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Fund Finance and releases of investor commitments: How can lenders protect themselves?

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Although the fund finance market has historically been, and continues to be, a particularly low-risk one for lenders, recent events have led some to consider a rather rare and unlikely scenario: what if a fund simply releases or waives the commitments of its investors without lender consent?

A credit agreement will usually include a contractual prohibition on a release or waiver of commitments in this manner, such that the eventuality is arguably just an example of a concern innate in any financing transaction: fraud risk (although the possibility of an inadvertent breach is not necessarily fanciful). This is perhaps particularly so in relation to covenants designed to protect and preserve a borrower's assets. Consequently, having conducted satisfactory due diligence, lenders will hopefully, for the most part, be able to regard the prospect of such a breach as sufficiently remote to proceed.

With that said, given that most lenders in the fund finance space extend credit in part or entirely in reliance upon investor commitments, the ramifications of such commitments simply disappearing are arguably more of a fundamental threat to a lender's interests than other breaches, particularly in the case of early stage funds. As such, taking reasonable steps to help protect against this concern is, in our view, appropriate and prudent.

We are aware that some jurisdictions (including for example, many US states) have enacted specific statutory provisions to help mitigate the risk of release/waiver by providing that in certain circumstances, persons extending credit to an entity in reliance on the commitments of its investors may, notwithstanding a compromise of those commitments, enforce the original obligations directly against the investors. Although this approach has been adopted in the Cayman Islands with respect to Limited Liability Companies ("**LLCs**"), no such provision is currently contained in the statutory regimes for Exempted Companies ("**Companies**") or Exempted Limited Partnerships ("**ELPs**"), which together constitute the vast majority of Cayman Islands funds. Consequently, while we intend to seek to have such a provision enacted in the future, it is currently worth considering as a matter of Cayman Islands law, what remedies may be available following such a waiver or release, and, perhaps more importantly, how can a lender best protect itself in advance?

Dealing with a waiver that has already happened

An affected lender's primary remedies will lie pursuant to the terms of the relevant finance documents. If the borrower is solvent then calling an event of default will ordinarily be the most straightforward route available.

The more difficult scenario is where the counterparties to the finance documents are insolvent. The remedies available in such a scenario will be highly fact-dependant (and in several instances, dependant on the knowledge and state of mind of the parties involved). This note does not purport to be an exhaustive list of all remedies that may be pursued, but rather

seeks to identify, in general terms, some of the options a lender may wish to consider in attempting to unwind or bring other claims in respect of a purported release or waiver in circumstances where the borrower is insolvent and the orthodox contractual remedies have no value.

Statutory remedies

Fraudulent transactions at an undervalue
Pursuant to the Fraudulent Dispositions Law and section 146 of the Companies Law (which effectively applies equally to LLCs and ELPs), a disposition of property by or on behalf of a fund made:

1. within the previous six years;
2. at an undervalue; and
3. with an intent to wilfully defeat an obligation owed to a creditor,

shall be voidable at the insistence of the creditor prejudiced (in the case of the Fraudulent Dispositions Law) or the fund's official liquidator (in the case of the Companies Law).

A "disposition of property" should generally be construed broadly enough to capture the fund's release of obligations owed to it, and demonstrating that such release was an "undervalue" should be relatively easy in circumstances in which little is being provided by the investors in return.

Consequently, the success of such an action will commonly turn on whether or not it can be shown that the fund made the release with a mind-set that was wilfully intended to harm the lender. While this is a relatively high bar for claimants to surmount, it is at least arguable that the deliberate breach of contractual restrictions in circumstances where insolvency exists or ensues could help demonstrate the necessary intent.

Fraudulent trading
In a similar vein to the remedies identified in the preceding section, pursuant to section 147 of the Companies Law, an insolvent fund's official liquidator is able to seek a declaration from the Court requiring persons who were knowingly parties to the carrying on of business by the fund with:

1. intent to defraud creditors of the fund;
2. intent to defraud creditors of any other person; or
3. any fraudulent purpose

to make such contribution to the assets of the fund as the Court thinks proper.

Although on its face a broad ranging remedy, the twin requirements to demonstrate an intent to defraud/fraudulent purpose on the part of the fund's management and knowledge of that fraud on the part of the investor whose commitment has been released, will mean that the evidential requirements to permit a liquidator to successfully make out such a claim will pose a relatively high bar.

Claims for reinstatement of commitments under the Exempted Limited Partnership Law
Pursuant to section 34 of the Exempted Limited Partnership Law, if a limited partner is released from its commitment, and at such time:

1. the ELP is insolvent (or becomes insolvent as a result of the release); and
2. that limited partner has "actual knowledge of the insolvency…",

then, for a period of six months from the date of such release, the limited partner shall remain liable to the ELP for its original commitment to the extent necessary to discharge any liability incurred by the fund while the commitment was in place.

The provision may prove a powerful tool for lenders in certain circumstances but there is a relatively short time frame within which the provision provides a remedy. In contrast to the fraudulent transaction legislation detailed above, there is also a need to demonstrate the knowledge and mind-set of the limited partner rather than the fund[1].

We would note that while there is a substantively equivalent provision that applies to LLCs under the Limited Liability Companies Law, no such provision exists in relation to Companies.

Equitable remedies

Outside of the statutory remedies identified above, there are a range of remedies which exist as a matter of case law that may prove of assistance to an aggrieved lender in certain circumstances. A key point to note in relation to these remedies is that they are firmly grounded in the state of mind of the parties involved, and accordingly the evidential requirements can prove challenging.

Claims against management
As a result of simply releasing investor commitments without proper consideration, individual members of management[2] may, depending on the circumstances, be in breach of their fiduciary duties to the fund or general partner of such fund, such that compensation can ultimately be sought from them. Notably, the right of action will generally be held by the fund (or general partner), such that a claim would likely need to be brought by a liquidator of such entity.

1. Although of course demonstrating a limited partner's knowledge of the insolvency is a lower burden that demonstrating an intent to willfully defeat an obligation, the requirement that the knowledge be "actual" is notable.
2. Whether directors or managers of a corporate fund, or of the general partner of an ELP.

Continued

However, in addition to practical limitations that may result from the relative "shallowness" of management's collective pockets, unhelpfully for lenders, such individuals will commonly have been granted broad rights of exculpation and indemnification from the fund or the general partner of such fund (although generally not where a breach is wilful or fraudulent). Set against this, where D&O insurance policies have been put in place, such a claim may still provide a a basis for material recovery by a lender.

Dishonest assistance
If an investor has in some way assisted or colluded with management in procuring the release of its commitment, then (as an alternative or in addition to the possible tortious claims identified below), a claim for dishonest assistance may potentially be brought against the investor. Such a claim that will generally be held by the fund (or general partner), and would accordingly likely need to be brought by an appointed liquidator.

To vindicate such a claim it will be necessary to establish that:

1. the release constituted a breach of fiduciary duty by management;
2. the investor procured, induced or assisted the breach; and
3. the investor was acting dishonestly in doing so.

The relevance of pursuing this route in lieu of (or in addition to) a tortious claim is that may open a broader ambit of potential remedies, including orders requiring that the investor commitments be honoured on their original terms.

Tortious remedies

If an investor can be shown to have encouraged or participated in the release of its commitment, it may be exposed to a tortious claim for economic loss. Although the evidentiary requirements to succeed with such a claim are challenging a key point to highlight is that if the claim exists it will likely lie in the hands of the aggrieved lender, rather than in the hands of the fund/general partner. This will mean that such claims can be pursued directly by the lender, rather than by a liquidator. Possible tortious claims include the following:

Intentionally inducing/procuring a breach of contract
To make out such a claim the lender would need to demonstrate that the borrower's breach of contract (in the form of a restriction on the release) was induced or procured by the investor, who was on notice of the existence of the prohibition (see below regarding such notice). If successful it would give rise to a direct and independent claim for damages against the investor for any losses suffered by the lender as a result of the breach.

Lawful or unlawful means conspiracy
Making out a claim for lawful means conspiracy would entail demonstrating:

1. that the investor acted in concert with the borrower to procure the release/waiver of its commitment with the predominant purpose of injuring the lender; and
2. that the lender was thereby injured.

An unlawful means conspiracy claim is similar, save that there is no need to demonstrate a predominant purpose to injure if the means deployed were unlawful in and of themselves. Whether such "unlawful means" would encompass a breach of contract is a matter which is not yet settled by the courts, and has been said to be one that will depend upon the precise nature of the relationship between the parties.

Protecting against the prospect of a waiver in the future

Provision in investor documentation

Absent statutory protection, a lender's strongest bulwark against a fund's unilateral release of commitments will likely be the inclusion of a specific provision in the investor documentation prohibiting the same without the express consent of the lender, drafted to ensure that it may be directly enforced by the lender pursuant to the Cayman Islands Contracts (Rights of Third Parties) Law (the "**Third Party Rights Law**").

As a legal matter, it is worth noting that while, in the case of an ELP, this would generally best be included in its limited partnership agreement, the ambit of the Third Party Rights Law does not extend to the memorandum and articles of a Company. As such, when dealing with a Company, such a provision should commonly be included the investors' subscription agreements instead.

As a practical matter, it is common for lenders to encounter resistance to the inclusion of third-party enforcement provisions generally and particularly where the investors documents have been finalised and the fund is already up and running. Further, there will likely be some sensitivity to seeking to include a provision specifically to address concerns about fraud-style risks. However, given that, in essence, such a provision largely seeks to replicate the practical effect of the statutory protections for LLCs referred to above (and to which many on-shore funds will already be subject), our view is that there should not normally be any substantive concern for sponsors in including it, and it may provide some genuine comfort to lenders and their credit committees.

Notifying investors of the restrictions on waiver and release

Continued

If a direct contractual nexus between the lender and the investors cannot be included in the fund documentation itself, our view is that there may still be a practical benefit to ensuring that the investors themselves are notified, in reasonable detail, of the fund's undertaking in the loan documentation not to waive or release without lender consent. By ensuring that investors are made aware of the fact that such a unilateral release or waiver would constitute a breach of contract (and perhaps certain fiduciary duties), many of the elements necessary to pursue the remedies outlined above may be easier to demonstrate.

Further, where security is being taken over the commitments, as a matter of Cayman Islands law, we would generally expect notice of the same to be being given to investors as part of the perfection process (in addition to helping guard against set-off rights arising); a summary of the contractual restrictions can thus easily be included in such notice.

Conclusion

As above, in our view, the risk of this eventuality is a notably small one; a view supported by the exceptional rarity of such an occurrence during the industry's decades long history.

However, as in any credit transaction, there is doubtless wisdom in taking steps to protect against even the more unlikely concerns, particularly given the fact specific nature of many of the available remedies, the minimal cost of doing so, and the likely benefit to the industry as a whole.

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