



Fund Finance

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Guernsey

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Overview

Guernsey is a leading funds domicile with more than 50 years' proven track record as an international financial centre, and as such is increasingly recognised by fund sponsors and promoters as a leading centre for the formation, administration and cross-border distribution of investment business such as private equity, alternative investments, property funds, hedge funds and funds of hedge funds. As at the end of 2017 there were over 1,000 funds domiciled in Guernsey, with the overall value of institutional and retail funds under management and administration in Guernsey standing at £256 billion.

There are a range of factors contributing to Guernsey's leading position in this space, including: (i) over 800 years of independent self-governance as a Crown Dependency of the United Kingdom; (ii) an AA-credit rating from Standard & Poor's representing Guernsey's very strong capacity to meet its financial commitments; (iii) historical familiarity with the jurisdiction by investors and fund sponsors; and (iv) the increasing dominance of the private equity sector in the funds market. In addition, Guernsey law, which is derived from a combination of English common law, Norman customary law and local legislation, ensures that Guernsey funds are recognised as internationally accepted and well recognised vehicles for all kinds of fund-related activity.

Collaboration between the Guernsey government and the private sector also ensures that Guernsey laws keep pace with market evolution and demand. New products were introduced to the market last year to keep Guernsey at the forefront of the international funds market, including manager-led products (**MLPs**) and private investment funds (**PIFs**).

The growth in this area shows a strong correlation with the fund finance space where Appleby's Guernsey office continues to see steady growth year on year in the subscription credit facility market. Indeed, Appleby's Guernsey office continues to be a market leader in this area, representing the majority of the largest global banks on a variety of different financing structures.

Fund formation and finance

Lending to Guernsey funds

Guernsey private equity funds have typically been registered as limited partnerships under the Limited Partnerships (Guernsey) Law, 1995, as amended (**LP Law**). Though registered pursuant to the LP Law, a limited partnership is not generally a separate legal entity (although it can elect to have separate legal personality from its partners at the time of registration).

A limited partnership reflects a formal legal arrangement between one or more general partners of the limited partnership and one or more limited partners of the partnership. A general partner of a Guernsey limited partnership (**LP**) is liable for all of the debts and obligations of an LP and is vested with certain duties and powers with respect to the business of the LP. On the other hand, limited partners contribute or agree to contribute specific sums to the capital of the LP only, and have no liability for any of the debts or liabilities of the LP beyond this amount so long as they refrain from taking part in its management. Any rights and obligations of the general partner and the limited partners are governed by the limited partnership agreement and any subscription agreements or side letters entered into by the limited partners, and are therefore contractual in nature. The LP's rights and property of every description, including any right to make capital calls and to receive the proceeds thereof, are held by the general partner in trust as an asset of the LP (and this remains the case even if an LP elects to have separate legal personality).

The typical security package

This contractual arrangement and ownership structure largely dictates the structure of the security package available to lenders offering subscription credit facilities to Guernsey vehicles. As previously mentioned, limited partners of an LP will usually commit in the partnership agreement and/or subscription agreement to fund investments or to repay fund expenses when called upon to do so by the general partner from time to time. It is this contractual obligation of a limited partner to make these capital contributions, to the extent that they have not already been called (**Uncalled Capital**), and the corresponding right of the general partner on behalf of a limited partnership to call for Uncalled Capital (**Capital Call Rights**) that is at the core of the typical subscription credit facility security package. Given that these rights are contractual in nature and will be governed by the laws of Guernsey, the appropriate form of security over such rights is an assignment of title in the form of a security interest agreement in accordance with section 1(6) of the Security Interests (Guernsey) Law, 1993, as amended (the **Security Law**).

As legal title to the assets of the LP ultimately vests in the general partner, the Capital Call Rights are exercisable by the general partner for the benefit of the LP. As such, the proper parties to any grant of security over the LP's assets (and in particular, the Capital Call Rights) must be the general partner as well as the limited partnership (acting through the general partner). The security package must be in strict compliance with the requirements of the Security Law and, ideally, should incorporate an express irrevocable power of attorney in favour of the secured party, entitling the secured party to exercise the general partner's Capital Call Rights following the occurrence of an event of default.

It should not be assumed that the assignment of Capital Call Rights is necessarily permitted under the limited partnership agreement governing the LP (although it is common enough that the requisite changes to an agreement to permit such security are fairly uncontroversial). The terms of the limited partnership agreement can have a fundamental effect on the structuring of the collateral package and must be reviewed in detail in order to ensure a number of key elements, including but not limited to:

- the ability of the LP to incur indebtedness and enter into the transaction;
- that security may be granted over (a) the Uncalled Capital, (b) the right to make and enforce capital calls, and (c) the related contributions; and
- that Uncalled Capital may be applied (when called) towards the secured obligations.

Service of notice in respect of security over Capital Call Rights

In order to be effective and comply with the Security Law, any security over a contractual right must satisfy two limbs (the **Two Limbs**): firstly, the secured party must have title to the collateral assigned to it under a security interest agreement; and secondly, express notice in writing of that assignment must be served on the person from whom the assignor would have been able to claim the collateral (for example, in the case of Capital Call Rights, the limited partners). On this basis, the serving of notice under the Security Law is a matter not just of the perfection of the security; the service of notice is crucial to the creation of the security interest, and without it no security interest exists. Attention must therefore be given to the sometimes tricky issue of the service of notice on limited partners who may otherwise be unaware of the financing arrangements proposed for the LP in which they invest; funds are often reluctant to serve notice promptly following the signing of the security interest agreement, and it can be important to educate lenders and fund managers as to the implications of not doing so.

Where a security interest is granted over Guernsey Capital Call Rights, priority of the security interest over any competing security interest will therefore be determined in accordance with Guernsey law and, given that a valid security interest is only created once both of the Two Limbs have been satisfied, priority may not be established in accordance with the time of execution of the relevant security interest agreements. A delay in the delivery of the Notice will therefore open up the secured party to the possibility that a general partner, on behalf of the Guernsey LP, may (quite unintentionally) grant a competing security interest or an absolute assignment over Capital Call Rights to a subsequent assignee. If both security interest agreements have been executed, provided that notice of the second assignment is provided to the limited partners ahead of notice of the first assignment, the second assignee will rank for repayment ahead of the first assignee.

Limited partners are increasingly aware of subscription facilities and familiarity with the product means that there is now, generally, less resistance by Guernsey LPs to giving notice to limited partners. This has led to notices typically being circulated to the limited partners immediately upon execution of the security documents in order to ensure that security is created and priority is achieved at closing of the subscription credit facility.

Given the importance of actual delivery of the notice to the limited partners, evidence of the notice having been received also assumes some importance. In general, where the limited partners are not part of the same borrower group, it is unlikely that any form of acknowledgment of the notice will be received. It is increasingly common for Guernsey limited partnership agreements to build in provisions that specify the circumstances in which notices delivered in accordance with their terms are “deemed” to have been received by the limited partners. Where a limited partnership agreement contains such provisions, lenders can take some comfort in proof of delivery of any notice in accordance with the provisions of the partnership agreement (rather than proof of receipt by way of a signed acknowledgment by the limited partners, which is the ideal). In all cases, the recommendation would be that the general partner sign and deliver the notice to the limited partners in accordance with the provisions of the limited partnership agreement governing service of notices on the limited partners, with a copy delivered to the secured party. Where no such provisions are included regarding the service of notice and deemed delivery, it is important to obtain proof of delivery to limited partners (such as receipt of copies of courier delivery slips).

We have also seen an increasing prevalence of limited partners, within the terms of the limited partnership agreement, appointing an agent specifically to receive notice of this nature on their behalf (and indeed, sometimes, to also acknowledge receipt of the notice on their behalf). Wording of this nature should be examined carefully to ensure compliance with the requirements of the Security Law.

In addition to facilitating the creation of a security interest, delivery of a Notice to a Guernsey limited partnership's limited partners of an assignment of Capital Call Rights has other distinct advantages. Two of the more important advantages of delivery of the Notice include preventing: (i) the limited partners from obtaining good discharge for their obligations to fund their Uncalled Capital in any manner other than as specifically indicated in the notice; and (ii) set-off arising after the date of service of such notice (on the basis of the common law principle that set-off works between the same parties in the same right).

Other elements of a typical security package

The typical security package will also include the grant of a security interest over a designated bank account under the control of the Lenders into which any capital call proceeds must be paid. Although the security interest agreement over Capital Call Rights in a Guernsey LP must be granted under a Guernsey law security interest agreement which complies with the requirements of the Security Law, security over such designated bank accounts should usually be governed by the law of the jurisdiction in which the account itself is situated. Whilst Guernsey is a popular choice for the accounts of both Guernsey and non-Guernsey private equity funds due to the well-established and regulated status of the jurisdiction, it is equally common for such accounts to be sited in the United Kingdom or United States and, in such instances, it would be usual for such security to be granted under a New York or English law governed security agreement. If the account is Guernsey situate, security should be taken in compliance with the requirements of the Security Law and take the form of a security interest agreement. Assuming that the secured party is not also the account bank, then notice is once again a key factor, and time should be factored in to deal with the requirements of individual account banks who maintain the accounts which are the subject of the security.

Less typical security elements

Other, less typical security packages may include security directly from the limited partners over their interests in the limited partnerships themselves and, particularly in relation to hybrid facilities, security is often taken over underlying assets of the fund. In Guernsey these might include shares in Guernsey registered subsidiary companies, units in Guernsey unit trusts, and/or contract rights arising under Guernsey law contracts. In respect of these asset types, security is taken by way of a Guernsey law security interest agreement and the formalities to finalise the creation of the security are as follows:

- Shares – notice of the assignment is given to the company whose shares are secured, possession is taken of the share certificates (together with blank stock transfer forms) and the register of members is annotated to reflect the security interest.
- Units – notice of the assignment is given to the trustee of the unit trust whose units are secured, possession is taken of the unit certificates (together with blank unit transfer forms) and the register of unit holders is annotated to reflect the security interest.
- Contract rights – notice of assignment is given to the contract counterparty and acknowledgment obtained.

Registration requirements

With the exception of land located in the Bailiwick of Guernsey, vessels flagged in Guernsey and Guernsey registered aircraft, there are no registration steps required in Guernsey and there is no general register of security interests in Guernsey accessible to the public. There is similarly no statutory requirement that a Guernsey entity keeps a private register of security interests.

Key developments

The protection afforded to investors in funds proposed by the Alternative Investment Fund Managers Directive (**AIFMD**) has been at the forefront of the minds of the entire Guernsey funds industry, and has seen increased emphasis on the substance of both funds and fund managers, in particular.

Guernsey has worked hard to ensure that from the outset its regulatory infrastructure is suitable to enable the distribution of Guernsey-domiciled funds to both EU and Non-EU countries. In July 2016, the European Securities and Markets Authority announced its recommendation that Guernsey be included in the first round for the granting of third country passport for the purposes of AIFMD. Guernsey is still one of only five non-EU jurisdictions to be given such an assessment and the recommendation (subject to relevant approvals at an EU level) will enhance Guernsey's position as a gateway to the European funds market. This enviable position will only further strengthen Guernsey's dominance in the offshore market in the EMEA time zones and make Guernsey a first point of call for the purposes of structuring funds distributing to both EU and Non-EU markets.

The Guernsey government reacted to significant market demand with the introduction of a Guernsey limited liability partnership (**Guernsey LLP**) under the Limited Liability Partnerships (Guernsey) Law, 2013 (**LLP Law**), which came into force by commencement order on 13 May 2014. This has been a significant development for the jurisdiction as it provides for the formation of a new type of business vehicle that is a hybrid entity, merging certain characteristics of a Guernsey non-cellular company limited by shares and a Guernsey limited partnership.

Guernsey publicly stated its intent to participate in the OECD's Base Erosion and Profit Shifting (**BEPS**) Project as an Associate in March 2016 and remains committed to the collective aim to reach a globally fair and modern international tax system. Accordingly it has signed a Multilateral Agreement to exchange tax information. The Multilateral Competent Authority Agreement provides for automatic exchange of information in accordance with country-by-country reporting by large multinational enterprises. BEPS refers to tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low- or no-tax jurisdictions where there is little economic activity, resulting in little or no overall corporate tax being paid.

Manager Led Product (MLP)

In May 2016, the Guernsey Financial Services Commission (**GFSC**) launched the MLP. The MLP is aimed at alternative investment fund managers (**AIFMs**) seeking to market into one or more EU Member States under national private placement regimes.

Under the MLP regime, all regulatory standards are borne by the AIFM and, by virtue of the AIFM's sponsorship, no alternative investment fund or underlying licensee will have rules imposed on it. The MLP regime avoids duplicating regulatory requirements over several entities. Further, derogation requests acceptable to the host country will be considered by

the GFSC. The GFSC will be able to register a fund and license an underlying licensee within 24 hours of notification.

The GFSC intends to extend Guernsey's suite of MLPs to include a similar offering for marketing outside the European Union.

Private Investment Fund (PIF)

In November 2016, the GFSC introduced a PIF regime which provides fund managers with greater flexibility and simplicity. The PIF, which was developed in response to market demand by the GFSC in consultation with the island's funds industry, recognises that certain investment funds are characterised by a relationship between management and investors that is closer than that of a typical agent. The PIF dispenses with the formal requirement for information particulars such as a prospectus in recognition of that relationship, significantly reducing the cost and processing time of launching of a fund.

The PIF, which can be either closed or open-ended, should contain no more than 50 legal or natural persons holding an economic interest in the fund. A key strength of the product is that, where an appropriate agent is acting for a wider group of stakeholders such as a discretionary investment manager or a trustee or manager of an occupational pension scheme, that agent may be considered as one investor. While there is a limit imposed on the number of investors in the PIF, no attempt has been made to limit the number of investors to whom the PIF might be marketed – a feature not available under comparable regimes.

The PIF is predicated on a close relationship between investors and the licensed manager, who will be responsible for providing warranties on the ability of the investors to assume loss. Under the new rules, both the PIF and its manager benefit from an application process that can be completed in one business day. The two processes may be completed in tandem by the GFSC, ensuring a short regulatory timescale.

The year ahead

2017 has continued the trend of making a mockery of any attempt to make accurate predictions about market developments. Political developments both in Europe and in the US continue to play out and it remains to be seen what effect they will have in the medium to long term. While some consensus and stability appears to have been achieved, there is still some way to go and Brexit negotiations have been far from smooth so far. The mid to long term effect on the UK and European markets remains far from predictable.

Being established in a non-EEA country, Guernsey funds can offer their investors separate regimes, depending on whether or not they wish to access EU investors. A choice exists between fully EU/EEA independent regimes, targeted "private placement regimes" with individual EU countries, or, once the AIFMD passport is granted, full access to EU member states under AIFMD. Some EU countries, such as Germany, have already indicated however that "private placement regimes" will be done away with once passporting rights are in place. Whether this comes about (and, if so, for which countries) remains to be seen.

The Guernsey market continues to see sophisticated lenders providing increasingly complex and tailored solutions to the funds market, with loans being made to the full cast of players in the funds market including funds, secondary funds (against their limited partnership interests, to finance the acquisition of limited partnership positions and release capital to investors), limited partners and general partners (to help finance GP and fund commitments). As the funds industry continues to flourish, so will the fund finance industry; the market shows all the signs of continuing to expand in 2018.

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Jeremy Berchem is a group partner and Group Head of the Corporate team at Appleby (Guernsey) LLP. He has a well-established fund finance practice, acting for major financial institutions in a wide variety of corporate finance transactions. Jeremy is a market leading finance lawyer and is highly regarded and rated globally across the leading legal directories. *Chambers UK 2018* recognises Jeremy as a notable practitioner and Jeremy has been named as highly regarded in the 2017 edition of *IFLR1000*. He is described as an “expert in the niche area of fund finance, commercial, responsive, solution focussed”, and “our first port of call when it comes to fund financing advice in Guernsey offering fantastic partner led advice”. The *Legal 500 UK 2017* praises Jeremy as someone who “leads from the front and provides clients with very commercial and practical advice”.

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