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Fraud in Subscription Credit Facilities

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Recent press coverage has brought to light allegations of fraud in relation to a subscription credit facility made available to a fund managed by a Florida-based private equity fund manager, JES Global Capital. The allegations claim that one of the managers of JES forged subscription agreements totaling $85 million from two institutions, as well as bank records showing wire transfers from those institutions. An audit letter attesting to the financial health of the fund was also said to be falsified by the manager. The investigation remains ongoing, with the accused manager having been arrested and facing up to 30 years in prison for wire fraud and aggravated identity theft.

How are subscription credit facilities susceptible to fraud?

The case has led to questions about the due diligence processes in the subscription credit facility market. Subscription credit facilities are secured by the unfunded capital commitments of the investors in the fund, the right of the fund to receive capital contributions from such investors and the right of the fund to call capital. In addition, a pledge of the bank account into which the capital is deposited is also typically required. Subscription credit facility lenders conduct due diligence on the fund (as well as its manager) and the investors in the fund, but the key link between the two is the documentation which evidences the investors' commitments to contribute capital to the fund following the issuance of drawdown notices. Such commitments are documented by subscription agreements or deeds of adherence, whereby each investor agrees to be bound by the fund's limited partnership agreement and commits to contribute capital up to the amount set out in such documentation. Due diligence reviews are focused on the contents of the contractual framework (i.e. who are the investors, what are their commitments and are there circumstances in which they are not required to honor capital calls) and whether they appear on their face to be enforceable. However, there are limitations around the extent to which a lender can be confident that an investor is committed to a fund through document review alone.

What are the implications when an investor's commitment to the fund has been forged?

The amount of credit that a lender is willing to extend to a fund is dependent on the amount of the fund's unfunded capital commitments. It is not clear from the JES case whether the forged commitments were the only commitments to the fund or, alternatively, whether the fund has genuine investors with an actual pool of unfunded capital commitments. Assuming the fund does include genuine investors, by forging investor commitments totaling $85 million, the apparent pool of unfunded capital commitments would be inflated and the amount the lender was willing to advance would be artificially increased.

In the JES case, the key question is who ultimately bears responsibility for repayment of the fund's debt. If there are genuine investors in the fund, then under typical documentation such investors will be obligated for the debt of the fund on a pro rata basis up to the amount of their unfunded capital commitments. This would depend on the exact wording of the fund's limited partnership agreement, but it is not unusual for investors to be required to fund drawdown notices without set-off, counterclaim or defense. We expect the lender would have the ability to enforce its pledge and take its own steps to issue drawdown notices to investors to recover the outstanding debt.

On the other hand, if there are no genuine investors (and no amounts available in the pledged bank accounts), the lender is likely to be in an unsecured position vis-à-vis the fund, but may be able to take steps as an unsecured creditor to seek recovery of the debt. This would depend on the extent to which the fund had assets available to meet such debts and/or whether a trustee in bankruptcy could seek to clawback any payments as preferential or fraudulent transfers in an insolvency process. Further, as the general partner of a fund is liable for the fund's debts, a lender could also attempt to recover from the general partner (although we would typically not expect the general partner to have substantial assets).

How can subscription credit facility lenders mitigate the risk of fraud?

Following the JES case, we expect that lenders will place greater importance on investor due diligence. Given the potential shortcomings in contractual due diligence, this may lead to the adoption of additional due diligence practices. As a practical matter, fund managers may start to see lenders take some of the following additional steps (some of which we already see on some deals but which are not universal and often resisted by fund managers):

- Requiring letters or acknowledgements to be provided by investors to the lender. Such letters are not generally required by a number of key lenders in the subscription credit facility market, except where lending to funds with concentrated investor bases. Requiring such letters does not eliminate the chance of fraud entirely given that typically the fund manager would be the one liaising with investors to obtain letters or acknowledgements.
- Requiring notices to be sent to investors informing them of the grant of security. This is standard in European deals given the requirement to give notice to perfect security, but there are differences in approach as to timing and methodology. In US deals, notices are not usually required except for investors in certain jurisdictions, in particular Cayman feeder funds.
- Requiring evidence that investors have already funded at least one capital call or a specified percentage of their aggregate commitment to the fund before the fund is able to draw under the credit facility. This not only ensures that investors have “skin in the game” before the lender advances funds, but also gives the lender the opportunity to verify bank records. Where the fund’s bank accounts are held with the lender, the verification process is straightforward. However, as demonstrated by the JES case, where this is not the case and the lender relies on the fund to merely provide copies of bank statements of third-party bank accounts, there is still potential for forgery.
- Spot checks by lenders making direct contact with investors. We aren’t aware of the extent to which spot checks currently take place, but the JES case may lead to lenders considering such checks as part of their due diligence.

Despite the above options open to subscription credit facility lenders, the closest a lender could come to eliminating the risk of fraud would be to make contact with each investor directly to confirm its commitment to the fund as part of the initial due diligence process. Even then, it is possible to envision extreme scenarios where a fraudulent fund manager supplies false contact details and impersonates the investor during the verification process. However, the more additional checks that are built into the due diligence process, the greater the likelihood of detecting fraud before loans are advanced, and the greater the deterrent effect on potential fraudsters. Fund managers may therefore see an increase in lenders employing more rigorous steps in their due diligence processes, with an increased focus on direct contact with investors. On its face, this direct contact is likely to be unappealing to fund managers from an investor relations perspective.

What is the likely fallout from the JES case?

No financial product is completely immune to fraud, and the fact that this is only the second major reported case in the subscription credit facility market suggests that this should not be a cause for panic. Understandably, lenders will be reviewing their due diligence processes and, we expect, requiring additional due diligence, particularly when looking to underwrite new business with a fund or its manager where the lender has no prior existing relationship. It would not be surprising if lenders applied greater pressure on fund managers to maintain the pledged bank account with the lender to assist in the verification steps outlined above (we already see some banks incorporate a soft obligation to do so, but it is not a widespread requirement). The ability of funds with very concentrated investor bases to obtain a subscription credit facility (which is already rare) may become more difficult. Further, investors may begin to take a closer look at the borrowing powers in fund documentation and the circumstances in which they are obligated to fund capital calls to repay fund indebtedness. The fallout from the JES case remains to be seen, but suggestions of increased pricing or requirements to completely overhaul processes on subscription credit facilities appear premature. We will provide further updates as the case develops and the market responds.

Proskauer's market leading international fund finance practice has considerable experience with subscription credit facilities and other fund finance products, both in the US and in Europe. Working together with the firm's corporate, tax and other practice groups, our fund finance practice is available to help our clients structure and implement such credit facilities to fit their needs. Please contact us with any questions.