To Luxembourg from the Cayman Islands with Fund Finance…

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The Cayman Islands has long been a leading investment funds jurisdiction, and the North American fund finance industry is relatively familiar with the key legal concepts arising on a fund financing involving Cayman Islands private equity and other alternative funds. The Cayman Islands is internationally recognized as a well-established, modern, transparent, commercial and flexible common law jurisdiction.

Luxembourg is the largest fund domicile jurisdiction in Europe and, over the past years, has become a key player in the fund finance industry. In addition to Cayman Islands funds, Luxembourg funds are often included in the fund structures acting as borrowers or parallel feeders on fund financings. Nonetheless, the perception, particularly in North America, of Luxembourg as a jurisdiction continues to be that of a traditionalist and complex system that struggles to attain the commercial expectations of the industry. In this article, we explore the background and evolution of Luxembourg as a jurisdiction, how it compares with the Cayman Islands, the essential Luxembourg fund finance points, and how to get the best of both worlds.

Background and evolution

As a dual-qualified Luxembourg *avocate* and Cayman Islands attorney, my perspective on the two jurisdictions is unique. I have been advising lenders in the fund finance industry for many years in respect of both Cayman Islands and Luxembourg law from a U.S. time zone, and have experienced not only the growth of the industry but its constant and organized evolution.

The Cayman Islands has undoubtedly achieved a level of legal service on par with the North American market, and the expectation of lead counsel teams is that Cayman Islands counsel will provide efficient, collaborative and business-minded legal advice to assist the progression of a financing transaction.

One of the reasons for this is that the Cayman Islands legal system is based on English common law and is similar in many aspects to the legal system in the United States in that it evolves in accordance with social, political and economic trends. Another reason for Cayman's reputation as an efficient, forward-thinking jurisdiction is cultural since most attorneys admitted to practice in the Cayman Islands come from various parts of the world and have an international business background. This encourages flexibility and a competitive modern vision of the banking and finance industry.

Luxembourg, on the other hand, is a civil law jurisdiction with a constitution dating back to 17 October 1868. As a member of the European Union, Luxembourg must also comply with a plethora of EU laws and regulations, which generally add to the perceived complexity of the jurisdiction. By comparison, Luxembourg legal advice can often appear uncertain and inefficient, with little or no room for commercial negotiation as lawyers argue their own legal interpretations in a market that has seemingly evolved beyond the texts. That notwithstanding, Luxembourg continues to be the leading European hub for fund structuring and has seen a considerable increase in fund finance activity as a result of the growth of the alternative investment fund market and the ability to offer efficient security packages. Luxembourg has successfully modernized its existing partnership regime to offer an alternative partnership regime mirrored on the English and American models and continues to introduce effective legal initiatives aimed at providing additional legal certainty as to the interpretation of its laws in the context of fund finance structuring, security and enforcement. Whilst Luxembourg law remains less flexible and more complex to a certain extent compared to Cayman Islands law, the two jurisdictions are finding common ground for improvements.

Luxembourg fund finance essentials

We will be focusing predominantly on lender considerations on subscription line financings when exploring the main Luxembourg law fund finance points.

Due diligence

The due diligence process should take into consideration the fund structure and the relevant fund documents. Depending on the type of vehicle that is involved in the transaction, the fund documentation may be more or less onerous, and certain specific borrowing restrictions may apply from a Luxembourg law perspective, including those pertaining to the right to provide security or to enter into guarantees. The fund documentation should be carefully considered in view of the specific transaction − specifically, the limited partnership agreement (or other constituent document, depending on the type of fund involved), subscription agreement, side letters, private placement memorandum and any management agreement.

It is important to establish whether the fund has the power to enter into the loan documents, and that no particular restriction applies. In addition, where the fund is a partnership, the general partner must be able to grant the security acting on behalf of the fund, and it should be confirmed that no powers have previously been delegated pursuant to the fund documents. Delegation to an alternative investment fund manager (AIFM) is common and should be carefully considered when reviewing the fund documentation to ensure appropriate consents or authorities are obtained.

Subscription finance-friendly provisions may be included in the fund documentation − in particular, providing that the fund may enter into subscription financings, that collateral may include the fund's right to make capital calls and that the investors must comply with a lender's requests in an event of enforcement. Furthermore, the investors' obligation to fund the capital calls should be absolute and irrevocable, with no defense or counterclaim or offset of any kind. Any provisions that could impact a lender's security should be flagged, including where some investors are excluded from meeting called capital contributions or are able to transfer or cancel their commitment as this would impact the calculation of the borrowing base.

AIFMD[1]

Where the Luxembourg fund is required to appoint an AIFM pursuant to the AIFM Law, it is important to ascertain whether there has been delegation of any borrowing or security powers to such AIFM pursuant to any of the fund documents. If this is the case, such AIFM should be a party to the credit facility and should grant security over its rights against the investors, or at the very least provide explicit consent to the transaction as well as the collateral package − in particular, any pledge or assignment of the rights over uncalled capital commitments of the investors.

Security

The collateral package on a fund financing involving a Luxembourg fund will typically include a pledge over claims and rights against the investors in relation to their uncalled capital commitments, and a bank account pledge over any bank account into which the investors are required to pay their capital contributions. However, depending on the structure of the transaction, other types of security may also be considered.

In addition to security governed by the laws of the main transaction documents, it is market practice to require standalone Luxembourg law-governed security.

According to Luxembourg conflict-of-law rules, the Luxembourg courts will generally apply the *lex situs* (the law of the place where the asset subject to the security interest is situated) in the case of creation, perfection and enforcement of security interest over the asset. As a result, Luxembourg law applies to the creation, perfection and enforcement of security interests over assets that are located or deemed to be located in Luxembourg, or which are governed by Luxembourg law. The capital call rights over uncalled capital commitments of the investors are considered "claims" (*créances*) under Luxembourg law, and security over such claims are governed by Luxembourg law where the fund documentation is governed by Luxembourg law or where the debtor is established in Luxembourg. Necessarily, bank accounts opened with a bank located in Luxembourg will be governed by Luxembourg law. Furthermore, EU Regulation 2015/848 of the European Parliament and of the Council of 20 May 2015 provides that an insolvency claim against a third party will be deemed to be situated in the EU member state where such third party has its center of main interests.

Security interests granted over the claims and rights against the investors in relation to their uncalled capital commitments fall within the scope of the Luxembourg law of 5 August 2005 on financial collateral arrangements, as amended (the Financial Collateral Law).

Legal opinions

The typical position in Luxembourg, which mirrors that of Europe and the United Kingdom, is to have split legal opinions, with lender counsel providing the enforceability opinion and borrower legal counsel providing a separate capacity and authority opinion.

Enforcement

On 7 July 2022, the Financial Collateral Law was amended[2] to reinforce contractual flexibility between parties and legal certainty to the benefit of secured lenders. The Financial Collateral Law strengthens the principle of freedom of contract by providing that an enforcement event means an event of default, or any other event whatsoever, as contractually agreed between the parties.

Subject to the provisions of the fund documentation and the contractual agreement between the parties, the lender would, upon an enforcement event, be entitled to exercise the rights of the fund or general partner, as applicable, in respect of the uncalled capital commitments of the investors, including to call capital from the investors, receive the proceeds from capital contributions and enforce any rights against the investors. The lender would be able to obtain control of the bank account security pursuant to the Luxembourg law-governed account pledge agreement.

The Financial Collateral Law further provides that the insolvency remoteness of security interests and set-off arrangements applies to both national and foreign law insolvency procedures.

Investor notices

Perfection of the Luxembourg law-governed security agreement is achieved by execution, thus rendering the security fully enforceable under Luxembourg law. However, it is important to require the delivery of a notice to each investor of the Luxembourg fund detailing the security granted to the lender over the claims and rights against the investors' uncalled capital commitments. Delivery of such notice should be on the closing date, or shortly thereafter, in order to prevent an investor from validly discharging its obligation under a subscription agreement on the basis that such investor had no knowledge of the security interest having been granted.

The best of both worlds with Travers Thorp Alberga (TTA)

Whilst the application of Luxembourg and Cayman Islands laws may differ due to the nature of each jurisdiction, TTA's approach is to provide aligned legal advice based not only on our technical expertise but also on our understanding of the global business environment and transaction-specific issues to ensure the optimal outcome.

TTA aims to streamline Cayman Islands law and Luxembourg law advice in order to provide our clients, whether in respect of one or both jurisdictions, consistently superior, efficient and commercial service. The dual jurisdictional advice at TTA is offered from a U.S. time zone and by a highly specialized partner-led team of fund finance attorneys with considerable industry experience. Our clients benefit from our in-depth knowledge of the current legal and commercial issues arising in the global fund finance industry.

TTA Cayman Islands fund finance partners:

Richard Mansi **bio**

Dr Agnes Molnar **bio**

Catharina von Finckenhagen **bio**

[1] Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers (AIFMD), implemented in Luxembourg by the Law of 12 July 2013 on alternative investment fund managers (AIFM Law)

[2] The Luxembourg Parliament (*Chambre des Députés*), adopted the draft law 7933 on 7 July 2022, amending, amongst other laws, the Financial Collateral Law.

FFF Sovereign Immunity Series – Part III

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By **Spencer Davies**
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We continue our alphabetical 50-state survey of sovereign immunity with our third installment in the series. Today we have something for everyone (tropical beaches, rugged mountains, big cities and wide-open spaces): Hawaii, Idaho, Illinois, Indiana and Iowa!

If you are new to the area of sovereign immunity, we recommend beginning with our first installment of the series, which contains links to an overview of the topic by Cadwalader attorneys. The link to that first installment may be found **here** (covering Alabama through California) and the link to our second installment may be found **here** (covering Colorado through Georgia).

As we mentioned in our previous coverage, sovereign immunity is a complex topic. Because the United States is a federal system, each state has, to some extent, sovereign status within that system as codified by the Eleventh Amendment. As a result of its sovereign constitutional status, a state may raise a defense that it may not be sued under the long-standing doctrine of sovereign immunity. Over time, as states have engaged in more commercial activity, most states have recognized the unfairness of this doctrine when applied to a commercial context, such as a breach of contract when the state is a party to such contract. As a result, most states, via statute or case law, have adopted or recognized waivers to the doctrine of sovereign immunity in a commercial context.

For most states, therefore, the fund agreements signed by a state entity will be subject to some explicit or implicit waiver of its sovereign status. When such a waiver is present and there are no other issues in any applicable side letter, both funds and lenders can be comfortable that a state entity may be sued for breaches of its subscription agreement and limited partnership agreement.

HAWAII

Hawaii has waived contractual sovereign immunity by statute. Although the action must be brought in a Hawaiian state court, such courts are authorized to hear "[a]ll claims against the State founded upon any statute of the State … or upon any contract, expressed or implied, with the State…." This general authorization to sue the state is codified in Hawaiian statutory law and has some exceptions, but none of these exceptions apply to ordinary course fund finance transactions.

The statutory waiver only applies if the state officer's power to enter into the contract is authorized by state law. In fund finance transactions, such actions are clearly authorized with respect to the state pension system. Section 88-22 of the Hawaii Revised Statutes expressly vests the Employees' Retirement System of the State of Hawaii with authority to invest state pension funds. The statute also explicitly authorizes the Retirement System to sue or be sued in its own name.

IDAHO

Idaho waives contractual sovereign immunity via case law when the state enters into an explicit commercial contract pursuant to express statutory authority. Idaho courts find that the state cannot be sued without its consent, but where "the legislature has by statute authorized the state to enter into certain contracts, the state … consents to be sued if it breaches the contract to the damage of the contracting party."

Idaho statutory law creates the Public Employee Retirement System of Idaho and authorizes its investment of state pension funds. Pursuant to statute, the Public Employee Retirement System of Idaho has the powers and privileges of a corporation. Therefore, the Retirement System can sue and be sued in its own name pursuant to state law and falls squarely into the contractual exception to sovereign immunity created by Idaho case law.

ILLINOIS

Illinois has waived contractual sovereign immunity through statute. Although the State Lawsuit Immunity Act bars the state from being made a defendant or party in any court, it provides exceptions for claims permitted by the Court of Claims Act and other specified statutes. The Court of Claims Act expressly provides a mechanism for filing contract claims against the state.

Pursuant to the Act, the Court of Claims has exclusive jurisdiction to adjudicate "[a]ll claims against the state founded upon any contract entered into with the State of Illinois." Thus, a plaintiff seeking contractual remedies against the state pension fund, for example, must file its suit in the Court of Claims. Notably, the Act requires any person filing a claim with the Court of Claims to first "exhaust all other remedies and sources of recovery" prior to filing notice with the court. Additionally, the court, by statute, must dismiss any claim that fails to comply with the Act's notice requirements. Finally, a claim must be filed within five years of the damages first accruing.

INDIANA

Indiana has an express statutory waiver of contractual sovereign immunity. Section 34-13-1-1 of the Indiana Code requires any person with a claim against the state pursuant to an express or implied contract to bring such claim within 10 years of the alleged damages. The claims are tried by a court, not a jury.

When the state enters into contracts with private citizens, Indiana courts consider the state to lay "aside its attributes as a sovereign" and bind itself "as one of its citizens does when [such citizen] enters into a contract." When a contractual party sues the state for breach of contract, Indiana courts adjudicate the state's rights and obligations to be equivalent to a private citizen. Therefore, sovereign immunity does not insulate the state from contractual liability from a breach of a subscription agreement or other fund document.

IOWA

Iowa has waived contractual sovereign immunity through case law. The Iowa Supreme Court has found that "the State, by entering into a contract, agrees to be answerable for its breach and waives its immunity from suit to that extent." In the fund finance context, Chapter 97B of the Iowa Code establishes the Investment Board of the Iowa Public Employees' Retirement System, which has the power to invest the Iowa Public Employees' Retirement Fund.

Provided that the Investment Board enters into a valid subscription agreement and limited partnership agreement (with no other side letter issues), it will be held legally responsible for any contractual obligations necessary to enforce such agreements.

CONCLUSION

This summary is meant to be a high-level overview of the states covered. If you are a fund or a lender and an investor is an instrumentality of a state, such as a public pension fund, this series may be helpful as a quick reference guide to assess sovereign immunity risk, but it is not intended to be legal advice. As always, we recommend reaching out to counsel on a case-by-case basis to determine sovereign immunity risk inherent to an investor's status as well as any language in an investor's side letter that may affect that status.

Up next in our series, Cadwalader will take you through granaries, bourbon, blues, lobster and crab as we present the ins and outs of sovereign immunity in Kansas, Kentucky, Louisiana, Maine and Maryland.

WFF NY Networking Event

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On Tuesday night, Women in Fund Finance hosted a pre-holiday networking event in New York at the Metropolitan Club. The event was sponsored and hosted by TriState Capital Bank, one of the newest sponsors of Women in Fund Finance. The event brought bankers, attorneys and fund sponsors together for an evening of cocktails and conversation.

Financial Times Article on Collateralized Fund Obligations

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Collateralized Fund Obligations (CFOs) are securities that create leveraged exposure to portfolios of fund investments through the issuance of an equity tranche and one or more debt tranches. Although CFOs have been around since the early 2000s, the product has recently received renewed interest from private equity sponsors and investors as a potential fund financing solution. *The Financial Times,* in a recent article, discussed CFOs, noting certain sponsors that have recently issued CFOs and mentioning interest in the product from insurance companies and public pension plans.

The article also notes that CFOs are currently a subject of increased scrutiny. It also briefly discusses fund finance generally, and makes some of the same generalized critiques that *FFF* readers will be familiar with – among others, that sponsors use fund finance to magnify returns figures and describing "layers of leverage." That aside, the *FT* article provides a good description of CFOs and is well worth a read. It even throws in a quote from FFA Chair Jeff Johnston!

The subscription-required article is available **here**.

PFCFO Article Addresses ESG-Linked Lines

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A recent article in *Private Funds CFO,* titled “Lenders get cautious on ESG-linked lines, but issuance remains resilient,” addressed some market developments involving ESG-linked subscription credit lines, including comments from Cadwalader’s Wes Misson. The subscription-required article is **here**.

Walkers 'We Talk Banking & Finance' Podcast Featuring Michael Mbayi

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Walkers' Julia Keppe and Alice Wight interview Luxembourg-based fund finance expert Michael Mbayi on the latest episode of "We Talk Banking & Finance" podcast. During this episode, Michael highlights fund finance activity over the last 12 months and the emerging trends in the practice. He also provides insight into the current capital market environment and how it converges with fund finance. To hear more on this topic, click **here**.

FFA NextGen CFO Panel and Holiday Networking Event

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The holiday season is near, and in NYC, networking is the gift that keeps on giving! Join FFA's NextGen committee for an engaging discussion with private fund CFOs followed by a networking reception from 5:30-8:00 p.m. next Wednesday, December 7. Register **here** for more details. We look forward to seeing you!