CADWALADER

FUND FINANCE FRIDAY

From Mistake to Misconduct

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Beyond the Boilerplate

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The term “boilerplate” originates from the printing industry, where “boilerplate” referred to metal plates with standardized text used for newspapers and other publications. In legal documents and contracts, boilerplate refers to standard clauses or sections that are common to most agreements and address general terms and conditions, such as dispute resolution, commencement, venue, choice of law, confidentiality, indemnification, etc.

When thinking about topics for *Fund Finance Friday*, the best source of content is most often the questions and issues that arise in day-to-day discussions and negotiations. The idea for this article popped up recently during a negotiation of a credit agreement and impacted a boilerplate section that doesn’t get discussed as often as some others. In this situation, the borrower was particularly concerned about the lender directly contacting their investors in the normal course (i.e., other than during an enforcement scenario). The usual assurances that the lender would not randomly contact investors during non-enforcement failed to alleviate the borrower’s concerns.

As a result, the lender agreed to modify the typical standstill and power of attorney language to specifically state that the lender would not contact investors outside of enforcement. Issue resolved? We thought so. However, as drafts were exchanged, it became clear that the borrower sought to not only have the lender affirmatively state that it would not contact its investors, but also wanted recourse against the lender should the no-contact agreement be violated – regardless of the circumstance.

Damages (or lack thereof) issues aside for an unintentional contact, the lender had agreed early on to insert to be determined no-contact language (aside from during an enforcement scenario). As the understanding moved from concept to drafting, the core issue moved past the lender agreeing to the concept. Instead, the issue was whether, and to what extent, the lender was comfortable carving out the no-contact promise from the indemnification protections. A modification of that protection would open the lender up to potential liability, depending upon the standard to apply to a breach of that promise by the lender. Stated differently, would an “honest mistake,” such as an analyst for some (unlikely) reason calling an investor regarding an incomplete subscription agreement result in liability? Further, what level of “mistake,” if any, would or should result in liability for the lender? For that analysis, a review of a certain “boilerplate” - standard section common to most agreements” was required – in this case, the indemnification section.

Lender Liability and Indemnification

The LSTA’s Complete Credit Agreement Guide states: “It is customary for lenders to obtain from the borrower a general indemnification against loss or liability suffered by the lenders in connection with the credit agreement.”

Inclusion of a general indemnification clause was not always boilerplate in loan documents. Indemnification sections started to make their way into loan agreements in the mid-1980s as a result of the fallout from lender liability cases arising in that decade and the decade prior. In a nutshell, lender liability refers to a body of liability theories based in contract, tort, other common law and statutes, with the common thread being they are asserted against lenders. The causes of action under these theories involve actions taken (or not taken) by the lender in connection with a loan that directly or indirectly results in losses to the borrower or a third party. For example, lenders found themselves being sued by the targets of hostile takeovers (e.g., for not funding), and wanted protection from borrowers for any damages awarded in connection with (and any costs incurred in defending) such claims. This specter of potential lender liability gave rise to the broad indemnification and hold harmless language that now appears in the boilerplate section of most credit agreements.

One quick point on “Indemnify” versus “Hold Harmless.” Although the concepts are used somewhat interchangeably, as a technical matter, indemnification is the borrower’s obligation to reimburse the lender(s) in connection with claims brought by third parties. Whereas, “hold harmless” is the borrower’s agreement not to sue the lender(s) for claims arising under the credit agreement.

At the end of the day, the standard boilerplate language protects the lender from a wide variety of “losses, claims, damages, liabilities, and related expenses” incurred in connection with the credit facility, whether in the context of claims brought by third parties or by the borrower itself. As a junior lawyer, the latter concept was a bit difficult to comprehend – if the lender does something wrong, vis-a-vis the borrower and the borrower sues the lender for damages and wins, the borrower would need to indemnify the lender for the damages the lender paid the borrower? This hit me similar to: “I know I damaged your car, but it is your fault for loaning it to me. If you hadn’t asked me to help, none of this would have happened.”

As explained to me in layman’s terms years ago by a senior lawyer: “Banks loan money to customers to make money, via fees and interest and ultimately to get their money back – they aren’t in the business of getting sued as a result of the service they are providing.”

Exceptions to Rule, but an Understandably High Bar

In our example, the borrower initially sought to exclude indemnification coverage for any violation of the no-contact agreement by the lender. For the lender, the likelihood of mistakenly contacting an investor was low, since that was not something that would occur in the normal course and depending on the fact pattern, actual damages resulting from a breach seemed unlikely. However, almost all lenders have multiple touch points with their borrower clients. In addition to a “regular banker” there most likely is a banker who monitors the credit, manages the cash, opens new accounts, provides swap services, etc. In a nutshell, regardless of the issue and the best efforts of everyone involved to provide the best service to their clients, things happen. Perhaps the best summary is to use a time-honored borrower statement – “We can’t be in default for a simple “foot fault.”

The reality is mistakes sometimes happen. Combine that with the fact that lenders aren’t in the business of getting sued as a result of the service they are providing to the borrower, while the standard boilerplate does contain indemnity exclusions, the “mistake” needs to exceed a high threshold to relieve the borrower from its indemnification obligation. In the indemnification context, the high bar exclusions usually include gross negligence and willful misconduct – meaning, the gross negligence or willful misconduct of the lender (indemnitee) excludes indemnification coverage, such that the borrower (indemnitor) isn’t obligated to cover losses arising from such severe or intentional wrongdoing by the lender.

The definitions of gross negligence and willful misconduct vary by state, but under New York law, gross negligence is more than just heightened negligence. Rather, it is closer to willful misconduct, and, thus, it is different in kind, not just degree, from claims of ordinary negligence. Gross negligence is “conduct that evinces a reckless disregard for the rights of others or ‘smacks’ of intentional wrongdoing.” Stated differently, gross negligence is not simply a worse form of negligence, but akin to intentional wrongdoing.

With respect to willful misconduct, under New York law, it generally refers to intentional actions or deliberate failures to act, taken with the knowledge that such conduct will likely result in harm or damage, indicating a reckless disregard for the rights of others. While the willful misconduct standard is similar to the gross negligence standard, willful misconduct focuses more on the harm that a party’s action or inaction caused. In summary, willful misconduct and gross negligence involve a higher level of intent or awareness of the risks involved compared to ordinary negligence.

Conclusion

if the borrower breaches any of the litany of covenants in the credit agreement, the lender may (depending on the exact circumstances) have all sorts of remedies at its disposal. Meanwhile, the lender is absolved of liability for anything short of gross negligence or willful misconduct.

You might be thinking that the remedies available to the borrower and the lender under a typical credit agreement seem quite asymmetrical—and you would be correct. So is that fair?

The answer (perhaps unsurprisingly) is yes. Asymmetrical remedies make sense in view of the asymmetrical risks of the lender versus the borrower. The lender is lending the money and assuming the risk of nonpayment. The lender would not be in a position of any liability but for its agreement to make the loan the borrower is requesting. That isn’t to say that the lender is completely isolated from its mistakes or actions. However, to the extent that the lender’s mistake or action doesn’t rise to the level of gross negligence or willful misconduct, the lender did not bargain for the additional assumption of liability to the borrower or any third party as a result of its agreement to provide the service requested by the borrower (and the borrower should have to reimburse the lender if borrower or someone else does).

ABA Business Law Spring Meeting 2025

April 11, 2025

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Cadwalader Capital Call Securitization Conference Recap

April 11, 2025

Last week, Cadwalader partnered with Fitch Ratings to host the inaugural Capital Call Securitization Conference at our New York office. The event convened industry leaders and experts for an afternoon of dynamic conversations exploring the latest trends, challenges and opportunities shaping the capital call securitization market.

Read on for key takeaways from the panels.

Defining The Deal: Capital Call Securitization Structures

Michael Johnson

Associate, Cadwalader

First off, thank you to everyone who attended the Capital Call Securitization Conference. It was great to connect with our clients and other members of the fund finance community on capital call securitization – an increasingly attractive and important capital solution and much more. To lead off the day, fund finance partner **Leah Edelboim** moderated a panel titled *Defining the Deal* and was joined by Bob Bengtson, Managing Director at Goldman Sachs; securitization partner **Joe Beach**; securitization partner **Nate Spanheimer** and fund finance partner **Trent Lindsay** for a robust discussion on the basics of securitization, the motivations behind securitization (and, specifically, those of a subscription credit lender), and the various structures parties use in these transactions. The group touched on Goldman's execution of Capital Street Master Trust Series 2024-1, the first-of-its kind broadly syndicated, publicly rated securitization of subscription credit facilities.

As capital call securitization is still relatively nascent, the panel set the stage with a primer on securitizations at-large, including the legal structuring of a securitization and the motivations behind securitizing. From both a buyer and seller's perspective, securitization at its core is a very capital-efficient form of holdings assets. But why are banks looking to securitize capital call facilities? Banks are looking at securitization from a number of different angles, some of which include balance sheet relief and, as a natural extension thereof, freeing up capital to meet their clients' liquidity needs, and others to alleviate portfolio risk. The panel discussed other motivations as well.

With this backdrop, the conversation turned to the specifics of capital call securitization and the panel covered topics from the investor base to the challenges of this particular product with structuring a securitization. In terms of the investor base, securitization allows for other pools of investors (including insurance and other asset managers) to come into this asset class that will continue to grow. The panel also spent some time discussing some of the challenges that subscription credit facilities present in the context of a securitization, chief among them is taking a revolving, short-duration unrated asset and putting it into a rated, funded vehicle. The panel also touched on balancing LP confidentiality concerns with rating agency disclosures and other disclosures that may be made in a securitization. Each of these concerns has been addressed in the public and private structures that currently exist and it will be interesting to see what other solutions come to market to balance the various competing concerns with the business prerogatives of the parties to a deal.

For those unable to attend and/or those seeking to learn more, please feel free to reach out to our team with your capital call securitization questions at **CapitalCall@cwt.com**.

CRTs & CFOs: Synthetic and Other Non-Cash Securitizations

Brian Kurpis

Associate, Cadwalader

Fund finance partner **Angie Batterson** led a discussion on the evolution of the CRT and CFO markets and synthetic securitization trends in the fund finance space. Angie's panel was joined by Terry Lanson, a managing director at Seer Capital Management LP and Cadwalader securitization partners **Gregg Jubin** and **Jed Miller**.

CRT (or SRT?)

The prevalence of CRTs continues to increase among U.S. financial institutions and subscription credit facility lenders seeking capital relief for their risk weighted assets ("RWAs") and subline loan portfolios. While CRTs are a newer product to the U.S. market, they have been used for some time by European banks with respect to their loan assets.

For those new to CRTs, a CRT is essentially a risk transfer transaction: the bank transfers its credit risk arising from the loan assets on its balance sheet to a third party buyer, and that buyer pays the bank for its losses on those loans in exchange for periodic payments from the bank. The CRT involves the use of a synthetic derivative instrument to synthetically transfer those loan assets, so the bank remains the owner of those loans, which stay on the bank's balance sheet. Those synthetic instruments are typically in the form of either (1) a bank-issued or SPV-issued credit linked note ("CLN") or (2) a bilateral credit default swap ("CDS") between the bank and an SPV. For additional background information, please see our primer on capital call securitization article **here** and Daniel Meade's and Jed Miller's CLN article **here**.

The panelists discussed that this space is still developing in the U.S., which was demonstrated in part by the non-consensus on the terms used to describe these transactions, including capital risk transfers or capital relief trades ("CRTs"), synthetic risk transfers or significant risk transfers ("SRTs) or just "synthetic securitizations". Despite the lack of universal agreement on the nomenclature, it is becoming more widely accepted that such transactions have noteworthy benefits to both the banks and investors.

For the banks, a primary motivation to enter into a CRT is to achieve a reduction of the risk based regulatory capital that banks are required to comply with, and that reduction may be accomplished by transferring their lending and credit risks to a third party. A properly structured CRT can result in a decrease of their RWAs by over 80%, which metric continues to attract subline lenders to this growing space.

For the investors, CRTs provide exposure to the loans originated by the banks without having to become a lender or direct participant in those loans. By investing through a CRT, the investors are implicitly getting a junior tranche, and since the loans are generally well performing, the banks can issue that CRT at an attractive spread. The loan assets are also carefully selected and may be subject to a variety of eligibility criteria, concentration limits and other portfolio guidelines (e.g., GP/sponsor "white lists") that they need to satisfy for inclusion in the portfolio. As a result, this product continues to be in greater demand from an investor base that wouldn't otherwise have access to the same investments or returns on the loans.

CFO (and Rated Note Feeders)

The CRT should not be confused with a collateralized fund obligation ("CFO") or its counterpart, the rated note feeder fund ("RNF"). A CFO is typically structured as an SPV that holds an underlying portfolio of private fund interests, and those fund interests become the collateral for a series of rated and unrated notes issued by the SPV to third party investors. Similarly, a RNF will be structured to issue rated debt and an equity tranche to investors, but is itself a feeder fund in a master fund structure.

The key feature of both is the rating component on each product, and the fact that the product is rated attracts certain investors (mostly insurance companies) to participate in the fund investments of the CFO and the investments made by master fund of the RNF. In each case, the rating allows the investor to make such investment without incurring a regulatory capital charge imposed by the NAIC rules applicable to insurance companies. The panelists discussed the significance of the regulatory benefit provided to the insurance companies by investing in these products given the NAIC's risk based capital and minimum reserve requirements for equity and debt investments.

There is a variety of NAIC criteria used to determine whether the interest is an equity investment or a debt investment, but the common theme is that the RNF needs to have "debt like" features, which among other things, includes having investors other than insurances companies involved in the transaction. The NAIC criteria and related rating methodologies are still developing in this market and the panelists are closely monitoring those industry trends and updates.

For additional information on CFOs and rated feeder funds, please see Gregg Jubin's and Michael Gonzalez's CFO article and presentation **here**.

Capital Call Securitization Market Roundtable Discussion

Fiona Cheng

Associate, Cadwalader

To round out Cadwalader's inaugural Capital Call Securitization Conference, Cadwalader Partner **Tim Hicks** was joined by market-leading panelists Missy Dolski, Global Head of Capital Markets, Värde Partners, Vicky Du, Managing Director, Standard Chartered Bank, Slade Spalding, Partner, NLC Capital Markets, David Wasserman, Managing Director, Morgan Stanley, Joyce Fargas, Senior Director, Fitch Ratings and Yezdan Badrakhan, Managing Director, MUFG, for an insightful roundtable discussion on the driving force behind capital call securitizations, a glimpse into Fitch's rating methodology, and the opportunities that arise from and the key ingredients that will fuel the growth and success of this buzzworthy product.

Driving Force

To give context to the mojo behind fund finance's hottest ticket item, the panelists touched on a range of considerations, including balance sheet capacity and optimization, and of course, enhancing format, pricing and returns. For certain lenders, securitizing their subscription lending portfolio was a way to get ahead with the expectation that there will be a demand for more capacity on the horizon. Whatever the use case, rationale or strategy however, our panelists were unanimous in agreeing that capital call securitization is a natural evolution of capital raising and ongoing fund finance needs.

Fitch and their Methodology

To date, Fitch has rated approximately 260 capital call facilities and has been mandated on more than 300 deals. The average risk rating is in the AA range but can be as low as BBB-, based on a number of quantitative and qualitative factors such as the creditworthiness and diversification of the limited partners whose capital commitments are the key underwriting consideration for the underlying capital call facility. Ratings are also based on an evaluation of a fund's general partner and its exposure, the terms of the partnership agreement, incentives for the limited partners, the overall performance of the portfolio and cash flows.

Opportunities and Growth

As with any novel product there has been some reticence, including from sponsors who do not yet perceive its value, notwithstanding the potential to generate lower spreads in the long term. The product also deviates from the intimacy that is associated with traditional, relationship-based subscription lines that allow more scope for flexibility e.g., in the event a waiver is required for a technical default.

Perhaps a testament to the popularity and growth of capital call securitization is the frequency with which borrowers are now asking whether their deals will be part of a securitization. The panelists discussed the importance of repetition and standardization for any growing product, including how to educate and get borrowers comfortable. For example, a key concern from the sponsors' perspective is confidentiality, which is structurally mitigated by reducing information being shared to blind pools. The panelists also emphasized the importance of discussing workable solutions for both sides, including with respect to liquidity and pricing. One panelist also remarked on the importance of recognizing that the traditional revolver model may not always yield the best returns on the basis of utilization and efficiency, and for this reason, we must continuously look to the next frontier to improve returns.

What's Next?

At the forefront of this exciting space, we are seeing an alignment of securitization and fund finance specialists (especially at Cadwalader) who are working rapidly to set up the "plumbing" that is the foundation of capital call securitization. While new transactions can take on average a year to close, it can feel like the pressure is on to make them count. Nevertheless, it is clear that the market driver for this product is based on an increase in fundraising and growth in privatization, and our space remains rife with opportunity and incentive to cross-skill. As Mike Mascia noted in his chapter of this year's GLI Pink Book, "All of Finance is now Fund Finance."

Fund Finance Hiring

April 11, 2025

Fund Finance Hiring

Here is who's hiring in Fund Finance:

Cadwalader, Wickersham & Taft LLP is seeking associates with three to six years of relevant experience for its Fund Finance practice in New York, Charlotte or London. Qualified candidates will have experience in syndicated lending, commercial lending, leverage finance, fund formation, CLOs, asset-based lending, NAV financings or acquisition financings. Candidates must possess excellent academic credentials and solid legal experience. Selected candidates will get extensive interaction with preeminent bank, asset manager and lending clients. If interested, please reach out to Margaret Cart at **Margaret.Cart@cwt.com**.

Pantheon is seeking an Capital Markets Associate in London to support their global debt and FX operations, ensuring optimal management of financial exposures while delivering value to clients. Learn more **here**.

Standard Chartered is seeking an Executive Director, Fund Finance in New York to maximize customer profitability from FI relationships, originate, lead, structure, execute and distribute fund finance transactions including but not limited to (i) Fund level subscription financing (ii) Fund level NAV financing (iii) GP financing. Learn more **here**.