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Due Diligence for Subscription Facilities in the Wake of the Abraaj and JES Global Capital Litigation: Recapping the Due Diligence and Lessons Learned Panel at the 2022 FFA Global Symposium

By Brent Shultz

There is no doubt that the facts and subsequent litigation surrounding the Abraaj Capital and JES Global Capital subscription financings are some of the most significant developments in the fund finance market since its inception. Last week, I had the privilege of moderating the "*Underwriting and Diligence Lessons Learned*" panel on this topic at the 2022 FFA Global Symposium. For those of you unable to join us in Miami, I thought a recap of our discussion may be helpful, since there has been so much interest in enhanced diligence procedures.[1]

Abraaj Capital was a major private equity fund based in Dubai that, at its peak, had over $14 billion of assets under management and major institutional investors, including the Bill and Melinda Gates Foundation. Reports have indicated that Abraaj was not generating enough income to cover its basic operating costs, so the fund was forced to borrow, eventually even dipping into one fund's capital to pay another fund's operating expenses. When investors became aware of this mismanagement, there was an exodus from the fund. Unfortunately for its capital providers, Abraaj had already secured a subscription facility and had already drawn under the line to fund an acquisition, while at the same time releasing investors from their commitments.

While Abraaj Capital was a case of mismanagement and abuse of funds, it had been quite successful in its fundraising efforts and closed in actual investors who committed capital to its funds. JES Global Capital, on the other hand, and based on the information that is publicly available at this time, obtained subscription financings based on at least some fabricated subscription agreements. In other words, the founder of JES Global Capital, Elliot Smerling, forged subscription agreements to demonstrate to lenders that his fund had received capital commitments from some large and well-known institutional and high net worth investors. When those investors were contacted, they stated that they did not have a relationship with Mr. Smerling nor any of his funds. In addition to fabricating subscription agreements, Mr. Smerling also fabricated bank account statements and audit letters in connection with obtaining or maintaining his subscription financings. Just this month, Mr. Smerling pled guilty to a number of federal fraud charges in connection with the case and is currently awaiting sentencing.

While many market participants have believed over the years that fraud is – and has always been – the largest risk to lenders in the subscription space, it is important to note that in the 36 years that this product has been in existence, there have been only two known cases of fraud in what is now a multi-hundred billion dollar industry. The panelists emphasized that there are a number of structural reasons for this, including diligence practices that are already robust and the fact that the product was first provided to some of the largest sponsors in the world, who implement significant internal controls, making fraud significantly harder for any investment professional to pull off. However, with more and more emerging sponsors seeking subscription lines, and given what happened with JES Global Capital, the time is ripe to re-examine diligence processes.

[1] Special thanks to Tim Hicks at Cadwalader, Keenan McBride at Morgan Stanley, Michael O'Connor at Conyers, Guy Simpson at Bridge Bank and Storey Whalen at First Republic Bank for serving on this panel and for their excellent insights.

In response to the Abraaj case, where many LPs withdrew from the fund even though a subscription facility was already in place, panelists reported seeing a tightening of investor notification requirements in facilities in foreign jurisdictions where investor notification is a requirement for perfection. Pre-Abraaj, larger sponsors could negotiate for quarterly notification requirements and having notifications contained in a larger packet of reporting where the investor is less likely to see the notice and with looser standards around evidence of such notifications. Post-Abraaj, panelists reported requiring these notifications to be sent concurrent with or within 3 to 5 business days after closing and requiring evidence of the same. Abraaj was, however, at the time, largely viewed as an isolated incidence of mismanagement, Other than an enhanced focus on procedural and evidentiary requirements associated with such perfection requirements, there was not a huge shift in market practices.

Then, in early 2021, when the market was still processing the fallout from the Abraaj case, news surfaced about the potential bank losses associated with the JES Global Capital fund vehicles. In speaking with the panelists about this, many of them highlighted enhanced scrutiny and due diligence regarding their potential borrowers and their operations, particularly with regard to emerging fund sponsors or sponsors with whom the bank may not have a pre-existing relationship. Certain examples provided by our panelists were more and frequent on-site visits (which has obviously been complicated by the COVID-19 pandemic), contacting a number of investing professionals at the sponsor, performing background checks, determining whether others at your institution have relationships with anyone involved in the fund operations, utilizing tools such as LinkedIn to determine connections with the investing professionals,, and speaking with third-parties who have relationships with the fund, such as the fund administrators (but ensuring that you also perform diligence on those very fund administrators) or in certain circumstances, the fund's external counsel. An emerging theme from our panelists was "know your borrower."

In addition to enhanced due diligence at the outset, panelists discussed a preference for having the fund's deposit accounts held with the lending institution, so that the lender can see for itself when capital is flowing through the accounts. Where this is not possible, panelists recommended ensuring that the lender has online monitoring access to such accounts. One panelist highlighted, however, that even with some of these structural safeguards, sponsors could always violate covenants in their loan documents and call capital into a different account or commit fraud in other ways and, further, that nothing can take the place of good old-fashioned diligence.

Panelists debated if and when lenders should perform their own detective work by making contact with a sponsor's limited partners. Some lenders require the sponsor to provide limited partner contact information, and reach out to the limited partners on a random basis, and our panelists felt that in certain circumstances it would be appropriate and a best practice for a lender to independently verify or authenticate a subscription agreement by making a phone call to a limited partner, since the subscription agreements are often provided to the lender by the fund itself. While private equity sponsors may not necessarily be enthusiastic to have their lenders calling their limited partners, our panelists stated there has been growing acceptance of this practice, at least with respect to the limited partners with the largest commitments to the fund. And, in fact, one panelist stated that some limited partners have even called lenders to verify that they are in fact providing a credit facility to the fund. Our banking panelists did not report having external counsel perform any non-legal work with respect to review and treatment of subscription agreements or side letters, and our legal panelists did not report being asked to engage in any type of detective or other non-legal work on the investor documents. One banking panelist mentioned that he often scrutinizes the subscription agreements and side letters himself, at least for the largest investors, to help him better understand the terms and conditions and nature of the relationship between the limited partner and general partner. Some panelists also mentioned increased scrutiny and diligence

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regarding the fund's underlying investments, both as a means of combatting fraud and as a secondary source of repayment.

Overall, our discussion was engaging, and we hope helpful to market participants who have been extremely eager to discuss these topics with us and with others over the past year. Methods not discussed in particular on the panel include requiring that the investment adviser to the fund is registered with the SEC, which puts the funds under more scrutiny. Sponsor legal representation by market leaders may also be helpful, in that such firms have a deep understanding of the risks, know the investors, and are accustomed to dealing directly with investors. In short, lenders should take care to use best practices, some of which have been outlined in this article, with an overwhelming emphasis on knowing their borrowers. That said, lenders should not be deterred from continuing to participate in this otherwise booming and historically safe sector of the financial markets. To the extent anyone wishes to discuss the contents this article, please feel free to reach out.

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