When Is Enough Enough?

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By Michael Hubbard
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As the Cadwalader European Fund Finance team commented at the end of 2022 (following an **industry-wide survey**), 2023 was predicted to be a challenging environment for subscription line financing given increased regulatory requirements, higher interest rates and liquidity constraints, among a number of other factors.

In the final quarter of 2022 and at the start of 2023, we have seen a number of these themes play out as predicted, with liquidity constraints clearly playing into pricing.

Spreads across all sizes of managers and asset classes are widening. This, coupled with the rising rate environment making the all-in cost to utilise subscription lines at an all-time high, has prompted a debate: at which point does subscription finance become uneconomical for GPs?

In our respective roles as Head of GP Solutions and as a European Fund Finance Partner, we spoke with a number of Sponsors who regularly utilise subscription lines to discuss the current pricing environment and the impact this may have on their demand and usage of such products.

What was abundantly clear from speaking with the borrower community is that there are any number of considerations for private market managers when weighing up the advantages and disadvantages of utilising subscription lines that reach far beyond pricing alone.

Starting with perhaps the most pertinent matter of dilution of returns for managers, sponsor attitude towards approach in this regard very much depends on the underlying investment strategy and target IRR.

For private credit managers, the current rate environment has already started to have an impact on approach to how subscription lines are utilised, with the duration of drawings already being shortened and their purpose of utilisation purely for operational efficiencies. One large cap sponsor in particular noted that the current level of all-in costs (benchmark/margin/upfront fee), assumed to be around 4.74% (using 3 month EURIBOR as at 24.02.23), is close to the level that it becomes unattractive for them to borrow.

Some secondaries managers felt there was some way for interest rate and margins to go before their stance on subscription finance would alter significantly, with one particular manager mooting 8% on an all-in costs basis as the ceiling. Quantum of borrowings has started to decline to address the rising costs, with one sponsor suggesting they have reduced their facility size in some vintages by c.20% - 25%.

Private equity sponsors have far more flexibility given the level of IRR they tend to target, and a number of sponsors in this space noted that the j-curve is far more accentuated in this asset class, so the benefit of subscription finance outweighs the detriment of rising rates. One large cap sponsor suggested cleaning down the facility more frequently (every 6 months) if rates continued to increase.

One manager highlighted the difficulty in marketing new strategies to LPs, with some investors (mainly pension funds) having a preference for their capital to not be called for the first 12 months. However, the challenge for GPs is generating an appealing net IRR with prolonged drawings under subscription lines when rates are rising, whilst appeasing the LPs looking to manage their own liquidity positions.

A topic that was common across Managers, regardless of underlying asset class, was the operational efficiencies that subscription finance brings, and the unquantifiable monetary value of these. This included providing speed of execution, limiting the number of capital calls made to investors as well as multicurrency facilities aiding FX. For one real asset manager, the ability to issue letters of credit was a fundamental part of some asset acquisitions and would always necessitate the need for fund level finance.

In summary, and perhaps reassuring for the fund finance community, whilst the approach to fund finance is likely to vary amongst managers when the cost of finance is rising, there is expected to be continued demand for subscription finance. But at the very least, we expect to see behavioural changes and, potentially, particularly for private credit managers, serious sensitivity to further pricing increases on subscription facilities. Watch this space as we continue to see how the next few months play out – having had an (albeit brief) period of confidence, we might be at the peak of rate increases, and fund managers will be paying close attention.

FFF Sovereign Immunity Series – Part VI

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Today's article marks the halfway point in our alphabetical 50-state survey of sovereign immunity, as this installment covers Montana, Nebraska, Nevada, New Hampshire and New Jersey.

For those who haven't yet had the chance to read our previous articles on the subject, our installments covering the first 25 states (Alabama through Missouri) can be found in the links below.

PART I (AL, AK, AR, AZ and CA)

PART II (CO, CT, DE, FL and GA)

PART III (HI, ID, IL, IN and IA)

PART IV (KS, KY, LA, ME and MD)

PART V (MA, MI, MN, MS and MO)

For readers who have read our previous installments, it should come as no surprise that we are quick to remind you that sovereign immunity is a complex, evolving, and highly nuanced area of law. In short, the purpose of sovereign immunity is to protect the government (and its relevant entities) from civil liability. In other words, without an express waiver, the assumption is that the government simply cannot be sued. The United States' federalist system means that each state has some sort of sovereign immunity protection that is afforded by the 11th Amendment of the U.S. Constitution. Protection is often bolstered by similar provisions in state constitutions, and as a result, each state has its own unique protections.

In recent decades, a number of state entities have begun to engage in commercial transactions with private actors. Clearly, if these government entities could simply renege on any contract to which they agreed with complete impunity, there would be little appetite for other parties to enter into such contracts. The result is that a complex system of waivers, carveouts, and even special courts have been created to provide protection to the parties that have entered into a commercial agreement with government entities.

In the fund finance context, this is most often seen with "sovereign investors," such as state pension funds. We frequently see sovereign immunity provisions in these investors' side letters in which they reserve their rights as a sovereign entity. Having an overview of how sovereign immunity is treated in the applicable state can be a useful guide in determining the appropriate treatment of that investor.

MONTANA

Via statute, Montana expressly waives sovereign immunity as a defense to contract claims.[i] Section 18-1-404 of the Montana Code Annotated provides that "[t]he state of Montana is liable in respect to any contract entered into in the same manner and to the same extent as a private individual under like circumstances..."

Montana Code Annotated § 18-1-401 requires that Montana state district courts have exclusive jurisdiction to hear, determine and render judgments on a dispute that arises out of an express contract with the state of Montana or any board, agency, or officer of the state of Montana. A Montana sovereign entity will also not be subject to punitive damages in the event that it is held liable in a contractual dispute.

NEBRASKA

Nebraska, the only state with a unicameral legislature, has waived its sovereign immunity in the commercial context. Article V, § 22 of the Nebraska Constitution allows for the state to sue and be sued, but the Nebraska legislature sets by law the manner and the courts in which such suits can be brought.[ii] Under Nebraska Revised Statutes § 25-21,206, the legislature provided that the state may be sued in matters arising out of an express or implied contract.[iii] That statute also dictates the Nebraska courts in which such suit may be brought and other procedural requirements for doing so.

NEVADA

Nevada has statutorily waived its contractual sovereign immunity. The legislature passed Nev. Rev. Stat. Ann. § 41.031, which says that the state's contractual liability will be determined by the same rules of law as are applied to "civil actions against natural persons and corporations."[iv] As such, any legitimate contractual claim against a Nevada state entity will be permitted to be brought by the Nevada court system.

NEW HAMPSHIRE

The Granite State has statutorily waived its immunity for breach of contract claims, meaning the relevant court will have the jurisdiction to enter judgment against a state entity if such entity is found liable in a contract dispute. Such judgment, however, will be limited to money damages, rather than other remedies such as specific performance.[v]

Further, any such action brought under the statutory waiver shall be instituted by a bill of complaint to the superior court and be tried without a jury − that is, it will be tried as a bench trial in which the judge acts as the fact finder, rather than a jury.[vi]

NEW JERSEY

New Jersey has waived contractual sovereign immunity by statute via the New Jersey Contractual Liability Act for any express or implied-in-fact contract.[vii] Like Montana, it also prohibits punitive damages, but otherwise the Contractual Liability Act is intended to treat the state in a similar manner to that of a person or corporate entity for contractual disputes.

[i] Mont. Code Ann. § 18-1-404 (2023).

[ii] Neb. Const. art. V, § 22.

[iii] Neb. Rev. Stat. Ann. § 25-21,206 (2022).

[iv] Nev. Rev. Stat. Ann. § 41.031 (2023).

[v] N.H. Rev. Stat. Ann. § 491:8 (2022).

[vi] *Id.*

[vii] N.J. Rev. Stat. § 59:13-3 (2023).

FFA Publishes Global Symposium Photo Album

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FFA has published photos from the 12th annual Global Fund Finance Symposium in Miami. You can view them **here**.

ICYMI: WFF U.S. ESG Series Discussion

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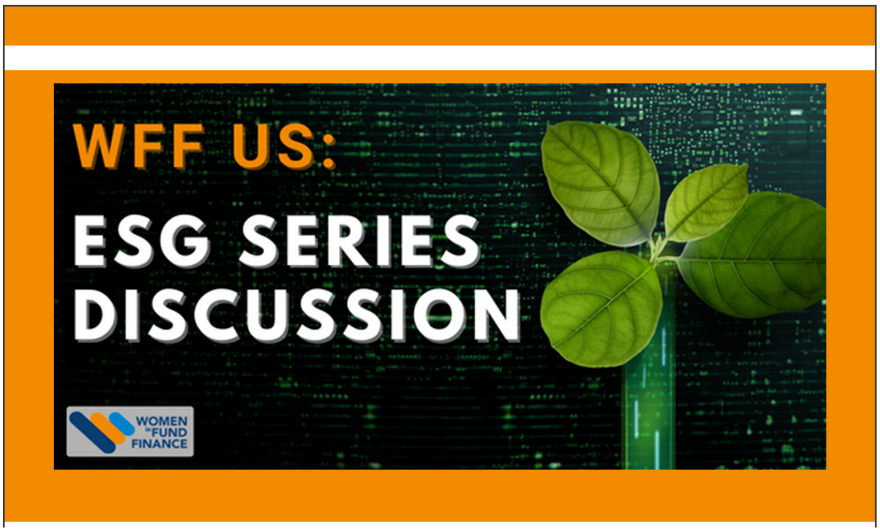

Women in Fund Finance (WFF) U.S. is hosting a virtual panel on "Navigating ESG Communications: Strategies for Challenging Times" this Tuesday, February 28 at 11 a.m. EST. The panel will focus on ESG data, disclosure, and ratings/scoring and will explore how different types of data may be used for risk analysis/mitigation, strategic planning/value creation and stakeholder engagement/communication. Click **here** to register and for the speakers' list.

Goodwin Article on NAV Financings and Preferred Equity

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With increasing demand for liquidity solutions, Goodwin has published a resource on reasons why fund managers are turning towards NAV financing and preferred equity tools. The resource offers a high-level summary on strategies, including the offensive and the defensive, as well as key considerations relating to the highly bespoke structures such as availability, pricing and LTV covenants/borrowing base. To read more, click **here**.

Fund Finance Hiring

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Fund Finance Hiring

Lloyds Bank is looking to hire an Associate for its Financial Sponsors team in New York. For more information, visit **here.**