

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

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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.

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.

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