Green initiatives and social impact often drive the focus. Despite the pandemic and market volatility experienced in 2020, the social and political agenda has established a clear message in favor of societal change and investing for the greater good. A sustainable future and one that we can be proud of shaping has taken priority in the corporate and investment world.

Fund finance is no exception. Since last summer alone, we have closed 6 ESG fund finance facilities at Cadwalader, including the **largest one ever closed and syndicated**.

ESG-linked technology is making its way into loan documents with more frequency. While a basic framework has been established, a lot of discretion remains with the lender and borrower on structuring considerations. Below are my top picks of the most important items to consider when launching your next ESG facility:

1. Facility type: Use of proceeds

Generally, a use of proceeds-focused facility will require that all investments funded via loan proceeds meet specific sustainability criteria. The LSTA, the LMA, the UN and others have published guidance on green loans and sustainability-linked loan principles. The borrower will typically have investment guidelines that sync with these principles and align with its overall investment strategy. The guidelines should be reviewed and agreed upon prior to closing the facility to establish an objective set of criteria that must be satisfied when facility proceeds are used for investment purposes. The borrower will provide reps and certifications related to the use of proceeds and satisfaction of the sustainability criteria each time it borrows for an investment. The asset class and projected usage by the fund must obviously align for this type of structure to work. It's generally favored on green facilities, such as a fund using a facility solely for investment in renewable and alternative energy sources.

2. Facility type: Performance-based outcomes

Another popular method and the approach that can be employed for a variety of different fund borrowers, regardless of asset class or investment focus, is to measure the borrower against certain objective performance criteria – often referred to as “KPIs” or Key Performance Indicators. The KPIs should be established upfront and align with sustainability guidance. Satisfying or failing to satisfy KPIs will trigger a positive or negative, as applicable, outcome under the facility. The triggers can be negotiated and lead to a variety of outcomes, but should be set up in a manner that incentivizes the borrower to achieve real results.

3. Pricing adjustment

This has become the most common outcome for performance-based facilities, but is not a requirement and is certainly not seen in all facilities. Achieving the agreed-upon KPIs under this structure will lead to a pricing reduction – typically 5-25 basis points. The opposite can also be true with failure to meet KPIs as a trigger to a pricing increase in a corresponding amount. The pricing outcomes may also be tiered based on which KPIs are achieved. This type of framework provides a strong incentive for borrowers to work toward the sustainability-linked goals and also gives lenders a corresponding way to put some skin in the game.

4. How to set KPIs

Agreed-upon KPIs should be both ambitious and meaningful to the borrower's business but also achievable within certain time intervals of the facility. KPIs can be measured monthly, quarterly, semi-annually or annually and will yield the negotiated trigger outcomes. There is wide latitude on establishing specific KPIs, and care should be taken to ensure the goals are suitable and aimed at real change to advance the investment. KPIs can be measured at

portfolio company or investment level or also at the fund level. Targets can include such items as reductions of greenhouse gas emissions or board diversity. Longer facility tenors may also be ripe for adjustments to KPIs or the ability of the parties to revisit the targets or request changes upon the occurrence of material events or set time periods.

5. Reporting

Once you set KPIs or use of proceeds targets, how will you ensure compliance? What reporting will be needed and from whom? Like the KPIs themselves, there is not a market standard on reporting. These are generally negotiated and will be specific to the borrower. Many times reporting will be provided quarterly and self-certified by the fund. This may be similar to the reporting that is provided to investors and may also require completion of a pre-agreed form compliance certificate provided by the borrower on the reporting date. Third-party reporting and certification may also be desired, particularly if not cost-prohibitive or the borrower uses an external review provider. A lot will depend on the fund's current practice, investor-driven requirements and how complex the KPIs are and the needed frequency of reporting.

6. Audit and dispute rights

Even where reporting is provided entirely by the borrower, negotiated audit rights are an option to provide a check – either as a matter of right by the lender upon a dispute or annually by the borrower as part of its regular reporting package. Another option is to avoid specific KPIs altogether but require a third-party sustainability ratings firm to provide a score for the borrower. The score can then be used to trigger the same outcomes as the KPIs. Frequency and costs of audits are all negotiated points. Where a third party provides the reporting, the audit right may not be necessary.

7. Role of sustainability agent

Will the lead bank alone or other banks collectively serve as sustainability agent? Will fees be paid for this role or will the benefit be title and discretion rights over negotiating and approving amendments to ESG criteria? Who will receive and monitor compliance with reporting? These are all questions that should be asked and are generally roles handled by the lead bank and any co-leads in the syndicate for a large facility. The sustainability agent role should be scoped into exculpatory clauses similar to other agent roles.

8. Defaults

What happens if the borrower fails to meet the KPIs? Will it trigger an event of default? Where a pricing toggle is tied to KPI satisfaction, generally there is no corresponding default for failure to perform. The borrower would fail to gain the benefit of a margin reduction or would be faced with a margin increase. For a use of proceeds facility or one that doesn't provide a pricing toggle, failure to comply may trigger a number of things that could include, but are not limited to: events of default (usually following a cure period); repayment obligations, particularly in situations where investments no longer qualify (materiality thresholds may apply); early maturity of facility or right for lender to restructure, particularly if the parties are unable to agree to suitable amended criteria if the defaults under the existing criteria cannot be cured; or automatic flip to a non-ESG facility with pre-agreed terms and loss of ability of parties to further market or make public statements regarding the facility as being sustainability-linked. It should be noted that, on the one hand, having an EOD can be helpful to deter bad behavior such as sustainability washing. However, an EOD may also have the effect of reducing meaningful impact by making the borrower reluctant to agree to take on ambitious sustainability targets.

9. Marketing benefit

The parties may want to consider certain changes to confidentiality sections that would permit them to publicly disclose certain elements of the facility, promote the greater good and market their roles. This should be discussed upfront in the transaction so that everyone is on the same page. In some cases, the parties may consider paying the benefits forward and donating any net income achieved from pricing reductions or increases to charities and causes related to the sustainability objectives.

10. Avoid sustainability washing

Sustainability washing can occur with misrepresentations, exaggerated claims or inaccurate reporting, which are ways that parties may take advantage of the market. It's important to have the right level of transparency, and to ensure that the targets are actually meaningful and the reporting and compliance is sound. Reputational risk

considerations could come into play if material events occur that question the quality or veracity of the achievements. The parties may look to employ protective clauses that would unwind the ESG nature of the transaction if a material likelihood of washing behavior exists or a triggering event happens that could cause substantial likelihood of embarrassment for the parties. These clauses are often difficult to negotiate and so the concerns are commonly mitigated via other factors, such as sponsor selection, track record, audit rights and third-party verification.

At the end of the day, there is no secret sauce to structuring an ESG facility. The parties retain immense flexibility but should keep in mind the desired environmental or societal objectives and set up real meaningful ways to measurably achieve and reward this behavior. After all, doing some good feels good.

'Fund Finance Friday: Industry Conversations' – Checking In with Bank of Ireland's Nicholas Armstrong

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FUND FINANCE FRIDAY
INDUSTRY CONVERSATIONS



Jeremy Cross

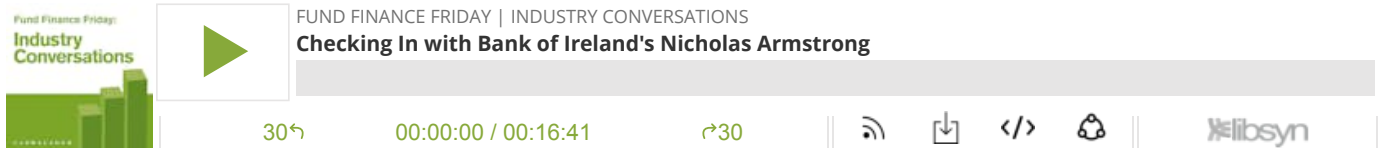


Nicholas Armstrong

Checking In with
Bank of Ireland's
Nicholas Armstrong

In this episode of *Fund Finance Friday: Industry Conversations*, Bank of Ireland's Nicholas Armstrong joins Cadwalader partner Jeremy Cross to discuss fund finance at BoI, as well as current market developments and predictions for the rest of 2021.

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Cayman Investor Notices Through the Ages (of Fund Finance)

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By **Derek Stenson**
Partner | Conyers



By **Michael O'Connor**
Partner | Harneys

As anyone who has ever worked on a subscription-based fund finance facility involving Cayman vehicles can tell you, there will at some point be engagement on the “investor notices.” Most attorneys and bankers in the space can explain why this matter arises (because the Cayman Islands does not have a forum to formally register security interests to establish priority or otherwise), and almost everyone has a view on what is “market standard” *vis-à-vis* the issue of such notices.

The reason for and use of investor notices is an evolving concept, however, and while we don’t anticipate Ken Burns or David Attenborough covering it in a documentary any time soon, a quick trip through the ages of fund finance is helpful to shed some light on what is, from a Cayman Islands perspective, an enduring feature of fund financing transactions.

The Dark Ages – When PE Was Just Two Letters

The root of the issue has its source long before the days of email, Zoom, FOMO or even Downton Abbey. This root is, of course, the English case of *Dearle vs. Hall*, which arose out of a set of transactions dating in the early 1800s. One party (an enterprising gentleman named Zachariah Brown) inherited the right to an annuity payment to be made by a trustee. He then, in return for a payment in each case, assigned his right to such annuity on three subsequent occasions to three different purchasers.

The final party who purchased the rights (Hall) had hired an attorney* who undertook due diligence on the annuity and served notice on the trustee that the assignment had occurred. Neither of the two previous assignees (one of whom was Dearle) had yet done so.

Subsequent to the final assignment and the notice being served by Hall on the trustee, the first two assignees (Dearle and Co.) notified the trustee of their interests and prior assignments. The trustee did what any trustee would do: hit the panic button hard and repeatedly and called in the Courts to help.

In simple terms, the Court held that notwithstanding the date on which the various assignments had occurred, Hall (the final purchaser of the rights in time) had priority to such rights over the two prior assignees as a result of his having first given notice to the trustee.

**Mr. Patten, whom we imagine to be something akin to a Downton Abbey character, gave attorneys a great example to point at when asked how to justify their necessity.*

The Middle Ages – Subscription Finance Emerges

The evolution and growth of the subscription finance industry in the 2010s came at the same time as corresponding growth in the use of Cayman Islands vehicles (particularly, exempted limited partnerships) in private equity structures. While the concept of taking security over contractual rights was not novel in the broader legal context, the issue of cross-border lending using a U.S.-governed security agreement to secure rights established by a Cayman Islands-governed agreement (generally, the exempted limited partnership agreement) was certainly one which merited thought.

Thankfully, salvation was found in the form of *Dearle vs. Hall*, which provided a clear path to establishing priority in respect of a security interest over capital call rights – being notice to the limited partners. This notice, once served on the limited partners, would satisfy the rule in *Dearle vs. Hall* and protect the priority of a lender’s security over such rights.

Unfortunately, it wasn’t all that simple in practise. The question of how this notice would be served became one which all parties were sensitive to. Lenders and their counsel wanted the best form of notice, being one which was sent immediately on closing and took the form of an independent document sent to limited partners and acknowledged by

such limited partners. Borrowers, on the other hand, wanted notice to be included amongst other investor communications, occurring, in some instances, months following closing.

Debate ensued, different lenders had different approaches, and different sponsors had different preferences. For the most part, investor notices were sent as independent documents to investors within 30 days or so, acknowledgement of receipt by limited partners was rarely seen, and the issue was one that was viewed as relatively negotiable by parties.

The Second Coming of Cayman Notices

Every industry has its coming of age moments and, following a high-profile sponsor insolvency, the issue of Cayman notices arrived back on the radar for the industry. Lenders became re-engaged about understanding the details of the issues and risks arising from delays in serving notice.

This led to a second coming of the issue where the market moved significantly towards notice being served as an independent document and within a much shorter timeframe post-closing (anywhere from on the date of closing to 15 days from that date). The days of investor notices being one paragraph in a quarterly report to investors were gone. Thankfully, however, this happened at a time where limited partners had also become much more familiar, informed and understanding of subscription facilities, and so, in many cases, sponsors were already “over” the issue and less sensitive to communications on the point raising queries in their investor base.

The position today is largely unchanged and generates a certain amount of paper tracing (with executed notices and evidence of sending being provided by borrowers post-closing) but relatively little debate.

The Roaring 2020s – What’s Next?

While the current formula works, nothing is ever perfect. The future of investor notices certainly lies in technology and, as the industry continues to evolve and develop, we can see a scenario whereby a party (or group of parties) form a more efficient system to serve the industry in this regard.

The other trend to watch is whether this modern Cayman phenomenon (with its roots in the 1800s) takes flight and becomes a feature in other jurisdictions where, although perhaps not a technical legal requirement, it is sought as a type of additional lender check and comfort. Watch this space!

Key Takeaways from Wildgen GP and Management Fee Facilities Webinar

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By Michael Mascia
FFA Board Member

Luxembourg law firm Wildgen last week hosted the seventh webinar in its fund finance series – a focus on GP and Management Fee Facilities. The panel was moderated by Michael Mbayi of Wildgen, and included Emily Rose of Silicon Valley Bank, William Lamain of Raiffeisen Bank International, Amira Hajili of Natixis, Richard Fletcher of Macfarlanes, and Brian Foster of Cadwalader. Here are *FFF*'s key takeaways from the panel.

Terminology

Sometimes the terminology can get mixed around and used interchangeably. In common parlance, the term “GP Facility” is often used broadly to cover any lending to a fund sponsor. But other times, “GP Facility” is used more specifically to describe a loan, the purpose of which is to help finance the GP’s obligations to purchase equity in the funds it manages (including meeting capital calls). “Management Fee Facilities” are more like a corporate loan to a sponsor that focuses on the sponsor’s key revenue streams: the management fee and earned carry. They can be for any reason that the sponsor needs financing, such as to pay bonuses, to outfit an office, to pay placement agent fees, to make an acquisition, etc. Often the collateral package includes the interests and cash flows from multiple funds, not just one.

Key Risks and Due Diligence

The key underwriting risks which the lenders focus on are the circumstances in which management fees and carry could be cut off, such as: (i) Under what circumstances could a sponsor be removed by the investors as the sponsor of the fund(s)?; (ii) Are there management fee offsets for things like advisory fees or board fees?; (iii) What is the likelihood that the subscription line lender takes exclusive control of the fund’s capital contribution account during a default, which would cut off the ability of the fund to pay management fees?; and (iv) There could be a significant decrease in the value of the assets or illiquidity in the market, which prevents expected asset sales and the forecasted cash flows and carry.

Related due diligence includes: (i) legal review of the partnership agreements and the management fee agreements, looking for restrictions on the authority to pledge (there can be workarounds in the U.S. under the UCC); (ii) understanding the management fee waterfall; (iii) terms in which the management fee can be reduced, cancelled or subordinated; (iv) the sponsor’s trailing earnings and current and projected financials; and (v) understanding the investment pool in an existing fund(s) to forecast potential carry to be earned.

Key Covenants, Negotiated Points and Unique Challenges

- The covenants often mirror the due diligence and seek to preserve similar levels of expected cash flow as contemplated at closing.
- Covenants can include: (i) minimum top-line revenue; (ii) minimum operating cash flow; (iii) limitations on investor defaults in the key fund(s); (iv) limitations on changes to the management fee and carry structure; (v) minimum AUM; (vi) minimum yearly management fee; and (vii) leverage ratio triggers.
- Key negotiating points include: (i) the repayment waterfall is often bespoke and highly negotiated; (ii) to what extent the management fees can be used to pay critical expenses of the sponsor during a default; and (iii) what are the clean-down provisions (*i.e.*, the facility needs to be periodically reduced to \$0 annually, but the sponsor would prefer to hold the loan outstanding for a longer period).
- Among the unique challenges: If not all the members (the people) at the sponsor are using the financing, some members may have concerns about the management fees being pledged to support the facility (*i.e.*, the bank is getting recourse to all the fees and carry, when the benefit of the loan only goes to some of the people).
- In a GP Facility, the lender needs a date certain as to maturity and repayment, but the dates of the future sale of the investments which generate the carry are inherently speculative.

Market Dynamics

- The volume of these facilities is very light compared to subscription finance, and only a subset of active subscription line lenders offer the products.
- The market is very bespoke; there are not really established market standards.
- These facilities are often done alongside a subscription facility for the new fund.
- The risks involved tend to lead to these facilities only being made available to very established sponsors with a positive track record across multiple funds.
- GP Facilities can be outstanding for as long as 10 years in order to enable time for the liquidation of investments.
- GP Facility demand is increasing for several reasons, including: (i) COVID-19 slowed some dispositions in prior funds, and sponsors need to make new capital commitments to the next funds; (ii) as sponsors grow and promote new partners, those partners often need cash to fund their capital calls; (iii) investors are at times pushing sponsors to put more skin in the game, increasing the size of GP capital commitments; and (iv) many sponsors are managing multiple strategies, which can often result in simultaneous fundraises and capital commitment obligations.
- There is a strong relationship aspect involved in this type of lending, as the facilities are for the sponsor itself and involve some intimacy with the principal's personal financials.
- Lenders use GP and Management Fee Facilities to differentiate themselves and to go beyond subscription financing. Providing these financings can lead to a deeper understanding of the sponsor and enhance the relationship.
- As sponsors are growing, facility sizes are increasing, and more facilities are being syndicated.
- Alternative lenders are increasingly interested in providing Management Fee Facilities on a preferred equity-type basis.

WFF Europe and Asia Event Announcement

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The Asia and Europe chapters of Women in Fund Finance this week announced a May 11th event titled “WFF Asia & Europe: Lead Like a Woman by Mastering the Power Game.” For more information, click [here](#).

WFF Europe Event Announced

April 30, 2021 | Issue No. 124

The FFA's Women in Fund Finance group this week announced an event titled "WFF Europe: The Technicalities of an ESG Financing," featuring the following guest panelists: Emma Russell of Haynes and Boone, Eimear Palmer of ICG, Sally Little of ING, Stella Saris Chow of ANZ, and Guillaume Ferrer of CACIB. The event will take place next Wednesday, May 5 from 9-10 a.m. GMT. For more information or to register, click [here](#).

Strafford CLE on Fund Finance

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Strafford Publications, Inc. this week announced a live CLE video webinar on fund finance titled “Structuring Umbrella Credit Facilities in Fund Finance.” The session will be held June 3rd at 1 p.m. EDT and will be led by long-time fund finance attorney Tom Draper of Foley Hoag LLP. For more information or to register, click [here](#).

Brickfield Guest Article in Private Funds CFO

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Brickfield Founder **Rory Smith** has published an article in *Private Funds CFO*, providing an update on developing trends in the U.S. fund finance mid-market, with comments and insight from **Mike Mascia** at Cadwalader, **Brad Ellis** and **Mike Breaux** at Stifel Bank, and **Michael Sinclair** and **Jonathan Sammarco** at People's United Bank. The article can be found [here](#).

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