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

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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.

Fitch Webinar on Expected Ratings for Astrea 7 CFO

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Fitch Ratings hosted a webinar this week on its expected ratings for the Class A-1, A-2 and B classes of the Astrea 7 Pte. Ltd. collateralized fund obligation of private equity fund interests. To access the webinar, click **here**.

Kayo Conference Announces Fund Finance Panel

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Kayo Conference this week announced a fund finance panel at its June 14th Credit and Debt Finance Summit in Boston. For registration information, click **here**.

Make Way for Others: Supporting the Next Generation of Leaders

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Women in Fund Finance, NextGen and Diversity in Fund Finance will be hosting a workplace diversity-themed panel for in-person attendance at Haynes & Boone’s New York office on May 16 at 6 p.m. Don’t miss this opportunity to discuss challenges faced by diverse fund finance professionals and improve your effectiveness as an ally! To register, click **here**.

Cadwalader Fund Finance Afterparty – Monday, May 16

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Please join the Cadwalader Fund Finance team for cocktails and to catch up with your fund finance friends immediately following the WFF, NextGen and Diversity in Fund Finance event on May 16 in NYC. We hope to see you there. To register, click **here**.

WFF Launches ‘Reader’s Series’

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On Tuesday, May 24, Women in Fund Finance will launch a new “Reader’s Series” that will feature members of the fund finance community who are avid readers of non-fiction, with an emphasis on topics concerning both social and economic impacts.

The inaugural event will discuss the award-winning book, *Dopesick: Dealers, Doctors and the Drug Company that Addicted America* by journalist Beth Macy, who is a prolific writer on the opioid crisis. Also discussed will be award-winning *Empire of Pain* by Patrick Radden Keefe, a staff writer for *The New Yorker* and a *New York Times* best-selling author. The discussion will be led by Walt Jackson of Onex Credit, Mike Henry of U.S. Bank, and Cadwalader’s Leah Edelboim. Click here to register **in-person** or here for **virtual** attendance.

WFF Event: Crypto 101

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On Wednesday, June 1, Women in Fund Finance will host a virtual event, “Crypto 101: Demystifying Cryptocurrency & Blockchain,” featuring speaker Bob Griffin of WhiteTower Capital Management, LLC and moderated by Fazillah Durante of Scotiabank. Please visit **here** to register.

Fund Fanatics Fast Facts, Existing LPs and Continuation Funds

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This Fund Fanatics Fast Fact highlights Sameer Shamsi's answer to the question: What do existing LPs choose? For more on the latest in secondaries and the creativity behind the growth, check out the full Fund Fanatics episode from Scott Aleali and Jeff Maier **here**.

Brickfield Post on NAV Hiring

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Brickfield Recruiting this week put out a post identifying a gap between NAV momentum and actual hiring. To view the post, click **here**.

On the Move – Fund Finance Tidbits

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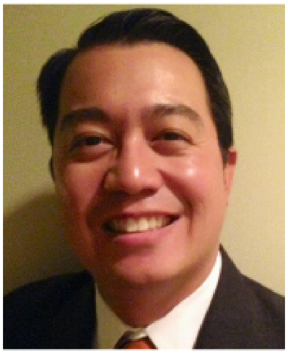
On the Move



Rafael Vistan

Ryan Riordan

Nathan Lee

MUFG has made some recent promotions, including: Rafael Vistan was promoted to Managing Director, Ryan Riordan was promoted to Director, and Nathan Lee was promoted to Assistant Vice President/Associate.

Rafael Vistan. Rafael is Head of Underwriting and Portfolio Management for MUFG's Funds Finance business in North America. Rafael is a seasoned banking professional with 24 years of experience. He has been with MUFG for 15 years, with the last 7 years overseeing the growth and risk management practice of the firm's Funds Finance business. Rafael also serves as product advisor in MUFG's expansion into the subscription/capital call finance business globally.

Ryan Riordan. Ryan is an experienced capital markets professional with a primary focus within the subscription finance, oil & gas, chemical and waste management sectors. Ryan has over 10 years of experience in origination, structuring and distribution of structured products, including fund financing, reserved based lending, term loan B and bridge financings.

Nathan Lee. Nathan is a banking and finance professional focusing on fund finance for leading sponsors across a variety of asset strategies. Nathan is a key member of MUFG's Fund Finance team based in New York. Nathan has been part of MUFG's Fund Finance team for over 3 years and supports the origination and structuring of subscription lines.

Fund Finance Hiring

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Fund Finance Hiring

Bridge Bank is looking for Credit Analysts to join its Equity Fund Resources team in the New York or San Jose offices. If interested, please apply **here**. It is also seeking an AVP-Portfolio Manager for its Equity Fund Resources Team in the New York, Boston or San Jose offices. If interested, apply **here**. If you have any questions, please reach out to **Westin Brake**, Senior Director.