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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Crafting Credit Facilities For Defined Contribution Plans

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Zachary K. Barnett

Over the last 10 years, there has been a steady trend transition from defined benefit plans to defined contribution plans. As further evidence of this trend, as recently as the end of the fourth quarter of 2013, defined contribution plan (DC) assets amounted to $5.9 trillion, compared to just $3 trillion in assets for private sector defined benefit (DB) plans.[1] At the same time, DC plan fiduciaries are seeking to achieve the historically higher returns of DB plans by venturing into alternative investments — real estate, private equity and hedge funds.

In the face of the large amounts of capital now being funded to DC plans and the desire by DC plan fiduciaries to improve returns, fund sponsors have been actively courting such DC plans and establishing investment vehicles tailored to the needs of such DC plans (such investment vehicles are referred to herein generally as “DC funds”).

Access to a line of credit offers a number of benefits to both DC plan fiduciaries and DC fund sponsors. A credit facility can help DC plan fiduciaries and DC funds manage the daily liquidity required by DC plan participants and fiduciaries, as well as provide bridge capital to fund DC fund investments. While alternative investments (real estate, private equity and hedge funds) are typically illiquid, the higher rates of return offered by such investments may offset the risks to DC plans and fiduciaries caused by such illiquidity, particularly when a credit facility can mitigate much of the illiquidity concerns.

This article provides background on a number of issues for DC fund sponsors and for lenders in connection with a credit facility to a DC fund (such credit facilities referred to herein generally as “facilities”). It also proposes structural solutions for certain of those issues.

Facility Size and Uses

Compared to credit facilities provided to typical private equity funds or private equity real estate funds, facilities for DC funds tend to be rather small in relation to the total size of the DC fund. While facilities may vary, they are often 10-20 percent of the total DC fund size. While there is potential for facilities to grow in size relative to DC fund size as lenders get more comfortable lending to DC funds and DC funds continue to find new ways to take advantage of the liquidity provided by a facility, limitations on collateral (discussed below) and the DC fund’s need for liquidity may prevent such facilities from

reaching the relative size of credit facilities traditionally sought by other types of private equity funds or real estate funds.

Historically, DC funds have relied upon facilities primarily for standby funding to match redemption requests of DC plan participants to the timing of redemption windows of the DC fund's underlying investments. Accordingly, such facilities have generally been used infrequently, and have not typically maintained long-term outstanding balances beyond redemption windows of the DC fund's underlying investments.

For DC funds that have longer track records and historically reliable streams of participant cash in-flows, facilities could potentially be used to fund investments in advance of capital contributions from DC plan participants. Fiduciary concerns related to increased leverage and potential losses for DC plan participants, however, may prevent the use of facilities as a means to further leverage investments.

Structuring/Security Issues

Borrower Structures

DC funds rely on a number of different legal structures and pooling vehicles, including separate managed accounts, collective investment trusts and insurance company separate accounts. A description and summary of these structures and vehicles is beyond the scope of this article, but it is important to recognize that each of these structures and vehicles carries distinct legal consequences that shape a facility's structure.

It is important for lenders to fully understand the relationship between DC funds and the actual borrower under the facility. Some structures used by DC funds do not utilize a separate legal entity for the borrower, rather the borrower consists solely as a specific set of assets or funds within a larger legal entity. It is important to consult with legal counsel not only to ensure that lenders have sufficient legal recourse with respect to a facility's borrower, but also to protect corporate formalities of the DC fund related to distinct pools of assets belonging to one or more related legal entities.

Security and Collateral

While a subscription-backed credit facility looks to a fund's investors for repayment and as the ultimate collateral, the participant-funded nature of DC funds is not compatible with such an approach.[2]

Instead, lenders can rely upon a variety of security packages tied to a DC fund's investments for collateral. Collateral packages for facilities typically fall into three categories: illiquid investments, liquid investments and distributions proceeds. A pledge of illiquid investments, such as interests in private equity funds, real estate funds or hedge funds, may be complicated by transfer restrictions applicable to such interests. Moreover, any such pledge may also require additional consents from third-party entities.

An indirect pledge of such interests could be structured with a pledge of the equity of an aggregating vehicle that holds such underlying investments. Careful review of the underlying investment documentation must then be undertaken to ensure that the indirect pledge does not breach any transfer restrictions or require any third-party consents.

In addition to illiquid investments, DC funds typically hold certain liquid investments in the form of cash/cash equivalents or other liquid securities. DC funds rely upon such liquid investments to support liquidity requirements of DC plan participants and to aggregate cash in-flows pending new investments. Liquid investments are unlikely to be subject to transfer restrictions or consent requirements and, to the extent such liquid investments are held in one or more securities accounts with the lender, perfecting rights in the collateral is usually straightforward.

Lastly, the collateral package could include a pledge of distribution proceeds from a DC fund's underlying investments, along with one or more account(s) held with the lender into which such proceeds are deposited. Again, careful review should be undertaken to ensure that such a pledge does not breach any of the underlying investment documentation.

Of course, given the creditworthiness of the borrower, the reliability of DC plan contributions, the value of the underlying DC fund investments and the multiple sources of repayment, a lender may also be comfortable offering a facility on an unsecured basis.

ERISA Concerns[3]

Facilities for DC funds may present different Employee Retirement Income Security Act[4] concerns as compared to credit facilities for more traditional private equity funds or real estate funds. Unlike other fund financing products where ERISA issues are focused on seeking comfort that loan parties will not be deemed to hold "plan assets,"[5] DC funds, by their nature, may hold "plan assets" and accordingly are subject to ERISA, including ERISA's prohibition on party-in-interest transactions. In a facility, the primary concern under ERISA arises with respect to any relationships between the lender, the DC fund itself and/or the underlying DC plans taking part in DC funds, due to the fact that such relationships may give rise to prohibited transaction excise tax penalties for the lender.

Conclusion

While to date, facilities for DC funds have been relatively rare, as more fund sponsors seek to establish DC funds, the opportunity is ripe for new market participants. With a careful review of the legal structure of a DC fund, including with respect to the borrowing entity for the facility, and attention to the collateral package, a facility can be structured to provide important and often vital liquidity to a DC fund while still satisfying the lender's credit criteria.

—By Zachary K. Barnett, Lennine Occhino and Mark C. Dempsey, Mayer Brown LLP

Zachary Barnett and Lennine Occhino are partners and Mark Dempsey is an associate in Mayer Brown's Chicago office.

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[1] Investment Company Institute, "The US Retirement Market, Fourth Quarter, 2013." Table 1.

[2] For a more detailed description of the subscription facility market and features of the subscription credit facility product in general, please see "Summer 2013 Subscription Credit Facility Market Review," Fund Finance Market Review, Mayer Brown, Summer 2013.

[3] For a general description of ERISA issues related to lending to real estate, private equity and other investment funds, please see “Subscription Credit Facilities: Certain ERISA Considerations,” Fund Finance Market Review, Mayer Brown, Summer 2013.

[4] Employee Retirement Income Security Act of 1974, as amended, and the rules and regulations promulgated thereunder by any U.S. governmental authority, as from time to time in effect.

[5] “Plan Assets” has the meaning given in 29 C.F.R. §2510.3-101, et seq., as modified by Section 3(42) of ERISA.

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