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Fund Finance Fraud: JES Global Capital and Implications for Subscription Line Lender Due Diligence

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I. INTRODUCTION

Private markets have seen unprecedented growth since the turn of the century, and over the past decade, more capital has been raised within private markets than in markets available to the public.[1] One way investors have capitalized on private markets is through private equity funds, collective investment vehicles used to make investments in non-public equity.[2] Although private equity funds take many shapes and forms,[3] it has become a common practice for these funds to utilize credit facilities to support their operations, primarily by supplying them access to liquid assets.[4] Capital call facilities, also known as subscription lines, are one specific type of credit facility used by private equity funds.[5] The fund industry describes subscription lines as a low-

1. *See* MICHAEL J. MAUBOUSSIN & DAN CALLAHAN, MORGAN STANLEY, PUBLIC TO PRIVATE EQUITY IN THE UNITED STATES: A LONG-TERM LOOK 4 (2020) ("Further, companies have raised more money in private markets than in public markets in each year since 2009. For example, companies raised $3.0 trillion in private markets and $1.5 trillion in public markets in 2017. These changes in how investors invest and how companies raise capital have important implications for holding periods, the perceived volatility of the returns, and liquidity.").

2. THOMAS P. LEMKE ET AL., HEDGE FUNDS AND OTHER PRIVATE FUNDS: REGULATION AND COMPLIANCE § 13:1 (2020-2021 ed. 2021) ("A private equity fund is a collective investment vehicle used for making investments in various non-public equity (and to a lesser extent debt) securities according to the fund's investment strategy.").

3. *See id.* (explaining that there are many variations of private equity funds, including venture capital funds, mezzanine funds, and distressed funds, to name a few).

4. *See* Leah Edelboim, *Feeling (In)Secure: Security Interests in NAV Facilities*, FUND FIN. FRIDAY, CADWALADER, WICKERSHAM & TAFT LLP (Aug. 19, 2022), https://www.cadwalader.com/fund-finance-friday/index.php?eid=1538&nid=202 [https://perma.cc/83ZJ-MGJ3] ("We have seen rapid growth in subscription line financings as well as a great deal of interest in other types of financings that allow funds to access liquidity . . . .").

5. *See Subscription Lines—How it Evolved from a Funding Tool into a Credit Strategy*, PRIV. EQUITY FUND INVESTING (Mar. 2019), https://pefundinvesting.com/articles/subscription-lines/ [https://perma.cc/QV4L-4AR6] (discussing how the prominent use of subscription lines benefits funds and lenders).

risk product, benefiting both funds and lenders because of their comparatively low-interest rates and utility to funds.[6]

However, a serious case of fraud has recently reached the public eye involving subscription lines, suggesting a point of weakness that lenders should consider when offering subscription lines to borrowers.[7] In the case *United States v. Smerling*, Elliott Smerling—a private equity fund manager from Florida—fraudulently crafted limited partnership agreements ("LPAs"), subscription agreements, and audit documents to acquire subscription lines from Silicon Valley Bank ("SVB") and Citizens Bank on behalf of the private equity fund JES Global Capital.[8] The FBI arrested Smerling after discovering he had submitted illegitimate documents to the banks, and both banks subsequently filed suit.[9] Smerling has since pleaded guilty to securities fraud and bank fraud and has been sentenced to eight years in prison.[10] Further, Smerling's fraudulent activity has forced both banks to engage in expensive and time-consuming litigation.[11]

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6. *See* Jeroen Cornel et al., *Understanding the Impact of Subscription Lines on Private Equity Funds*, BLACKROCK https://www.blackrock.com/institutions/en-us/insights/investment-actions/impact-of-subscription-lines [https://perma.cc/KAQ9-U9E8] (last visited Jan. 1, 2023) (describing the risk exposed to the private equity funds and the lenders).

7. *See* Anastasia N. Kaup & Louise Melchor, *Fund Finance: How to Mitigate Risk and Facilitate Financing*, DUANE MORRIS LLP (Dec. 30, 2021), https://www.duanemorris.com/articles/fund_finance_how_to_mitigate_risk_facilitate_financing_1221.html [https://perma.cc/3DDZ-E472] ("Due diligence in fund financing transactions is critical, now more than ever, for investment funds as well as lenders.").

8. *See* Press Release, U.S. Att'y's Off. S. Dist. of N.Y., Dep't of Just., CEO of Private Equity Fund Pleads Guilty to Scheme to Defraud Banks of $140 Million (Feb. 8, 2022), https://www.justice.gov/usao-sdny/pr/ceo-private-equity-fund-pleads-guilty-scheme-defraud-banks-140-million [https://perma.cc/9KFH-5K7J] ("[Smerling] obtained the loans on the basis of falsified documents and material misrepresentations, including: (1) a forged audit letter, purportedly prepared by an international network of accounting, audit, tax, and professional services firms, attesting to audited financial statements; (2) forged subscription agreements that falsely represented, among other things [$85 million in commitments] . . . ."); Judgment in a Criminal Case at 1-2, United States v. Smerling, No. S1 21-CR-00317-01 (DLC) (S.D.N.Y. judgment rendered May 13, 2022).

9. Press Release, U.S. Att'y's Off. S. Dist. of N.Y., Dep't of Just., *supra* note 8 (stating that Smerling plead guilty to "one count of bank fraud" and "one count of securities fraud"); Judgment in a Criminal Case, *supra* note 8, at 1–2 (rendering judgment for 97 months).

10. Judgment in a Criminal Case, *supra* note 8, at 1–2 (stating that Smerling was sentenced to ninety-seven months in prison).

11. *See* Order Granting the Unopposed Motion to Sell the 2020 Cadillac Escalade and Related Relief at 3–4, *In re* Smerling Litigation, No. 21 Civ.2552 (JPC) (S.D.N.Y. 2022) (detailing one of the many requests by the banks to liquidate Smerling's assets in order to cover their losses).

United States v. Smerling constitutes one of the first public cases of subscription line fraud in the 36-year history of the product, calling the security of subscription lines into question.[12] Because of this, banks and other lenders should question whether this was an outlier within the fund finance industry that warrants no concern, or whether their due diligence processes require additional attention to ensure secure subscription line transactions in the future.[13]

This Note will proceed in five parts. Part II will describe the facts and results stemming from the *United States v. Smerling* case, provide a comprehensive background of the workings of private equity funds and the dynamics of subscription facilities, and present the standard due diligence procedures commonly conducted by lenders when offering subscription lines.[14] Part III will analyze the loan agreements between the banks and the JES Global Capital Fund to see how they compare to subscription line due diligence norms.[15] Part IV will analyze additional due diligence measures lenders may wish to undertake to prevent fraud from occurring in the future.[16] Part V will provide the final takeaways of the Note.[17]

II. BACKGROUND

A. Background of United States v. Smerling

In February of 2022, Elliott Smerling pleaded guilty to one count of bank fraud and one count of securities fraud, landing him

12. *See* Symposium Summary: Brent Shultz, Haynes and Boone LLC, 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 (Feb. 25, 2022), https://www.haynesboone.com/news/alerts/due-diligence-for-subscription-facilities-in-wake-of-abraaj-and-jes-global-capital-litigation (click "Read the full article here" to access the pdf document) [https://perma.cc/2RGE-4U85] (stating that there have been two cases of public fund finance fraud that have reached a wide audience). The other case is regarding the Abraaj Group, a fund whose GP had made misrepresentation to his investors, rather than his lenders. *Id.* Because of this, we will focus only on the Smerling case.

13. *See* Kaup & Melchor, *supra* note 7 ("Due diligence in fund financing transactions is critical, now more than ever, for investment funds as well as lenders.").

14. *See infra* Part II.

15. *See infra* Part III.

16. *See infra* Part IV.

17. *See infra* Part V.

ninety-seven months in prison.[18] In addition to the criminal action, SVB and Citizens Bank brought a civil suit against Smerling in his role as the General Partner for JES Global Capital.[19] According to SVB's civil complaint, Elliott Smerling portrayed himself as the founder of JES Global Capital III, L.P. (the "JES Fund") and Defendant JES Global Capital GP III, LLC (the "JES GP"), both of which are incorporated as Delaware entities.[20] Under his company JES GP, Smerling acted as the managing partner of the JES Fund.[21] On December 1, 2020, Smerling contacted the SVB seeking a subscription line for the JES Fund.[22] Smerling represented that the JES Fund had $500 million in investments from the fund's limited partners ("LPs")—many of which were investors with strong reputations—including the endowments for New York University and the University of Miami, as well as the Bank of New York Mellon.[23] He also falsely represented to SVB that the LPs had already invested $100 million in three companies.[24]

After this initial contact, SVB began its standard pre-lending diligence process, including a request for the standard fund operational documents.[25] SVB requested audited financial documents from Smerling,[26] who turned over several fraudulent documents, including a two-page addendum purporting to be an "unqualified audit opinion"

18. Press Release, U.S. Att'y's Off. S. Dist. of N.Y., Dep't of Just., *supra* note 8 (stating that Smerling plead guilty to "one count of bank fraud" and "one count of securities fraud"); Judgment in a Criminal Case, *supra* note 8, at 1–2 (rendering judgment for 97 months).

19. Complaint at 1, *In re* Smerling Litigation, No. 21 Civ. 2552 (S.D.N.Y. 2022) [hereinafter SVB Complaint]; Complaint at 1, Citizens Bank v. JES Global Capital II, No. 21 Civ. 5766 (S.D.N.Y. filed May. 5, 2021) [hereinafter Citizens Bank Complaint].

20. SVB Complaint, *supra* note 19, at 1, 4. The facts listed in this section primarily reflect the case between SVB and the JES Fund. *See id.* However, the facts are nearly identical to the other case of fraud involving Citizens Bank. *See* Citizens Bank Complaint, *supra* note 19.

21. SVB Complaint, *supra* note 19, at 5.

22. *Id.*

23. *Id.* at 1.; *see also* Citizens Bank Complaint, *supra* note 19, at 1 ("Defendant Smerling held himself out to be the founder of JES Fund II, a legitimate private equity fund with investments in portfolio companies and approximately $200 million in capital commitments from prominent limited partners, including an endowment for a prestigious university, preeminent international financial institutions, and high net-worth individuals.").

24. SVB Complaint, *supra* note 19, at 1.

25. *See id.* at 2 ("These documents include a roster naming approximately 20 limited partners who purportedly had committed $500 million in the aggregate to the JES Fund, subscription agreements signed by the limited partners, bank statements and other financial records.").

26. *Id.*

signed by BDO USA, LLP ("BDO").[27] All these documents were fabricated. There was no business relationship between the JES Fund and BDO.[28] Additional documents provided to SVB included a roster of twenty investors who allegedly had committed $500 million to the JES Fund pursuant to the agreements between Smerling and the investors.[29]

SVB, in reliance on these documents, entered into a loan agreement with the JES Fund and the JES GP,[30] giving the JES Fund a $150 million line of credit backed by the purported investments from the LPs.[31] The same day the loan agreement was finalized, the JES Fund borrowed almost $95 million under the loan agreement, most of which was sent directly to the Sumitomo Mitsui Bank Corporation by SVB to close out a prior line of credit.[32]

After closing on the subscription line, SVB sought to complete additional post-closing diligence according to the loan agreement.[33] SVB requested the name of the individual auditor who completed the unqualified audit opinion, in addition to the corporate governance documents of the JES Fund's investment portfolio companies.[34] Smerling did not supply any of the information requested.[35] This failure prompted further investigation by SVB.[36] SVB directly reached out to the legal department at BDO, where SVB learned there was no relationship between BDO and the JES Fund.[37]

After attempting to resolve the issue with the JES Fund, SVB sent a notice of default to the JES Fund pursuant to the loan agreement

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27. *Id.*
28. *See id.* at 11 (explaining that when asked about their relationship with the JES Fund, BDO stated that they have not worked with the fund at or created any audited opinions for the JES Fund).
29. *Id.* at 2.
30. *Id.*; Jonathan Stempel, *Florida Private Equity Manager Indicted in New York for Loan Fraud*, REUTERS (May 12, 2021 5:30 PM), https://www.reuters.com/business/legal/florida-private-equity-manager-indicted-new-york-loan-fraud-2021-05-12/ [https://perma.cc/8WXB-ASRH].
31. SVB Complaint, *supra* note 19, at 2; *see also* Stempel, *supra* note 30 ("Smerling obtained the credit line after providing subscription agreements from investors who had purportedly committed $500 million to his fund, but that the documents were inauthentic, inaccurate or forged.").
32. SVB Complaint, *supra* note 19, at 2.
33. *Id.*
34. *Id.* at 2–3.
35. *Id.*
36. *Id.* at 3.
37. *Id.*

provision stating that an event of default occurs if there is a material misrepresentation made by the general partner ("GP"), requiring all obligations under the loan agreement to immediately be due.[38] When SVB sent the notice, Smerling still had an outstanding credit balance of almost $80 million.[39] BDO and the banks subsequently reported the fraudulent activity to the FBI and Smerling was arrested and charged with securities fraud and aggravated identity theft.[40]

The SVB civil action was later consolidated with a claim brought by Citizens Bank against the JES Fund and Smerling.[41] In the civil actions, the court ruled in favor of SVB and Citizens Bank and later moved to preserve Smerling's assets held with numerous banks across the globe to reimburse SVB and Citizens Bank.[42] The criminal case resulted in a plea deal, where Smerling pleaded to one count of bank fraud and one count of securities fraud, resulting in a ninety-seven-month prison sentence.[43]

B. Overview of Private Equity Funds and Subscription Lines

Smerling used a private equity fund as his vehicle to commit fraud.[44] Private equity funds are structured as collective investment vehicles used to invest in non-public equity securities.[45] Collective investment vehicles function as a special type of investment vehicle in which money invested in the fund is pooled together by an adviser who then makes investments on behalf of the fund.[46]

Most commonly, investors are large institutions like pension funds or university endowments, but wealthy and sophisticated

38. *Id.* SVB held a video conference with JES Fund Counsel where the parties tried to come to an agreement to close on the subscription line by certain specific dates. *Id.* After several negotiations, SVB's complaint states that they subsequently declared the fund as having defaulted on the subscription line. *Id.* at 12.
39. *Id.*
40. *See id.* at 12 (explaining that the specific statutes that Smerling was charged under include 18 U.S.C. §§ 2 & 1343 (wire fraud) and 18 U.S.C. §§ 2, 1028A(a)(1), & 1028A(b) (aggravated identity theft)).
41. Order Granting Joint Motion to Consolidate SVB Action and Citizens Bank Action into a Single Action at 9, *In re* Smerling Litigation, No. 21 Civ. 2552 (S.D.N.Y. 2022).
42. Order Confirming the Finality of Judgments Against Defendants at 2, *In re* Smerling Litigation, No. 21 Civ. 2552 (JPC) (S.D.N.Y. 2022).
43. *See* Judgment in a Criminal Case, *supra* note 8, at 1–2.
44. SVB Complaint, *supra* note 19, at 1.
45. LEMKE ET AL., *supra* note 2, § 13:1.
46. *See id.* (explaining that the adviser commonly takes the form of a private equity firm).

individuals may also choose to invest in a fund.[47] The investors contribute to the fund by pledging a fixed amount of money to the fund through "capital commitments," which are then used in the fund's operation.[48] These investors are referred to as limited partners ("LPs").[49]

The fund's daily operations are controlled by the GP.[50] The GP is responsible for selecting the services that will drive the operations of the fund.[51] The GP may also choose to form its own business entity, as was the case with the JES GP entity formed by Smerling.[52]

Additionally, private equity funds are considered "closed-end" vehicles because they do not accept additional investors after they conclude their fundraising stage or "closings."[53] Private equity funds may have a small number of closings, and some may space out closings over a specific period, meaning that GPs may choose to have multiple fundraisings for one private equity fund, depending on the chosen fund structure.[54]

Private equity funds typically invest in numerous companies, colloquially known as "portfolio companies."[55] Private equity funds invest by purchasing large blocks of privately placed securities directly from these companies, meaning the securities are unregistered and only available to private investors.[56] Funds purchase the companies from the entrepreneurs who have started the business or they purchase them from other private equity funds themselves.[57] The nature of a private equity fund is significantly different from that of a hedge fund, as the investments are not actively traded and the securities are held for a

47. *See id.* (explaining that these wealthy institutions cover a wide variety of entities and range from non-profit educational institution endowments to state pension plans).
48. *Id.*
49. James Garrett Baldwin, *What Is the Structure of a Private Equity Fund?*, INVESTOPEDIA (May 19, 2022), https://www.investopedia.com/articles/investing/093015/understanding-private-equity-funds-structure.asp [https://perma.cc/RY3E-94LE].
50. LEMKE ET AL., *supra* note 2, § 13:1.
51. *Id.*; Baldwin, *supra* note 49.
52. *See* SVB Complaint, *supra* note 19, at 1 (stating that Elliott Smerling operated the fund under a separate entity called the JES Global Capital GP III, LLC).
53. LEMKE ET AL., *supra* note 2, § 13:1.
54. *Id.*
55. *Id.*
56. *Id.*
57. *Id.*; *see* Baldwin, *supra* note 49 ("Because [private equity funds] are private, their capital is not listed on a public exchange.").

considerably longer period.[58] Private equity funds often take a controlling interest in the portfolio company, meaning they help the company make important business decisions or employ individuals with operational expertise to assist the company.[59] This assistance helps the portfolio companies increase in value, resulting in the sale of the portfolio companies to an acquirer like another private equity fund or another company looking to purchase the business.[60] On occasion, the fund may make a public offering of the portfolio company.[61] After the sale, the proceeds are distributed to the investors in the fund, and the GP takes a fee for its services.[62]

At the beginning of the fund's lifecycle, LPs will pledge a fixed amount of money to the fund.[63] Then, when GPs need capital to conduct fund operations, like purchasing a company, they "call" capital from the LPs to make its investments.[64] Capital may be called throughout the fund's operation, and the right to call capital may be assigned to other entities, such as lenders who provide credit facilities to the fund.[65]

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58. *See* LEMKE ET AL., *supra* note 2, § 13:1 ("Unlike hedge funds or registered funds, which usually invest mainly in liquid, publicly traded securities, a private equity fund typically acquires large blocks of privately placed, generally illiquid securities from issuing companies, commonly known as 'portfolio companies.'").

59. *See Private Equity Funds*, INVESTOR.GOV, https://www.investor.gov/introduction-investing/investing-basics/investment-products/private-investment-funds/private-equity [https://perma.cc/3VDY-CEYY] (last visited Jan. 16, 2023).

60. *See id.* ("A typical investment strategy undertaken by private equity funds is to take a controlling interest in an operating company or business—the portfolio company—and engage actively in the management and direction of the company or business in order to increase its value."); LEMKE ET AL, *supra* note 2, § 13:1 ("In the middle of the trading day a seller will contact various investment banks asking them to bid on a large block of an issuer's stock by the end of the day.").

61. *See* Baldwin, *supra* note 49 ("After a certain period of time, the private equity fund generally divests its holdings through a number of options, including initial public offering (IPOs) or sales to other private equity firms.").

62. LEMKE ET AL., *supra* note 2, § 13:1.

63. Tara Naughter, *Private Equity: What is a Capital Call?*, SECUREDOCS: BLOG (Jan. 11, 2021), https://www.securedocs.com/blog/private-equity-what-is-a-capital-call [https://perma.cc/N6CP-SUDZ].

64. *Id.* The reason that capital is not supplied entirely at the beginning of the investment is so that the money can continue to garner interest for the investor. *See id.* "[I]nvestors are able to hold onto their funds and keep them in a favorable investment account, such as a mutual fund or retirement account, so that the investment can continue to appreciate until the [fund] needs it."

65. *See* Bryan Petkanics et al., *Subscription Line Lending: Due Diligence by the Numbers*, *in* GLOBAL LEGAL INSIGHTS: FUND FINANCE 15, 16–17 (Michael C. Mascia ed., 2022) ("The LPA should contain an irrevocable commitment of the investors to fund capital when called (subject to certain limitations that may be set forth in the LPA or other governing

Subscription lines are a specific credit facility used to supply liquid capital to the fund.[66] Funds use credit from subscription lines to help bridge financial needs the fund may face between capital calls to investors.[67] The subscription line gives the fund access to capital immediately, compared to capital calls which generally take some time and require more effort than drawing on a preexisting credit facility.[68] The subscription line is similar to a credit card, where a defined amount of credit is extended to the fund and the credit can be drawn upon as needed.[69] Notably, subscription lines are backed by the capital commitments of the LPs.[70] The capital commitments function as collateral if the fund defaults on the subscription line.[71] The lender would then acquire the right to call capital from the fund LPs to pay the remaining balance on the subscription line.[72] Therefore, capital commitments are the primary factor banks evaluate when determining how much credit to allow on the subscription line.[73]

As subscription lines have become more popular, funds have become creative in how they use subscription lines within the fund's operations.[74] For example, subscription lines have been used to consolidate smaller capital calls into larger scheduled ones.[75] This

documents), expressly allow the fund . . . to assign the right to make capital calls, and to enforce the obligations of the fund's investors to fund their capital commitments (the typical collateral package in a subscription credit facility).").

66. *See* Kaup & Melchor, *supra* note 7 (discussing two examples of short-term and long-term capital uses after the subscription lines have supplied the capital).

67. *Id.*

68. *See id.* (describing two benefits that result from the use of the subscription facilities, both of which relating to the immediate access to cash rather than waiting to get capital from the investors); Naughter, *supra* note 63 (explaining the time period between the capital call and when the money actually is received by the fund).

69. *See* Kaup & Melchor, *supra* note 7 (noting that funds can draw down a certain amount from the subscription line, and repay it in order to later draw more capital from the line in the future).

70. *See id.* ("The size of the SCF and advances are based on value of pledged uncalled capital commitments as well as the number and creditworthiness of eligible investors.").

71. *Id.*

72. *See* LEMKE, *supra* note 2, § 13:1 (explaining that the right to call capital is commonly assigned to investors as a remedy if the fund defaults on the credit facility).

73. *See* Kaup & Melchor, *supra* note 7 ("The size of the [subscription credit facility] and advances are based on value of pledged uncalled capital commitments as well as the number and creditworthiness of eligible investors.").

74. *See Subscription Lines—How it Evolved from a Funding Tool into a Credit Strategy*, *supra* note 5 (stating that versatile nature of subscription lines, in combination with their benefit to funds and LPs, have led to the establishment of funds that specifically raise capital to support other funds through similar financing options.).

75. *Id.*

structure helps LPs manage the administrative hassle of the capital calls and establishes a capital call pace that parties can more easily follow.[76]

Further, because subscription lines often carry a higher interest rate than bank debt over a shorter period, the loans tend to be more lucrative for lenders.[77] These higher yields have attracted more lenders into the space, opening up more possibilities for an unscrupulous actor to take advantage of the system to defraud lenders.[78]

C. Lender Due Diligence Processes

Before a bank offers a subscription line to a fund, the bank must conduct thorough due diligence into the fund's organizational structure, investor commitments, and other documents related to the fund's operation.[79] Due diligence processes generally have two focuses: an assessment of the creditworthiness of the fund's LPs, and the creation of legal backstops used to ensure proper collateral for the subscription line in the case of default.[80] The lenders' underwriters typically assess the LP's creditworthiness through their financial due diligence, and the bank's in-house or outside counsel conducts legal diligence.[81] Financial due diligence typically includes an assessment of the accuracy of the documents substantiating the transaction, which plays a strong role in the decisions regarding how much money to allow on the subscription line.[82] Legal due diligence assesses the terms and conditions of the agreements between the parties of the fund, ensuring that there are no terms that would limit the lenders' remedies in the case of default.[83]

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76. *Id.*
77. *Id.*
78. *See* Shultz, *supra* note 12, at 1 ("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.").
79. Petkanics et al., *supra* note 65, at 15.
80. *Id.*
81. *See id.* ("A close working relationship between lender and counsel is critical to covering both of these bases; lenders will assess the overall credit quality of the mix of investors presented by the fund, and counsel will review the legal documents that make up its basket of collateral.").
82. *See* Rachel Duncan, *What's the Difference Between Legal and Financial Due Diligence?*, ACCOUNTS & LEGAL CONSULTANTS LTD (Feb. 21, 2022), https://www.accountsandlegal.co.uk/legal-advice/what-s-the-difference-between-legal-and-financial-due-diligence [https://perma.cc/8U3L-TRK3] (explaining how financial due diligence aims to ensure that companies' financial statements are accurate representations about the businesses' finances).
83. *Id.*

Within these processes, the key consideration when offering a subscription line lies within the LPs' commitment to supply their capital when called.[84] Because the investors are so important to this process, most diligence focuses on the relationship between the fund and its investors.[85]

The first step in the due diligence phase is a thorough analysis of the fund's organizational structure and organizational materials.[86] A fund's organizational structure should detail the fund's purpose, investment strategy, tax implications, and the makeup of the investor pool.[87] This information can be found in the fund's organizational chart.[88] Upon review of the organizational structure, a lender should request documents relating to each party within the organization, primarily involving the LPs, the GP, and other third parties engaging with the fund, like an investment manager and auditor.[89] These documents consist of the limited partnership agreement ("LPA"), subscription agreements, and side letters, each of which is discussed in more detail below.[90]

The LPA details the fund's operations and explains the relationships between LPs and the GP.[91] Generally, lenders consider several parts of the LPA as a part of their diligence:[92]

- The lender should ensure that the LPA states whether the fund is permitted to receive loans and whether the LPA lists limitations on the loans themselves.[93]

84. *See* Petkanics et al., *supra* note 65, at 15 ("After all, the foundation of subscription line lending is the strength of the commitment of the investors to fund their capital commitments when called.").
85. *Id.*
86. *Id.*
87. *Id.* at 16.
88. *Id.*
89. *See* James Heinicke et. al., *Fund Finance Lending: A Practical Checklist, in* GLOBAL LEGAL INSIGHTS: FUND FINANCE 132–33 (Michael C. Mascia ed., 2022) ("[A] detailed documentation review and analysis should be undertaken.").
90. *See* Petkanics et al., *supra* note 65, at 16.
91. *See* Baldwin, *supra* note 49 ("When a fund raises money, institutional and individual investors agree to specific investment terms presented in a limited partnership agreement."); Petkanics et al., *supra* note 65, at 16.
92. Petkanics et al., *supra* note 65, at 16.
93. *See id.* (noting that this includes limits on the amount a fund may borrow, limits on the amount of time borrowings may remain outstanding under a credit facility, and on the permissible use of the borrowings).

- The lender should check whether the LPA states that capital may be called to repay the subscription line and whether the fund is given permission to assign the right to call capital from investors to the lender.[94]
- The lender should evaluate whether there is a waiver of counterclaim and setoff provision.[95]
- The lender should evaluate the period in which the GP can call capital from investors and ensure that they possess the right to call capital during any part of the fund's life cycle.[96] Typically, capital may only be called during this term, also known as the investment period, but a lender should request the ability to call capital regardless of the point of the fund's lifecycle. [97]
- The lender should investigate the terms that may lead to the termination of the investment period, such as a keyman clause.[98] Ensuring that the lender may call capital outside of the investment period would protect the lender from any default by the fund by maintaining their ability to call capital and repay outstanding debt on the subscription line.[99]
- The lender should evaluate whether the LPA has an excuse or exclusion provision that would cause investors to cease capital contributions for certain investments or in certain scenarios.[100]
- The lender should consider whether there is a percentage limitation on the amount that a single investor may

94. If these terms are not explicitly in the LPA, it may be brought to the fund's attention and subsequently changed. *Id.* at 16–17.
95. *See id.* at 17 (explaining that this provision would prohibit investors from deducting amounts from their capital commitments that they believe is owed to them by the fund).
96. *See id.* (stating that a key man clause requires certain individuals to be present and involved when making investment decisions).
97. *Id.*
98. *See* Heinicke et al., *supra* note 89, at 133 ("The applicable law of the relevant jurisdiction in which the fund is formed will likely set out how a fund can be terminated and the circumstances that result in such termination.").
99. *See* Petkanics et al., *supra* note 65, at 17 ("A lender will want the right to call capital to repay fund indebtedness at all times, whether before or after the termination of the investment period.").
100. *See id.* at 18 ("Lenders should understand these excuse and exclusion provisions and account for them in the credit facility, including by ensuring that the capital commitments of the excused or excluded investors are not included in the relevant borrowing base.").

contribute to a capital call.[101] This limitation may restrict lenders from calling capital from investors on a fully joint and several basis, inhibiting their ability to repay the outstanding debt on the subscription line.[102]

- The lender should consider what remedies are available to the fund when an investor fails to satisfy a capital call.[103]

This list is by no means exhaustive, but it indicates the primary considerations that are viewed when evaluating a fund LPA.[104]

In addition to the LPA, the lender should conduct diligence on the subscription agreements between the fund and the LPs.[105] Subscription agreements hold key information regarding the LPs and represent the investor's agreement with the rights and obligations of the fund's LPA.[106] The lenders should note the LP's legal name, contact information, capital commitment amounts, and the GP's acceptance of the investor.[107] This information can help confirm the reputation of investors and plays a significant role in determining the terms of the subscription line.[108]

Lenders should also review side letters.[109] Side letters are often used to alter the terms of the LPA or the subscription agreement

101. *See id.* ("For example, an investor's capital commitment may be limited to no more than 10% of a fund's aggregate capital commitments. Overcall and concentration limits restrict the ability of the lenders to seek capital on a fully joint and several basis among the investors, increasing the risk that an investor default may affect the lenders' ability to be fully repaid.").
102. *Id.*
103. *See* Heinicke et al., *supra* note 89, at 138 ("Another crucial point for fund finance lenders is to know how the security interests over the uncalled capital commitments of investors . . . will be enforced upon the occurrence of an event of default . . . .").
104. *See* Petkanics et al., *supra* note 65, at 16 ("While an exhaustive analysis of the relevant LPA provisions is not possible (and counsel should be engaged to review the operative relevant documents), lenders and counsel should keep the following in mind while undertaking a review.").
105. *Id.* at 19.
106. *Id.*
107. *Id.*
108. *See id.* ("[I]nvestors typically must fill out an investor qualification statement or other investor questionnaire," confirming that the investor is qualified under applicable laws to invest in the fund and "provid[ing] supplementary information and appropriate representations required by the sponsor.").
109. Katie McShane & Kaitlin Clardy, *Side Letters: A Round-Up of Common Issues for Lenders*, CADWALADER, WICKERSHAM & TAFT: FUND FINANCE FRIDAY (May 17, 2019), https://www.cadwalader.com/fund-finance-friday/index.php?eid=245&nid=36&cont=44 [https://perma.cc/KQU3-DYZR].

between a specific investor and the fund.[110] These alterations could adversely affect lenders, such as terms restricting the investor from contributing capital to paying back debt on the subscription line.[111]

The fund may also supply other documents to assist in lender due diligence.[112] Requesting a legal opinion from the fund's counsel has become a common practice within fund finance, as the opinion will confirm that capital commitments have been made to the fund.[113] The legal opinion will also confirm the remedies that are enforceable by the lender in the case of a default.[114] Additionally, lenders may ask for the fund's private placement memorandum, a document that details the broad overview of the fund's investment strategy, the history of the GP, and the risk factors associated with the fund.[115] Lenders should ask for the fund's financial documents and other financial statements if the fund is already in operation.[116] This due diligence assists the lender with the evaluation of the creditworthiness of the investors and the proper operation of the fund.[117]

Each document received from the fund should be evaluated for its proper completion and execution.[118] This allows lenders to cross-reference each form to ensure that information is consistent across all the documents, including the legal name of the investors and the amount of committed capital from each investor.[119] Improper completion and

110. Petkanics et al., *supra* note 65, at 20.
111. *See* Heinicke et al., *supra* note 89, at 136 ("The terms of any side letters should be reviewed to confirm the absence of provisions that adversely affect any of the findings arising from the LPA due diligence review or any factors that would otherwise conflict with the obligations of the fund . . . .").
112. *See* Petkanics et al., *supra* note 65, at 16 ("Lenders should consider reviewing other materials that can help assess a given fund's creditworthiness and enhance the credit and risk analysis of the underwriting process.").
113. *See id.* at 17 ("In situations where the LPA does not expressly permit a pledge and assignment of the expected collateral, the fund should confirm to the lenders that the fund's counsel will give a clean legal opinion on these powers or, in the alternative, the lenders should determine whether an amendment to the LPA is necessary.").
114. *Id.*
115. *Id.* at 22.
116. *Id.*
117. *See id.* ("Lenders should consider reviewing other materials that can help assess a given fund's creditworthiness and enhance the credit and risk analysis of the underwriting process.").
118. *See* Kaup & Melchor, *supra* note 7 ("This due diligence may include (without limitation) review to confirm that: The documents are fully completed (*i.e.*, that the correct boxes have been checked for that type of investor, dates and other fields are completed, and attachments such as tax forms or authorizing resolutions (for entities) are included).").
119. *Id.*

execution of documents or inconsistencies between documents can indicate fraudulent activity, which should always be on the lender's mind when completing due diligence processes.[120]

III. DUE DILIGENCE ANALYSIS OF *UNITED STATES V. SMERLING*

Because the *Smerling* case revolved around the banks' due diligence processes and their inability to foreshadow fraudulent activity, an analysis of the banks' due diligence measures may help target any points of weakness.[121] The loan and security agreements ("loan agreements") between the banks and the JES Fund confirm the banks' ability to conduct the most common due diligence measures when deciding whether to grant a subscription line to a fund.[122] This is demonstrated through the requisite conditions precedent, representations and warranties of the credit parties, affirmative and negative covenants, and remedies.[123] Each of the separate sections are detailed individually below.

A. Information Confirmed through Conditions Precedent

Under the loan agreements of both banks, the bank must have received documentation before credit is extended to the fund,[124]

120. *See id.* ("Although the potential for fraud can never be entirely eliminated, taking additional measures such as these in the due diligence process will increase the likelihood of detecting fraud before advances are made . . . .").
121. *See id.* (suggesting that those who conduct the due diligence should analyze their existing diligence measures to see what processes may be improved).
122. *See* Complaint Exhibit A at 1, *In re* Smerling Litigation, No. 21 Civ. 2552 (S.D.N.Y. 2022) [hereinafter SVB Loan Agreement] (detailing the terms of the credit agreement between SVB and the JES Fund, and thus demonstrating the diligence procedures conducted by SVB that must be met before offering the subscription line to the JES Fund); Complaint Exhibit Revolving Credit and Security Agreement at 1, Citizens Bank v. JES Global Capital II, L.P., No. 21 Civ. 5766 (S.D.N.Y. Jul. 06, 2021) [hereinafter Citizens Bank Loan Agreement] (detailing the terms of the credit agreement between Citizens Band and the JES Fund, and thus demonstrating the diligence procedures conducted by Citizens Bank that must be met before offering the subscription line to the JES Fund).
123. *See generally* SVB Loan Agreement, *supra* note 122 (detailing the various terms of the SVB loan agreement, including the requisite conditions precedent, representations and warranties of the credit parties, affirmative and negative covenants, and remedies); *see generally* Citizens Bank Loan Agreement, *supra* note 122 (detailing the various terms of the SVB loan agreement, including the requisite conditions precedent, representations and warranties of the credit parties, affirmative and negative covenants, and remedies).
124. SVB Loan Agreement, *supra* note 122, at 6; Citizens Bank Loan Agreement, *supra* note 122, at 37–38.

including the fund's LPA, the subscription agreements between LPs and the fund, any side letters between the LPs and the fund, bank statements for the fund, and a legal opinion describing the security interest of the fund.[125] Each of these documents are discussed below. Generally, before the subscription line may be closed, the following documents must have been received by the banks and found satisfactory.[126]

1. LPA

The confirmation of receipt of the LPA by the banks demonstrates that the banks had sufficient information about the fund's operations to make them comfortable enough to offer a subscription line.[127] This means the lenders confirmed that (1) the fund had the ability and permission to receive loans, (2) capital calls were permitted to repay the debt on the subscription line, and (3) that there were no exclusion provisions that would prohibit LPs from completing the capital calls.[128] This also confirms that the bank was satisfied with any existing limitations on the LPs' contributions to capital calls, the provisions that may bar non-parties to the LPA from benefiting from its provisions, and the remedies available to the fund when an investor fails to satisfy a capital call.[129] Overall, the LPA seemed to make the lenders

125. *See supra* note 124.

126. *See* SVB Loan Agreement, *supra* note 122, at 6 ("Bank's obligation to make the initial Credit Extension is subject to the condition precedent that Bank shall have received, in form and substance reasonably satisfactory to Bank [an extensive list of documents.]"); Citizens Bank Loan Agreement, *supra* note 122, at 37 ("The Loan Documents shall not become effective until the date on which Lender shall have received each of the following documents and each of the other conditions listed below is satisfied to Lender's reasonable satisfaction[.]").

127. *See* SVB Loan Agreement, *supra* note 122, at 6 (suggesting that the confirmation receipt of the LPA and the terms in the Loan Agreement help show that the bank was satisfied with the information within the LPA because it additionally has terms that state the fund is being truthful and confirms that they are not lying or breaking the law); *see also* Citizens Bank Loan Agreement, *supra* note 122, at 37 (stating that the constituent documents must be received by the bank, which according to the definition section of the loan agreement includes the fund LPA).

128. SVB Loan Agreement, *supra* note 122, at 6; Citizens Bank Loan Agreement, *supra* note 122, at 37; *see* Petkanics, *supra* note 65, at 16–18 (detailing the important information to be looking for in the fund's LPA).

129. Because the banks both lent to the JES Fund, we may presume that the banks were comfortable with the terms of the LPA so that they would not limit the ways that the bank could recover in the case of default. SVB Loan Agreement, *supra* note 122, at 6; Citizens Bank Loan Agreement, *supra* note 122, at 37–38.

feel comfortable lending to the JES Fund within the terms governing its operation.[130]

2. Subscription Agreements

The subscription agreements supplied to the banks confirmed that the LPs had agreed to the terms within the LPA and listed the key information for each purported investor in the fund.[131] The legal name of each investor, capital commitments from each investor, and an acceptance of the investor by the GP of the JES Fund were supplied in these documents, even though these representations were fraudulent.[132] The banks then used this information to craft the terms and details of the loan agreements for the banks, demonstrating they were satisfied with the information represented in the subscription agreements.[133]

3. Side Letters

The requirement of delivering side letters to the banks helps confirm that the banks were satisfied with terms associated with any of the investors which might negatively affect the lenders' ability to recoup money lent to the fund.[134] This may include limitations on the LP's contribution to the subscription line or percentage contribution to capital calls.[135] If there were limitations within the side letters, the banks still

130. *See supra* note 129.
131. Because the banks had begun supplying capital to the fund, we may presume that the lenders reviewed the subscription agreement and consented to the use of a subscription line under the terms of the subscription agreement. SVB Loan Agreement, *supra* note 122, at 6; Citizens Bank Loan Agreement, *supra* note 122, at 37–38.
132. *See* Petkanics et al., *supra* note 65, at 16–18 (detailing the important information to be looking for in the fund's subscription agreements with LPs); SVB Loan Agreement, *supra* note 122, at 6; Citizens Bank Loan Agreement, *supra* note 122, at 37–38.
133. *See* SVB Loan Agreement, *supra* note 122, at 6 (listing the subscription agreement as a necessary document that must be received before the loan agreement is completed); Citizens Bank Loan Agreement, *supra* note 122, at 37-38 (listing the subscription agreement as a necessary document that must be received before the loan agreement is completed).
134. Because the banks had begun supplying capital to the fund, we may presume that the lenders reviewed the side letters and consented to the use of a subscription line under the terms of the side letters. SVB Loan Agreement, *supra* note 122, at 6; Citizens Bank Loan Agreement, *supra* note 122, at 37–38.
135. *See* Petkanics et al., *supra* note 65, at 20–21 (detailing the important information to collect from side letters).

seemed to be satisfied enough with their terms to create a sufficient borrowing base for the subscription line.[136]

4. Bank Statements

Bank statements and audit documents were supplied to the banks detailing the investments the fund purported to have made, demonstrating to the banks that the fund had already been in operation and was continuing past the beginning stages of the lifecycle.[137] The diligence conducted on these documents intends to function as another source indicating that the fund's investors had truly been supplying their capital when called, showing more reason that the lender would be comfortable offering a subscription line.[138]

5. Legal Opinion

Outside fund counsel signed and supplied a legal opinion confirming the security interest for the subscription line and the acceptance of remedies in the case of default, even though there were no capital commitments to back the subscription line.[139] The legal opinion intends to function as the primary backstop to verify that investors had

136. *See* SVB Loan Agreement, *supra* note 122, at 6 (listing side letters as a required document to be received before consecration of the loan agreement); *see* Citizens Bank Loan Agreement, *supra* note 122, at 37–38 (listing side letters as a required document to be received before consecration of the loan agreement).

137. Because the banks had begun supplying capital to the fund, we may presume that the lenders reviewed the bank statements or other comparable documents and were satisfied with the contents enough to offer the fund credit. SVB Loan Agreement, *supra* note 122, at 6; *see also* Citizens Bank Loan Agreement, *supra* note 122, at 77–78 (listing the purported investments made by the JES Funds LPs which were used to calculate the amount on the subscription line).

138. SVB Loan Agreement, *supra* note 122, at 6; Citizens Bank Loan Agreement, *supra* note 122, at 77–78*; see* Petkanics et al., *supra* note 65, at 22 ("If the fund is already operating, lenders should review available financial statements of the fund and request copies of communications sent to investors.").

139. Because the banks had begun supplying capital to the fund, we may presume that the lenders reviewed the legal opinion and consented to the use of a subscription line under the terms of the legal opinion. SVB Loan Agreement, *supra* note 122, at 6; Citizens Bank Loan Agreement, *supra* note 122, at 37; *see also* Petkanics et al., *supra* note 65, at 17 ("In situations where the LPA does not expressly permit a pledge and assignment of the expected collateral, the fund should confirm to the lenders that the fund's counsel will give a clean legal opinion on these powers or, in the alternative, the lenders should determine whether an amendment to the LPA is necessary.").

valid capital contributions to the fund and that the collateral of default was sufficient.[140]

B. Representations and Warranties

In addition to fulfilling the conditions precedent of the loan agreement, many representations and warranties were put in place to ensure the confirmation of diligence-related information contained within the requisite documents.[141] The presence of these terms demonstrates the bank's compliance with many commonplace diligence measures used for subscription lines.[142] This includes the JES Fund's representation that the information listed about each LP was correct and that the JES Fund had the right to call capital from the LPs and assign that right to the bank.[143]

Further, the loan agreements stated that there were no limitations or conditions on the LPs' obligation to supply capital contributions to the borrower, including a restriction that the LPs may not contribute less than what they originally agreed to contribute to the fund.[144] Similarly, it also represented that capital may be called at any

140. *See* Petkanics et al., *supra* note 65, at 17 ("In situations where the LPA does not expressly permit a pledge and assignment of the expected collateral, the fund should confirm to the lenders that the fund's counsel will give a clean legal opinion on these powers or, in the alternative, the lenders should determine whether an amendment to the LPA is necessary.").

141. *See* SVB Loan Agreement, *supra* note 122, at 7–10 (listing numerous requirements for the fund to comply with in order to consummate the subscription line); Citizens Bank Loan Agreement, *supra* note 122, at 40–43 (listing numerous requirements for the fund to comply with in order to consummate the subscription line).

142. SVB Loan Agreement, *supra* note 122, at 7–10; Citizens Bank Loan Agreement, *supra* note 122, at 40–43; *see* Petkanics et al., *supra* note 65, at 19 ("By executing a subscription agreement and providing investor disclosures, an investor is agreeing to its rights and obligations in a fund's LPA, and is making representations and warranties to the fund, including confirmation that it is qualified to invest in the fund.").

143. *See* SVB Loan Agreement, *supra* note 122, at 7–10 ("The execution, delivery and performance by each of Borrower and General Partner of the Loan Documents to which it is a party have been duly authorized . . . "); Citizens Bank Loan Agreement, *supra* note 122, at 40–43 ("Each Credit Party has the partnership, limited liability company or corporate power, as applicable, and requisite authority to execute, deliver, and perform its respective obligations under the Loan Documents to be executed by it, its Constituent Documents, and its Subscription Agreements.").

144. *See* SVB Loan Agreement, *supra* note 122, at 9 ("There are no provisions in the Partnership Agreement or any Subscription Agreement or Side Letter restricting either Borrower or General Partner from entering into and performing its respective obligations under this Agreement."); Citizens Bank Loan Agreement, *supra* note 122, at 36 ("The rights of Lender hereunder shall not be released, diminished, impaired, reduced or adversely

time regardless of whether the capital call occurs before or after the expiration of the investment period.[145] This means that in the event of default, lenders could call capital from the LPs regardless of whether the GP's capital call period had expired.[146] These enforceable representations and warranties covered a broad range of recommended due diligence measures and seemingly ensured that the banks entered into an agreement that appeared safe and operating, as the banks would like.[147]

C. Affirmative and Negative Covenants

The loan agreement listed numerous affirmative and negative covenants between the parties, such as a requirement for the credit extended by the bank to be used only for a specific purpose or to make permitted investments in accordance with the LPA.[148] This included requirements of proper regulatory compliance, the requirement to report

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affected by (i) any adjustment, indulgence, forbearance or compromise that might be granted or given by Lender to any primary or secondary obligor or in connection with any security for the Obligations . . . .").

145. *See* SVB Loan Agreement, *supra* note 122, at 6 ("[E]ach Investment made by Borrower or any Alternative Investment Vehicle using the proceeds of any Advance will be of the kind and nature such that the Partners are unconditionally obligated by the Partnership Agreement to fund a Capital Call for the purpose of repaying such Advance regardless of whether such Capital Call is made before or after expiration or termination of the Investment Period or during a suspension of the Investment Period."); Citizens Bank Loan Agreement, *supra* note 122, at 36 ("Lender may, at any time and from time to time, without further consent of or notice to any Credit Party, and with or without consideration . . . release or pay to any Credit Party, or any other Person otherwise entitled thereto, any amount paid or payable in respect of any such other direct or indirect security for the Obligations.").

146. *See* Edelboim, *supra* note 4 (explaining that subscription lines are "secured" by the commitments by the investors, and the lenders could step in to receive their commitments to repay the credit on the subscription line in the case of default).

147. *See* SVB Loan Agreement, *supra* note 122, at 7–10 ("The execution, delivery and performance by each of Borrower and General Partner of the Loan Documents to which it is a party have been duly authorized . . . ."); Citizens Bank Loan Agreement, *supra* note 122, at 40–43 ("Each Credit Party has the partnership, limited liability company or corporate power, as applicable, and requisite authority to execute, deliver, and perform its respective obligations under the Loan Documents to be executed by it, its Constituent Documents, and its Subscription Agreements.").

148. *See* SVB Loan Agreement, *supra* note 122, at 10 ("Borrower and General Partner shall . . . . [c]ause the proceeds of the Credit Extensions to be used solely (a) as working capital, (b) to fund Borrower's general business purposes or (c) to make Permitted Investments, all in accordance with the Partnership Agreement . . . ."); Citizens Bank Loan Agreement, *supra* note 122, at 51 ("No Fund shall use the proceeds of any Loan for the payment of a Distribution to any Investor.").

quarterly financial statements to the lender, and a requirement to notify the bank when the GP made a capital call.[149] These covenants helped the lender regulate how the fund's money was spent and allowed the banks to monitor the fund while it was operating, which should help spot unscrupulous use of capital or irresponsible business practices.[150]

D. Remedies

Finally, the loan agreement listed numerous instances of how the fund could default on the subscription line, including the failure to pay the principal and interest of the subscription line on the day it is due or the failure to comply with a covenant of the agreement.[151] In any of these cases, the lender could declare a default on the subscription line and step in to call capital from the LPs to repay the outstanding debt on the subscription line.[152] Additionally, the banks could step in and use any capital in their possession belonging to the borrower to repay the outstanding amount on the subscription line.[153] This could include the

149. *See* SVB Loan Agreement, *supra* note 122, at 10 ("Borrower and General Partner shall each do all of the following: . . . comply with all laws, ordinances and regulations to which it is subject, noncompliance with which could reasonably be expected to have a Material Adverse Effect."); Citizens Bank Loan Agreement, *supra* note 122, at 43-45 ("Credit Parties shall deliver to Lender the following: . . . the audited consolidated balance sheet and related statements of operations or income, changes in partners', members' or shareholders' equity or capital and cash flows of Funds . . . . [and] [s]uch other information concerning the business, properties, or financial condition of Credit Parties or Investment Manager as Lender shall reasonably request.").

150. *See* SVB Loan Agreement, *supra* note 122, at 10–14 ("Borrower and General Partner shall . . . . [c]ause the proceeds of the Credit Extensions to be used solely (a) as working capital, (b) to fund Borrower's general business purposes or (c) to make Permitted Investments, all in accordance with the Partnership Agreement, and not for personal, family, household or agricultural purposes or to repay outstanding principal indebtedness in connection with any other Credit Extension.").

151. *See id*. at 14. (explaining what constitutes a default for the fund, including the failure to comply by the terms of the loan agreement); Citizens Bank Loan Agreement, *supra* note 122, at 51–52 (listing what constitutes a default on the part of the fund).

152. *See* SVB Loan Agreement, *supra* note 122, at 15 ("If an Event of Default shall have occurred and be continuing, then Bank may . . . exercise any right, privilege, or power set forth in [the loan agreement.]"); Citizens Bank Loan Agreement, *supra* note 122, at 53 ("exercise any right, privilege, or power set forth in Sections 5.2 or 5.3 or elsewhere under the Loan Documents, including, but not limited to, the initiation of Capital Calls on the Uncalled Capital Commitments . . . .").

153. *See* SVB Loan Agreement, *supra* note 122, at 15 ("If an Event of Default shall have occurred and be continuing, then Bank may . . . apply to the Obligations any (i) balances and deposits of Borrower it holds, or (ii) any amount held by Bank owing to or for the credit or the account of Borrower . . . ."); Citizens Bank Loan Agreement, supra note 122, at 54 ("Lender is hereby authorized, in the name of the Lender or the name of any Credit Party, at

borrower's bank account balances, payments, or proceeds realized as a result of the disposition of collateral.[154] This confirms the bank's ability to enforce the remedies in the loan agreement for recovering the debt from the fund in the case of default—an essential aspect of lender due diligence.[155]

Overall, the loan documents between the banks and the JES Fund contain many provisions demonstrating their compliance with most, if not all of the standard due diligence measures as detailed in part II of this note.[156] This includes receiving all required fund documents and confirming that all the information within those documents was sufficient to extend a subscription line to the fund.[157] This also demonstrates the bank's satisfaction with the two broad issues key to the due diligence process: the creditworthiness of the LPs and the legal standards and remedies within the loan agreement.[158] Still, this thorough analysis of the fund was insufficient to prevent fraud, begging the question of whether any additional measures could have successfully stopped the fraud before it occurred.[159]

IV. ANALYSIS OF ADDITIONAL DUE DILIGENCE RECOMMENDATIONS

In response to the *Smerling* case, several proposals have been made regarding additional diligence measures to try to prevent fraud

any time or from time to time during the existence of an Event of Default, to . . . provide instruction and direction to Account Bank as to the application of monies in the Collateral Accounts, and apply such monies to the payment of the Obligations . . . .").

154. *See* SVB Loan Agreement, *supra* note 122, at 17 ("If an Event of Default has occurred and is continuing, Bank may apply any funds in its possession, whether from Borrower account balances, payments, proceeds realized as the result of any disposition of the Collateral, or otherwise, to the Obligations in such order as Bank shall determine in its sole discretion.").

155. Because the banks lent to the JES Fund, we can presume that they were satisfied with the legal mechanisms in place to recover in the event of a default. SVB Loan Agreement, *supra* note 122, at 15–17; Citizens Bank Loan Agreement, *supra* note 122, at 53–56.

156. *See supra* Part II.C.

157. *See supra* Part II.C.

158. *See supra* Part II.C.

159. *See* Shultz, *supra* note 12, at 2 (describing a panelist's concern that even with enhanced due diligence measures, a borrower could still commit fraud using other methods).

from occurring in the future.[160] These additional diligence protocols, analyzed for their viability in the *Smerling* case, are discussed below.[161]

A. Recommendation: Confirming the GP is Registered as an "Investment Adviser"

Since the enactment of the Dodd-Frank Act, private fund managers have been required to report particular filings to the Securities and Exchange Commission ("SEC") through their annual Form ADV filing.[162] These filings are mandated for those registered as investment advisers under the Investment Advisers Act and supply important information relating to the adviser, the fund business model and practices, and the fund's personnel and clients.[163] Additionally, the Form ADV consists of the investment adviser's "narrative brochures," which lists the other important information regarding the fund like business operations, fees, conflicts of interest, and past disciplinary information.[164] The SEC then uses these documents to monitor investment advisers' compliance with the Investment Advisers Act, which requires investment advisers to create certain investment policies and act in the client's best interest.[165] The Form ADV is accessible to the public, allowing lenders to check the SEC form database as a part of their diligence process.[166]

Despite the regulation provided by a fund's registration as an investment adviser, a bad actor could fill out the Form ADV with

160. *See* Kaup & Melchor, *supra* note 7 (listing numerous possible solutions to fraud regarding the *Smerling* case); Shultz, *supra* note 12, at 2 (suggesting different solutions to prevent fraud regarding the *Smerling* case).

161. *See infra* Part IV.

162. Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) § 403, 15 U.S.C. § 80b-3(a) (2018).

163. *See* Petkanics et al., *supra* note 65, at 22–23 ("Registered investment advisers, as well as private fund managers and venture fund managers, must file a Form ADV annually and are subject to SEC examination. The form includes extensive information regarding: the adviser; its business, business practices, personnel and clients; and the people whom it controls and who control it."); *see generally* Investment Advisers Act of 1940 204, § 204, 12 U.S.C. § 80b–4 (detailing the requirements that registered investment advisers must comply with).

164. Press Release, Off. of Inv. Educ. & Advoc., U.S. Sec. & Exch. Comm'n, Investor Bulletin: Form ADV – Investment Adviser Brochure and Brochure Supplement (Aug. 27, 2020), https://www.sec.gov/oiea/investor-alerts-bulletins/ib_formadv.html [https://perma.cc/9Z2R-Q55K].

165. Petkanics et al., *supra* note 65, at 22–23.

166. U.S. Sec. & Exch. Comm'n, *supra* note 164.

misrepresentations about its business and supply documents to the SEC that were also crafted fraudulently.[167] Even Bernie Madoff was a registered financial adviser;[168] and in this case, *so was Smerling*.[169] Additionally, not all private equity fund managers are required to register as investment advisers under the Dodd-Frank Act.[170] An exemption exists for private fund managers that have less than $150 million under management in the United States.[171] Therefore, confirming proper registration as a financial adviser can only help so much.[172]

B. Recommendation: Requiring Funds to Supply "Investor Letters" Before Closing

An investor letter is a document from an investor acknowledging the risks they are exposed to through their investments.[173] This letter could require an acknowledgment of the LPs' responsibilities under the subscription credit facility agreements

167. *See* Thomas C. Baxter, Jr. & Anita Ramasastry, *The Importance of Being Honest—Lessons from an Era of Large-Scale Financial Fraud,* 41 ST. LOUIS U. L.J. 93, 96 (1996) (explaining that bank fraud occurs not in single occurrences, but rather results from long term patterns that occur over lengthy period of times, suggesting that it is common for fraudulent activity to be strung across years of time,). Thus, registration as an investment adviser may be a low barrier to overcome when engaging in fraudulent activity.

168. John Taft, *Let's Not Forget—Bernie Madoff Was a Fiduciary*, FINANCIALPLANNING (Nov. 12, 2018, 1:19 PM), https://www.financial-planning.com/opinion/lets-not-forget-bernie-madoff-was-a-fiduciary [https://perma.cc/3ZQ9-QZSH].

169. Elliot Scott Smerling, BROKER-CHECK BY FINRA, https://brokercheck.finra.org/individual/summary/1979101 [https://perma.cc/8PMQ-AKZX] (last visited Jan. 1, 2023) (listing the histories of registered financial advisers for transparency regarding a specific adviser's background).

170. *See Client Newsletter: Impact of the Dodd-Frank Act on Private Equity Funds, Hedge Funds and Their Investment Advisers,* DAVISPOLK (Sep. 16, 2010), https://www.davispolk.com/sites/default/files/files/Publication/66d6504a-7e38-43e2-b1f6-00e52e205c19/Preview/PublicationAttachment/507520c9-230f-4669-a368-0622e2cbb2cf/091510_PE_NL.pdf [https://perma.cc/Y6SL-43F2] ("The Dodd-Frank Act does provide a number of new exemptions from registration for investment advisers . . . .").

171. Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) § 403, 15 U.S.C. § 80b-3(m)(1) (2018).

172. *See* Taft, *supra* note 168 (explaining how Bernie Madoff was able to get away with fraud under the keen eye of regulation).

173. MUN. SEC. RULEMAKING BD., GLOSSARY OF MUNICIPAL SECURITIES TERMS 52 (3rd ed. 2013).

and their exposure regarding the fund's use of a subscription line.[174] The investor letter could be an additional document to cross-reference investor information and add an extra layer of confirmation.[175]

Although requiring the receipt of investor letters would allow more eyes to evaluate the deal and give underwriters more documents to assess, Smerling could have created fraudulent investor letters that would have tricked the banks, just like the fraudulent LPAs and audit documents.[176] If Smerling were willing to produce the fraudulent documents we see in this case, it would be an easy task to create more fraudulent documents to successfully trick lenders into offering him a subscription line.[177] Therefore, this solution would be meaningless when engaging with an experienced fraudster.

C. Recommendation: Instituting a "Seeding Call"

A seeding call would require the fund to call capital contributions of "5-10% of aggregate capital" before permitting the fund to draw down on the subscription line.[178] This is supported by the theory that because investors have funded a capital call, there is confirmation of the investor's ability and willingness to fund capital calls when repaying credit obligations.[179] This could be confirmed by reviewing fund bank records and supplying lenders with additional documents to cross-reference with each other to verify LP authenticity.[180]

Similar to the investor letters, a fraudster like Smerling would have no problem altering fraudulent financial documents to show that

174. *See* Kaup & Melchor, *supra* note 7 (stating that investor letters could be asked for in situations where that are not already required, showing that they could be used in more subscription credit facility agreements with little friction).
175. *See id.* (suggesting that having more documents gives the underwriters a chance to evaluate more sources to spot fraud).
176. *See Why Fraudsters Commit Fraud Repeatedly*, INS. FRAUD BUREAU N. Z.: BLOG (July 12, 2021), https://ifb.org.nz/blog/why-fraudsters-commit-fraud-repeatedly/ [https://perma.cc/T465-MTU8] ("Breaking the 'moral seal' – after an initial genuine claim, some people then progress to making fraudulent claims once they're familiar with the claims process.").
177. *See id.* (explaining how individuals may produce fraudulent documents after becoming familiar with the due diligence processes in place).
178. Kaup & Melchor, *supra* note 7.
179. *Id.*
180. *Id.*

capital had been called from the investors.[181] Smerling represented that he had already called capital from his investors and purported to use those funds to make his first investments.[182] Therefore, this solution would not stop the experienced fraudster.

D. Recommendation: Monitoring Capital Flow

Lenders could request that fund managers keep accounts with their bank to monitor the cash flow from their subscription lines and capital calls.[183] If fund managers are unwilling to accommodate this request,[184] banks could alternatively ask to for access to the different bank accounts to monitor the use of the funds online.[185] This would permit banks to review payments, capital calls, and other cashflows to prevent fraudulent behavior.[186] However, monitoring cash flow would be useless if a bad actor defied loan document covenants by feeding capital calls into accounts that are not accessible to the lender banks.[187] Therefore, this would not be the optimal solution for the lender.

E. The Unique Nature of the Smerling Case

Although additional diligence methods can be used to cross-reference documents and look out for any inconsistencies that may indicate fraud, each of the previous methods discussed suffers a fatal flaw that would still expose banks to the risk demonstrated in the *Smerling* case.[188] None of the due diligence measures discussed prior would help indicate that the lender fraudulently forged documents

181. *Why Fraudsters Commit Fraud Repeatedly*, *supra* note 176.
182. *See* Stempel, *supra* note 30 ("Smerling, a principal at JES Global Capital, falsely claimed in his loan application that New York University had agreed to invest $45 million with him, while an unnamed investment manager would invest $40 million.").
183. Shultz, *supra* note 12, at 2.
184. *Id.*
185. *Id.*
186. *See id.* (explaining that panelists recommended ensuring that the lender has online monitoring access to such accounts, further suggesting that this monitoring process allow lenders to catch bad actors in the act of fraud).
187. *Id.*
188. *See id.* (detailing the processes that some lenders are putting in place to prevent this fraud in the future and analyzing what may or may not work depending on the specific situation).

because they can be bypassed by a fraudster continuing to create fraudulent documents.[189]

The prior examples help demonstrate the core problem faced in the Smerling case—the lender's failure to confirm the relationship between the fund and its LPs.[190] As discussed earlier,[191] the key consideration when deciding to offer a fund a subscription line lies within the investors' commitment to supply their capital commitments when called.[192] If there is no way to confirm the investors' commitments to the fund beyond a piece of paper, then lenders will always be subject to this risk of fraud.[193] Therefore, the solution lies within the independent verification of the fund LPs, which can be conducted through additional bank due diligence processes.[194]

F. Directly Contacting and Verifying the LPs

Despite the difficulty in guarding against fraud, directly contacting and verifying LPs is an effective way to solve the problem faced in the *Smerling* case. Directly contacting and researching fund LPs can be completed through the independent verification of subscription agreements and other financing documents via phone call, video conference, or in-person meeting.[195] This could include on-site visits with LPs, performing background checks on LPs, and speaking with third parties who have relationships with the LPs.[196] Additionally, this practice could be targeted to specific larger LPs or applied as "spot checks" to verify authenticity rather than independently verifying every LP in every subscription credit agreement.[197] Further, this diligence

189. *See Why Fraudsters Commit Fraud Repeatedly*, *supra* note 176 (describing the different theories for repeated fraudulent activity).
190. Petkanics et al., *supra* note 65, at 15.
191. *See supra* Part II.B
192. *See* Petkanics et al., *supra* note 65, at 15 ("After all, the foundation of subscription line lending is the strength of the commitment of the investors to fund their capital commitments when called.").
193. *See* Baxter & Ramasastry, *supra* note 167, at 94 ("Cooperation and candor can prevent small-scale fraudulent activity from mushrooming into a catastrophic loss.").
194. *See* Shultz, *supra* note 12, at 2 (stating that directly contacting investors through phone calls or on-site trips is becoming a more common practice within lender due diligence).
195. *Id.*
196. *Id.*
197. Kaup & Melchor, *supra* note 7.

could be applied to other third parties to confirm the authenticity of other fund-related documents, like the auditors in the *Smerling* case.[198]

One limitation of this solution is the fund's possible objection to allowing the lender to contact its LPs, but it is becoming a more accepted practice.[199] Trust being an essential element of all business deals, requesting permission to contact LPs would have to be addressed with sensitivity.[200] Additionally, independent verification of LPs would be more understandable when utilized with new clients because of the lack of an established business relationship.[201] However, a lender should be careful not to be overbearing, or funds may seek subscription lines from other lenders.[202]

In some scenarios, independent verification of LPs is the most effective way to confirm that funds are not trying to defraud the lender, despite the additional time it may take to close on subscription lines.[203] In comparison, lenders may not seek to verify income by contacting the employer of someone who seeks a credit card, but when engaging in a subscription line consisting of millions of dollars, direct verification may save the lender money and hassle.[204] Overall, it is always a good idea to ensure lenders know their borrowers.[205]

V. CONCLUSION

With the increasing use of fund finance products, fraud will remain a risk within the fund finance industry.[206] That being said, only two public fraud cases have been reported during the subscription line's

198. *See* Shultz, *supra* note 12, at 2 (recounting the remarks of numerous industry professionals regarding the networks of the limited partners).
199. *See id.* (reporting that contacting fund investors is becoming more common, thus indicating that funds of all stages and types should be aware of the possibility).
200. *See* Baxter & Ramasastry, *supra* note 167, at 94 (stating that trust and confidence is key within business and finance as a whole).
201. *See* Shultz, *supra* note 12, at 2 (reporting that contacting fund investors is becoming more common, thus indicating that funds of all stages and types should be aware of the possibility).
202. *See id.* at 2–3 (explaining the panelists' general hesitance to change practices too drastically from standard diligence practices).
203. *Id.*
204. *See id.* at 1–2 ("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.").
205. *See id.* at 2. ("An emerging theme from our panelists was 'know your borrower.'").
206. Kaup & Melchor, *supra* note 7.

almost forty-year lifespan, showing the product's general acceptance and security.[207] The answer to whether the Smerling case necessitates implementing additional due diligence measures is, as in so many areas of the law, it depends. If the lender deals with an emerging fund or a fund with which they do not have any preexisting business relationships, the lender may elect to take further diligence measures by directly contacting LPs.[208] On the other hand, if the lender has an established relationship with the fund, taking additional diligence measures may be unnecessary.[209] Seeking information from other connections related to the fund or LPs of the fund may be another alternative, as this may verify the legitimacy of fund LPs and preserve the relationship between the lender and the fund.[210]

The risk of fraud can never be eliminated entirely, but additional diligence methods can be implemented to reduce risk as much as possible.[211] Although *United States v. Smerling* is one of the first instances of public fund finance fraud involving subscription lines, lenders can never be too safe when working to protect their interests.[212]

JOSHUA S. ALMOND*

207. *See* Shultz, *supra* note 12, at 1 ("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.").

208. *See id.* at 2. ("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.").

209. *Id.*

210. *See id.* ("Certain examples provided by our panelists were . . . speaking with third-parties who have relationships with the fund, such as the fund administrators . . . .").

211. *See* Kaup & Melchor, *supra* note 7 ("Although the potential for fraud can never be entirely eliminated, taking additional measures such as these in the due diligence process will increase the likelihood of detecting fraud before advances are made, thus reducing: (i) the risk of loss for the lender and (ii) the risk of reputational harm or loss of access to capital under the SCF for the fund.").

212. Shultz, *supra* note 12, at 1–2.

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