What Sanctions Mean For Funds' Subscription Credit Facilities

By **Brent Shultz, Todd Cubbage and Robert Bruner** (May 23, 2022)

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Russia's invasion of Ukraine has unleashed an unprecedented wave of sanctions against wealthy Russian oligarchs.[1] While the seizure of mega yachts and massive villas worldwide has grabbed headlines,[2] these oligarchs have substantial investments in hedge funds and private equity funds in the U.S. and abroad.[3]

This article will examine the impact of an investor becoming sanctioned after its admission into a fund, with a particular focus on the impact of a sanctioned investor on a fund's subscription credit facility.

Subscription credit facilities are revolving credit facilities secured by the right to call unfunded commitments of investors in these private equity funds.[4] Funds take advantage of subscription credit facilities to bridge capital calls, for working capital, to fund expenses or to use for quick acquisitions.[5]

They are generally priced better than other types of acquisition or permanent financing, and in many cases can serve to bridge putting such portfolio-level financing in place.[6] The use of subscription credit facilities by private equity funds is widespread,[7] and these facilities universally require a fund to comply with sanctions covenants.

Private equity funds — and subscription lenders that advance money against the capital commitments of investors in private equity funds — typically perform know-your-customer, or KYC, diligence on the fund investors when they are admitted to the fund, which typically includes, among other things, running the investor's name and its beneficial owner's name through various sanctions databases.

But this approach will only work if the beneficial owner is someone who is obviously on a sanctions list. While difficult and rare, some privacy-minded investors utilize investment vehicles, such as blind trusts, where it is not clear who actually owns or controls the investor, making it extremely challenging for lenders to determine whether an investor is sanctioned.

Further, after an investor's admission into the fund, many funds and lenders have relied on ongoing investor representations made to the fund regarding the continuing accuracy of the KYC representations rather than actively conducting ongoing KYC diligence on these investors. Should this practice change?

While the Loan Syndications and Trading Association has model sanctions-related provisions in its model credit agreement, due to the unique nature of subscription facilities, the sanctions-related credit facility provisions in these facilities go well beyond the LSTA baseline recommendations.[8]

For example, subscription facilities often require affiliates of the loan parties to be included in covenants and representations, the maintenance of sanctions compliance programs by the funds, and the absence of any sanctions investigations on any loan party.

In addition, many subscription facilities contain prohibitions on repaying the credit facility with any proceeds derived from a sanctions-prohibited transactions, representations that no investors are sanctioned entities, and specific notice requirements for sanctions violations.

Both the LSTA guidance and private equity funds focus their regulatory provisions on sanctions regimes administered by: the U.S. (primarily those administered by the U.S. Department of State and the Office of Foreign Assets Control), and to the extent relevant, the United Nations, the European Union and Her Majesty's Treasury in the U.K.[9] In addition, lenders organized outside the U.S. or U.K. will usually require inclusion of sanctions regimes for the country in which they are based.

These regimes not only apply to the direct individuals or organizations on the various sanctions lists maintained by these governmental entities or agencies but also extend automatically to entities or trusts beneficially owned — or sometimes controlled — by the sanctioned individuals or organizations, without any listing of these entities or trusts on those sanctions lists.

The test for beneficial ownership in the U.S. is whether a sanctioned entity or person owns, individually or in the aggregate with other sanctioned entities or persons, directly or indirectly, a 50% or greater interest in the entity.[10]

The EU and HMT also have their own 50% rule, but in addition, both the EU[11] and HMT[12] automatically sanction entities controlled by sanctioned persons. The beneficial ownership information an investor provides enables funds and lenders to ascertain the ownership of an investor, but it does not necessarily resolve who controls it, because control can be exerted without any formal documentation or ownership.[13]

In apparent recognition of this fact, the EU and HMT sanction regimes do not apply strict liability standards like the U.S., and instead they apply only if the fund knows or has reasonable cause to know an investor is sanctioned.[14]

Private equity funds will conduct due diligence on investors prior to their admission to the fund, and for lenders, this process often occurs after investors are admitted to the fund, but prior to the fund entering into a credit agreement.

In connection with subscribing for interests in the private equity fund, an investor will enter into a subscription agreement that typically requires it to make representations on the beneficial ownership of the investor, so the fund can comply with the sanction regimes. These provisions typically include the investors' identities, addresses and government-issued identification materials, to allow the fund to maintain compliance with sanctions.

If these representations — including the investor's affirmation that it is not sanctioned — are, or become, untrue, a general partner generally has the right under the fund's organizational documents to remove an investor from the fund because the investor's participation materially and adversely affects the fund, for example.

However, the general partner cannot remove a sanctioned investor without a license from the sanctioning bodies because an investor's interest, in addition to any associated assets, are immediately frozen.[15] As a result, the fund cannot remove the investor, and while the investor retains title to its interest, the investor is immediately blocked from exercising any of the rights or obligations associated with its interest in the fund, including receiving any amounts from the fund.

Generally, the investor's representations as to ownership are brought down, meaning the investor reaffirms the representations when the investor (1) funds a capital call, (2) transfers its interest to an alternative investment vehicle and (3) in some cases, when the fund makes an investment.

Similarly, a typical subscription facility credit agreement will have a number of representations and warranties that the fund needs to make to the lenders both at the closing of the credit facility and again each time the fund wants to borrow. This bring-down mechanic in a facility credit agreement is similar in some ways to the bring-down mechanic in a fund's governing and subscription documents, which effectively bring down the investor's representations and warranties at critical times.

In addition to typical representations and warranties in a facility credit agreement, such as the fund being in good standing and no existence of a credit facility default, the fund will often be required to represent that no investor is the target of sanctions and, under the typical LSTA sanctions provisions, no loan party is a sanctioned entity.[16]

While the baseline LSTA sanctions provisions regarding use of proceeds and no loan parties being sanctioned entities do mitigate legal risk to the lenders, they are in many ways more applicable to established companies that have a long track record of doing business rather than recently formed funds, when a credit facility is put in place that may only exist for a few years before being dissolved once the fund has realized all of its investments.

However, the standard LSTA provisions do not protect a lender from the significant reputational risk that would come from lending to a fund that has a sanctioned person in it and receiving the pledge of an unfunded capital commitment of a sanctioned investor. This is why many lenders require representations and warranties that go beyond the standard LSTA provisions, including requiring that the fund to represent that no investor is a sanctioned investor.

If an investor becomes subject to sanctions under a facility with typical sanctions provisions and the sanctions representations are untrue, and in particular the representation that no investor is a sanctioned investor, then the fund cannot bring down the sanctions representations and warranties.

As a result, the fund will not be able to borrow under the credit facility until it can truthfully make the representation to the lenders. If the fund is relying on the subscription financing to fund acquisitions, for working capital or access to a letter of credit facility, its business may be seriously affected if its funding source is unexpectedly unavailable.

This will have the practical effect of bringing the fund and the lender back at the negotiating table to discuss a solution, so the fund can continue to access its credit facility.

Further, if the fund previously made representations that are untrue, it is generally an immediate event of default under the credit facility, which exposes the fund to the risk that the lenders can exercise remedies under the credit facility, and at minimum, prevent the fund from future funding under the credit facility until the default is cured.

Subscription credit facilities also include covenant packages that require the fund to comply with sanctions, to not be a sanctioned entity itself, and to not do business or use the proceeds of a credit facility in a way that would breach applicable sanctions.

Merely having a sanctioned investor in the fund would usually not lead to a breach of these sanctions covenants, but a breached covenant usually leads to an event of default under the credit facility, with the same consequences as an untrue representation and warranty.

And, if the fund is a separately managed account or a co-investment vehicle, having a sanctioned investor that owns more than 50% of the vehicle or fund, the fund itself may become a sanctioned person.

This situation would generally trigger an immediate default under the fund's subscription facility; however, even if it is not a default, lenders could not extend new borrowings because the fund would itself be automatically sanctioned.

The borrowing capacity under subscription credit facilities is governed by a borrowing base, which is a list of investors that are deemed creditworthy by the lender and whose capital commitments have been pledged by the fund to the lender.

These credit facilities include exclusion events that serve to exclude the commitments of an otherwise eligible investor from the borrowing base calculations, and as a result, the amount that the credit provider is willing to advance to the fund. The list of exclusion events is often lengthy, but it almost always includes an exclusion event for an investor becoming subject to sanctions.

If an investor is removed from the borrowing base and its removal causes a borrowing base deficiency, then the fund will be required to either cure the borrowing base deficiency with cash on hand or call capital from its investors to cure. Neither is an ideal outcome for the fund, and if the fund cannot make the prepayment in accordance with the facility terms, then it will be in immediate default under the credit facility.

As funds have typically filtered sanctioned investors prior to their admittance to the fund, the large-scale implementation of sanctions to oligarchs has led to a novel situation for many funds and lenders: sanctioned investors in a fund. Fund sponsors and banks both have regulatory responsibilities regarding KYC knowledge and compliance, so each is highly concerned about maintaining sanctions regulatory compliance.

Going forward, both lenders and sponsors should regularly run sanctions checks on their investors and the beneficial owners of their investors by rerunning the investor's beneficial ownership information through its KYC process, as is done on the front end. From a fund's perspective, this will provide more certainty that the fund can accurately make its representations and warranties under the credit agreement.

Sanctions provisions are often a focus of negotiation in credit facilities; however, most lenders have little scope to revise them. Given the recent expansion of sanctioned individuals to include Russian oligarchs, both lenders and funds should review the fund's credit facility to understand the specific impact of having a sanctioned investor in a fund and whether current sanctions provisions should be revised in light of current circumstances in Ukraine.

If a fund has a sanctioned investor and the fund cannot borrow under its facility, how should the lender respond? If a fund requests to modify the representation that only investors in the borrowing base are not sanctioned, how should the lender respond? This would theoretically allow for unlimited sanctioned investors in a fund that is banked by the lender, which is a result no lender desires.

These are important questions that many lenders are now considering as they address this novel situation.

In any event, the treatment of sanctioned investors in a fund is an extremely complicated analysis that will involve careful review of the fund's governing documents, the credit agreement and the specific sanctions to which the investor is subject.

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[1] Press Release: Treasury Sanctions Kremlin Elites, Leaders, Oligarchs, and Family for Enabling Putin's War Against Ukraine, U.S. Dep't Treas., (Mar. 11, 2022), https://home.treasury.gov/news/press-releases/jy0650.

[2] Spencer S. Hsu, U.S. seizes superyacht of Russian billionaire close to Putin, Wash. Post (Apr. 4, 2022), https://www.washingtonpost.com/dc-md-va/2022/04/04/yacht-seized-russia-sanctions/.

[3] Chris Cumming, Sanctioned LPs Complicate Private-Equity Fund Dynamics, Wall St. J. (Apr. 5, 2022) https://www.wsj.com/articles/sanctioned-lps-complicate-private-equity-fund-dynamics-11649152801.

[4] Id. Note that since lenders are getting only a pledge of the right to call capital, the lenders do not have direct contractual privity with the investors. If the credit provider has privity with the investor, it raises questions on whether the lender can release the investor from its capital obligation without raising sanctions compliance concerns.

[5] Id.

[6] Id.

[7] Albert C. Tan, Guangsheng Zang, & Phong Tran, Subscription Facilities as a Useful Tool for Energy-Focused Funds in a Capital Constrained Environment, Lexology (Sept. 26, 2019) https://www.lexology.com/library/ detail.aspx?g=4b8cf295-96dd-45d5-b650-a5f15981b854.

[8] Loan Syndication Trading Assoc'n, LSTA Regulatory Guidance: U.S. Sanctions Issues In Lending Transactions (Apr. 25, 2022), available to LSTA members at https://www.lsta.org/content/us-sanctions-issues-in-lending-transactions/ [hereinafter LSTA Guidance].

[9] See id. at 20 n.81 and accompanying text.

[10] U.S. Dep't Treas., Revised Guidance On Entities Owned By Persons Whose Property And Interests In Property Are Blocked (Aug. 13,

2014) https://home.treasury.gov/system/files/126/licensing_guidance.pdf; see also U.S. Dep't Treas, Frequently Asked Questions: Entities Owned by Blocked Persons (50% Rule), https://home.treasury.gov/policy-issues/financial-sanctions/faqs/topic/1521#:~:text=OFAC's%2050%20Percent% 20Rule%20states,blocked%20persons%20are%20considered%20blocked.

[11] The Russian-related sanctions do not define control, but often use the phrase "at the direction of" to denote a similar concept. See Council Regulation 833/214, 2014 O.J. (L 229) art. 5aa, ¶1(c) (EC), consolidated as amended, available at https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:02014R0833-20220413; see also Secretariat-General, Sanctions Guidelines—update, (doc. 5664/18) (May 4, 2018) at 20–22, https://data.consilium.europa.eu/doc/document/ST-5664-2018-INIT/en/pdf.

[12] The Russia (Sanctions) (EU Exit) (Amendment) (No. 6) Regulations 2022, SI 2022/241, art. 2, ¶6(2)(b) (UK).

[13] See supra note 11; id. at Sch. 1, ¶11(2) (defining control as ability to direct the exercising of a right).

[14] The Russia (Sanctions) (EU Exit) (Amendment) (No. 6) Regulations 2022, SI 2022/241, art. 3, ¶16(1) (UK); Council Regulation 833/214, 2014 O.J. (L 229) art. 10 (EC) ("Actions by natural or legal persons, entities or bodies shall not give rise to liability of any kind on their part, if they did not know, and had no reasonable cause to suspect, that their actions would infringe the measures set out in this Regulation.").

[15] U.S. Dep't Treas, Off. For. Ass. Ctrl., Frequently Asked Questions: What do you mean by "blocking?", https://home.treasury.gov/policy-issues/financial-sanctions/faqs/9. ("Title to the blocked property remains with the target, but the exercise of powers and privileges normally associated with ownership is prohibited without authorization from OFAC. Blocking immediately imposes an across-the-board prohibition against transfers or dealings of any kind with regard to the property.").

[16] LSTA Guidance, at 19–22.