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Summer 2013

Fund Finance Market Review

Trends and Developments in the Subscription Credit Facility and Fund Finance Markets

In this Summer 2013 edition of our *Fund Finance Market Review* we discuss some of the more noteworthy developments and trends in the subscription credit facility and fund finance markets, including a review of the current challenges and opportunities being driven in large part by the difficult fundraising environment. We also explore the evolution of fund terms and structures and the resulting impact on credit facilities, as well as some of the new and returning financing products surfacing in the market.

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Summer 2013 Subscription Credit Facility Market Review

ANN RICHARDSON KNOX

Despite continued challenges in the fundraising market for sponsors of real estate, private equity and other investment funds (each, a "Fund"), the positive momentum capital call subscription credit facilities (each, a "Facility") experienced in 2012 has continued and perhaps accelerated in early 2013. And for good reason: on all the panels at the Subscription Credit Facility and Fund Finance Symposium in January of 2013 in New York City (the "SCF Conference"), mention by panelists of institutional investor funding delinquencies could be counted on one hand.

This type of historical investor (each, an "Investor") funding performance of course translated to near perfect Facility performance through and coming out of the financial crisis. Yet despite the excellent Facility performance and the measured growth of the Facility market generally, there is growing recognition that certain trends in the market are creating very real challenges. Below we set out our views on the Facility market's key trends, where they intersect and the resulting challenges and opportunities we see on the horizon.

Key Trends

There are four key trends in the market we see creating material impact: (i) the general maturation of the Facility product and market; (ii) the continuing expansion of Facilities from their real estate Fund roots into other Fund asset classes, and particularly, private equity; (iii) Fund structural evolution, largely responsive to the challenging fundraising environment and Investor demands; and (iv) an entrepreneurial approach among Funds to identify new Investor bases and new sources of capital commitments ("Capital Commitments"). We analyze each below.

The Maturing Facility Market

Many Facility lenders (each, a "Lender"), Funds and other Facility market participants have for a long time benefited from the under-the-radar nature of the Facility market. While the market was certainly sizeable—for example, in 2011 Mayer Brown LLP alone worked on Facilities with Lender commitments in excess of $16 billion—it remained a niche in which only a subset of Lenders participated and was largely unknown to the greater financial community. That has certainly changed. The Facility product and its market recognition have matured and are continuing to grow rapidly for a variety of reasons, not the least of which was the publicity created by the sale of the WestLB AG, New York Branch Facility platform to Wells Fargo Bank, N.A. in 2012. Five years ago, the Facility market was operating in virtual obscurity; today it is a common staple familiar to nearly the entire finance community. DBRS has published rating criteria, an insurance company has approached Lenders offering to write credit enhancement on transactions or even individual Investor Capital Commitments and 400 people registered for the SCF Conference, up from 60 in 2010.

There are certainly benefits to being in a more recognized market, but there are also growing challenges. On the plus side, management now fully understands the product, and has context when considering requests for resource allocations. A Fund sponsor's (each, a "Sponsor") CFO no longer needs to explain the product to his partners; they now understand the timing and internal rate of return benefits. Credit personnel analyzing Facilities now have a better grasp of both the embedded risks and the practical performance, leading to better structured and more accurately priced Facilities. But challenges abound. New entrants (Lenders, law firms, etc.) are eager to join the market, some with extensive understanding from lateral hiring and others with more limited degrees of experience. This creates pricing pressure (a positive or negative, depending on your side of the aisle), as new entrants are often forced to compete on price when they cannot credibly demonstrate execution capabilities. It also tends to lead to Facilities being consummated with security structures and collateral enforceability issues that are different or weaker than what has traditionally been deemed "market," as newer participants are less tied to historical structures. Further, as the product matures and garners increased managerial attention, the inherent channel conflict at certain Lenders as to where within the institution to house the product often surfaces. Such channel conflict often leads to centralization of execution, as management realizes the disparities of credit standards and structures in different areas within the institution. Centralization of course leads to challenges, as both Fund relationships and execution experience are critical to a successful overall platform. Finally, a number of Lenders have become quite adept at providing Facilities, and have amassed impressive portfolios. In connection with these increasing exposures, these Lenders have rightfully garnered increased attention from the credit and risk management departments within their institutions. This increased attention often results in the creation of policies and procedures setting guidelines for what a Lender is able to do for the product and what items are outside of policy and require special considerations. Not surprisingly, these types of policies are being tested by the next several material trends.

Continued Expansion into Private Equity

Facilities are sometimes seen as a commodity product in the real estate Fund space, as some real estate Sponsors have been using the product for many years. This extensive experience has lead to provisions in limited partnership agreements ("Partnership Agreements") that tend to adequately contemplate a potential Facility and incorporate the Investor acknowledgments and agreements that a Lender would like to see for a Facility. As real estate Fund Sponsors form new Funds, the precedent Partnership Agreement typically already has these provisions, they carry forward, and the new Fund is ready for a Facility upon its initial Investor closing. But other asset classes are different. As private equity, mezzanine, infrastructure, energy, venture and other Funds (and especially buyout Funds) have traditionally enhanced returns with asset level leverage and less so with Fund level debt (if they used leverage in the first instance), their predecessor Fund Partnership Agreements are frequently less explicit or developed with respect to a Facility. And, of course, when the next Fund is to be formed, Sponsors naturally want to keep revisions to the precedent Partnership Agreement as limited as possible so as to minimize the changes that need to be presented to prospective (and in many instances recurring) Investors. This often leads to a minimal language insertion authorizing the incurrence of debt and the pledge of Capital Commitments; language far less robust compared to what Lenders are traditionally used to seeing and relying on from real estate Funds. Further, Sponsors outside of real estate have more frequently included overcall limitations and other structural complexities, which prove challenging for Lenders.[1] Thus, as Lenders continue to expand Facilities into Funds focused on private equity and other asset classes, they are increasingly challenged by Partnership Agreements that are less conducive to the Facility structure Lenders have grown to expect. This challenge is presenting almost weekly and standard setting for acceptability is going to be a key element for any Lender in the near future.

Fund Structural Evolution

Depending on your data source and region, 2012 fundraising was between flat globally and at best up just incrementally, especially in the United States. And while our fund formation practices have certainly seen some robust activity in early 2013, we remain guarded as to whether 2013 fundraising will materially outpace last year. The increased negotiation leverage of Investors derived from a difficult fundraising environment and their increased coordination facilitated in material part by the formation and advocacy of the Institutional Limited Partners Association is resulting in significant structural evolutions for Funds (especially outside of the real estate space, where traditional structures seem to be holding more firmly). Funds are increasingly structuring more tailored options for particular Investors (often to accommodate their particular tax or regulatory needs), leading to more Fund entities and more complicated Fund structures. We continue to see Investors making larger commitments to fewer, more seasoned

Funds, increased use of separate accounts, sidecars and other co-investment vehicles, Investors committing through special purpose vehicles (each, an "SPV"), formation of Funds as open-ended or evergreen, and extensive concessions provided to material Investors. We have seen structures where certain parallel funds are "funds of one" that cannot be cross-collateralized, where Investors have cease-funding rights in the event the Sponsor fails to fund a capital call (a "Capital Call"), and where an Investor invests directly into a separate, newly formed SPV, created specifically for such Investor on a deal-by-deal basis. These are just a few examples of some of the trends.

To a Facility Lender, of course, "fund structural evolution" means: "Your collateral package is changing." And, when you have a Lender-led trend toward the centralization of the product and the establishment of policies and guidelines, combined with a Fund trend of increased structural complexity designed to accommodate Investors (i.e., not accommodate Lenders), you have a natural tension. Thus, Lenders are working on getting their arms around things like the credit linkage between an SPV and the actual creditworthy Investor, how to efficiently add alternative investment vehicles as borrowers, and how to handle withdrawal rights related to violations of placement agent regulations. So an emerging challenge—and opportunity—is how to best manage this natural tension. How do Lenders develop policies that incorporate optionality into their product suite to accommodate a rapidly evolving Fund structural environment? For example, how does a securitization group tackle a Facility with a parallel fund of one that cannot be joint and severally liable but which has an investment grade Investor? How do Facilities with tight overcall limitations price compared to standard Funds without overcalls? How do you structure a Facility to an open-ended fund?[2] And while these issues are certainly challenging, they clearly trend away from a commodity product, and, thereby, create opportunity. Bespoke structures require customized solutions, and because customized solutions cannot be provided by all, they afford the potential for attractive returns.

New Sources of Capital

As Sponsors have sought to expand their sources of capital, the private wealth divisions of the major banks have not missed a beat and have created a variety of product offerings to bridge the gap between high net worth individual Investors ("HNWs") and Funds. Many major banks have created or are creating feeder funds ("Aggregator Vehicles") whereby a large number of HNWs can commit directly to the Aggregator Vehicle (or make an upfront one-time investment in the Aggregator Vehicle) and the Aggregator Vehicle in turn commits to the Fund.[3] This enables the HNWs to obtain exposure to Funds whose minimum Capital Commitment threshold they could not otherwise meet. In certain circumstances Aggregator Vehicles can even offer more liquidity than a traditional investment in a Fund by including redemption and transfer rights that would be atypical at the Fund itself. The banks sponsoring Aggregator Vehicles customize the opportunity to the wishes of the Sponsor and the HNWs, and Aggregator Vehicles may be structured to facilitate participation by the HNWs in a single Fund, in a series of Funds sponsored by the same Sponsor, or in multiple Funds sponsored by unrelated Sponsors. There are Aggregator Vehicles being marketed with minimums as low as $50,000. The Aggregator Vehicles often make material Capital Commitments to Funds, and hence their inclusion or exclusion from a Facility's borrowing base can have a material impact on Facility availability. While Aggregator Vehicles are not rated institutions and can be challenging for traditional Facility underwriting guidelines with respect to Investors (including for those Lenders that advance against HNWs that commit directly), they clearly have inherent value worthy of some level of advance or overcollateralization benefit. In fact, it could be argued that in some ways they could be more creditworthy than a traditional institutional Investor, as their source of funds comes from a diversified pool, typically with overcall rights to cover shortfalls created by any particular HNW's failure to fund. Figuring out the right level of advance rate and concentration limit for Aggregator Vehicles is clearly an emerging challenge and opportunity. And the development of similar vehicles and concepts that deliver HNW Investor Capital Commitments to Funds is likely to continue and increase.

Along similar lines, we expect that the continuing shift from defined benefit plans to defined contribution plans will ultimately lead Sponsors and their advisors to create products that allow defined contribution plans and related individual investor savings accounts access to Funds. While the challenges are real: the lack of redemptions does not sync well with the portability of 401(k)s, the accredited investor standard, etc., we believe the challenges are not insurmountable. And while we do not anticipate a sudden change anytime soon to open access to this source of funds, it does seem that the historically favorable rate of return provided by Funds, combined with the sheer size of long-horizon assets invested in IRAs and 401(k)s, makes their eventual connection somewhat inevitable over the long term. Whether the ultimate vehicles and structures formed to facilitate this source of funding involve Capital Commitments or something similar that would enable application for a Facility remains to be seen.

Conclusion

The Facility market is maturing and evolving in ways that create challenges and significant opportunities. We expect that the Facility market will continue to grow at a solid clip as fundraising improves, Fund formation increases and the product further penetrates the various private equity and other asset classes. But we expect that the evolution of Fund structures and new sources of Capital Commitments will challenge the historical Facility structures, leading to more customized and tailored and less standardized Facility constructs. Those Lenders nimble enough to move with these tides will have significant opportunities.

Endnotes

1 For an in-depth review of overcall limitations, please see Mayer Brown's Legal Update, "Subscription Facilities: Analyzing Overcall Limitations Linked to Fund Concentration Limits."

2 For further information about open-ended funds, please see Mayer Brown's Legal Update, "Structuring a Subscription Facility for Open-ended Funds."

3 Sponsors tend to refer to these HNW vehicles as "feeder funds." We prefer to refer to them as "Aggregator Vehicles" to avoid confusion with traditional feeder funds formed by a Sponsor itself.

Subscription Facilities: Analyzing Overcall Limitations Linked to Fund Concentration Limits

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As the subscription credit facility (each, a "Facility") market has evolved further from its real estate fund roots and deeper into the buyout fund and private equity world, lenders (each, a "Lender") active in the space have increasingly found overcall limitations ("Overcall Limitations") in the partnership agreements or other governing documents (collectively, "Fund Documentation") of their prospective fund borrowers (each, a "Fund").

These Overcall Limitations take various forms, but in each case limit the ability of the Fund to call capital (each, a "Capital Call") from its limited partners (each, an "Investor") to make up for shortfalls created by other Investors' failure to fund their Capital Calls (each, a "Defaulting Investor"). Such Overcall Limitations fundamentally conflict with a Lender's general expectation in a Facility that each Investor is jointly and severally obligated to fund Capital Calls up to the full amount of its unfunded capital commitment ("Unfunded Commitment"). Therefore, Lenders have naturally taken a skeptical view of such Overcall Limitations due to the credit implications of such provisions. As described below, there are three primary forms of Overcall Limitations and one particular form that is linked to a Fund's investment diversification or concentration limits (a "Concentration-Linked Overcall") that has proved especially troubling for Lenders. This is because the application of such limit means that the degree of overcollateralization afforded to the Lender varies with the size of any particular Fund investment (each, an "Investment"). This variation in the overcollateralization cushion complicates the credit analysis, adding another variable required to be modeled in order to assess the actual credit impact of the Overcall Limitation on a Facility. This Legal Update provides background on Overcall Limitations generally and proposes structural solutions to address some of the issues presented with certain Concentration-Linked Overcalls.

Background

The collateral for and expected source of repayment of a Facility is the Unfunded Commitments of the Investors. As described below, Facilities are underwritten based on an analysis of selected high credit-quality Investors that comprise a borrowing base (the "Borrowing

Base") as well as upon an analysis of the likelihood of Defaulting Investors. Analyzing these issues turns, in part, on the contractual provisions governing payment of Unfunded Commitments in the Fund Documentation. Funds have historically taken a two-pronged approach in their Fund Documentation to mitigate the risk and impact of Defaulting Investors, providing for: (1) severe and almost draconian default remedies (e.g., Fund Documentation often provides, for example, that the Fund may sell a Defaulting Investor's equity interest at a significant discount, oftentimes 50% or more, to a third-party Investor) and (2) the ability of the Fund to make additional Capital Calls on any non-Defaulting Investors up to the amount of their Unfunded Commitment to compensate for any shortfall created by a Defaulting Investor's failure to fund (such subsequent Capital Call, an "Overcall").[1] The first prong aims to discourage any Investor from defaulting on its obligations in the first instance, whereas the second prong is designed to permit the Fund to continue to conduct its business (consummate Investments, repay debt, etc.) despite the existence of a Defaulting Investor. This approach has worked extremely well historically as very few Investor defaults have been reported, even at the height of the financial crisis.

The typical Fund approach to mitigate Investor defaults described above and the resulting high quality of Investor funding performance has led to a robust Facility market, as Lenders favorably view the asset-class on a risk-adjusted basis. Facilities, therefore, have been structured on the premise that Funds will employ the above approaches. That is, as with virtually all asset-based credit facilities, Facilities are typically structured assuming the ability of one receivable (here, an Investor's Unfunded Commitment) to overcollateralize any other defaulting receivable (here, a Defaulting Investor's Unfunded Commitment). To buffer defaults, Facilities employ Investor eligibility criteria for inclusion in the Borrowing Base and often use tiered advance rates for various types of Investors, including, in some cases, Investor concentration limits. The eligibility criteria for an Investor to be included in a Borrowing Base is intended to ensure that the Lender only advances against Investors of a sufficient credit quality; the Borrowing Base and its components provide structural mitigants to allow for a certain predicted percentage or number of Defaulting Investors (times a stress factor) to be absorbed while still permitting the Lender to be repaid in full from the proceeds of Capital Calls from remaining Investors. Thus, in a standard Facility, the structure provides that the Lender only takes the payment risk of the Investors that meet the applicable eligibility criteria (the "Included Investors"), so that if there is a Defaulting Investor, the Fund (or if necessary the Lender) could issue Overcalls on the non-Defaulting Investors to repay the resulting shortfall up to their then-Unfunded Commitments. As described below, Overcall Limits in the Fund Documentation cut against these traditional asset-based lending constructs, as they create both a contractual limitation on the Investors' funding obligation as well as potential credit exposure for the Lender to non-Included Investors.

Overcall Limitation Formats

While Overcall Limitations are still relatively rare in the Fund Documentation of Funds who typically use Facilities, there are several varieties that are commonly seen. Three of the most common formulations are detailed below.[2]

1) PERCENTAGE OF PRIOR CAPITAL CALL.

One form of Overcall Limitation caps an Investor's obligation to fund an Overcall at a predetermined percentage of the initial Capital Call (a "Percentage of Prior Call Overcall"). The limitation is often styled as follows:

> If any Investor defaults on its obligations to fund any Capital Call hereunder, the General Partner shall be authorized to make a subsequent Capital Call on the non-Defaulting Investors for the resulting shortfall, *provided that no such non-Defaulting Investor shall be obligated to fund such a subsequent Capital Call in an amount in excess of [50]% of the amount it initially funded pursuant to the original Capital Call*.

In practice, this means that if an Investor contributed $1,000,000 with respect to an initial Capital Call, that Investor would only be obligated to contribute up to $500,000 pursuant to an Overcall to make up any shortfall created by a Defaulting Investor, even if its Unfunded Commitment was far in excess of $500,000. The percentage restriction in Fund Documentation is sometimes as low as 15% or 20%.[3]

2) PERCENTAGE OF CAPITAL COMMITMENT.

Another type of Overcall Limitation formulation caps an Investor's obligation to fund an Overcall at a predetermined percentage of the Investor's Capital Commitment. This limitation is typically styled as follows:

> If any Investor defaults on its obligations to fund any Capital Call hereunder, the General Partner shall be authorized to make a subsequent Capital Call on the non-Defaulting Investors for the resulting shortfall, provided that no such non-Defaulting Investor shall be obligated to fund such a subsequent Capital Call in an amount in excess of [15]% of its Capital Commitment.

Under this type of Overcall Limitation, if an Investor has a capital commitment (its "Capital Commitment") of $10,000,000, such Investor is only obligated to contribute up to $1,500,000 to make up any shortfall created by a Defaulting Investor. Care should be taken in reviewing the applicable Fund Documentation to determine if this form of Overcall Limitation applies to each Overcall or all Overalls in the aggregate.

3) CONCENTRATION-LINKED OVERCALLS.

Funds often have individual and aggregate concentration limits on their Investments ("Concentration Limits") built into their Fund Documentation to ensure that the Fund invests in a reasonably diversified portfolio of Investments. These Concentration Limits may restrict the Fund from investing, for example, greater than [15]% of the aggregate Capital

Commitments of the Investors in any single Investment or greater than [25]% of the aggregate Capital Commitments in Investments in a particular geographic region or in any particular industry sector. These Concentrations Limits of course vary across Investment asset classes and are individually tailored in connection with a particular Fund's investing objectives. Concentration-Linked Overcalls cap a non-Defaulting Investor's obligation to fund an Overcall at the amount that would be the most such Investor would have to fund if the applicable Concentration Limit were applied on an individual basis, as opposed to an aggregate basis. Thus, they seek to keep any particular Investor's exposure to a particular Investment from exceeding the Concentration Limit. The limitation has been styled as follows:

> If any Investor defaults on its obligations to fund any Capital Call hereunder, the General Partner shall be authorized to make a subsequent Capital Call on the non-Defaulting Investors for the resulting shortfall, *provided that no such non-Defaulting Investor shall be obligated to fund such a subsequent Capital Call if it would result in such Investor exceeding the concentration limits set forth in Section [X] as to its individual Capital Commitment.*[4]

> This formulation means that if the Fund Documentation includes a Concentration Limit that no single Investment may comprise more than 15% of the Fund's aggregate Capital Commitments, no Investor would have to make Capital Contributions with respect to such Investment (i.e., the original Capital Call plus the Overcall) in excess of 15% of its own Capital Commitment. Thus, at the extreme, if an Investment was acquired that required each Investor to fund 15% of its Capital Commitment originally, and any Investor defaulted, there would be no contractual obligation remaining on the non-Defaulting Investors to fund any Overcall to make up the shortfall.

Implications for Lenders

LIMITATION ON OVERCOLLATERALIZATION

The implications of Overcall Limitations for Lenders are material in several obvious ways. First, the Lender may not have the full benefit of the entire pool of Unfunded Commitments to support repayment. For example, let us assume the following hypothetical at the maturity of a Facility:

Hypothetical

- $200 million of Unfunded Commitments
- $50 million Borrowing Base
- $20 million Loans outstanding
- $20 million initial Capital Call to repay Loans
- a Percentage of Prior Call Overcall set at 50%

If 25% of the Investors (by Capital Commitments) default on the initial $20 million Capital Call, it would result in capital contributions ("Capital Contributions") received of $15 million, leaving $5 million of Loans due and owing. If the Overcall is issued to the non-Defaulting Investors, they are obligated to fund up to $7.5 million (50% of their funded $15 million), and hence the

Lender is covered.[5] However, if 50% of the Investors default on the initial $20 million Capital Call, only $10 million would be collected, leaving $10 million of Loans due and owing. The Overcall would only produce $5 million (50% of $10 million), leaving the Lender uncovered for the final $5 million, despite ample Unfunded Commitments.[6] With a Percentage of Prior Call Overcall set at 50%, the percentage of Investors (by Capital Commitments) that must default in order for the Loans not to be repaid in full by Unfunded Commitments (the "Inflection Point") is 33.3%. If the Percentage of Prior Call Overcall is 25%, the Inflection Point is 20%.

EXPOSURE TO NON-INCLUDED INVESTORS

Second, an Overcall Limitation greatly shifts credit risk from just Included Investors to all Investors, which means additional reliance on the creditworthiness of those Investors that the Lender excluded from the Borrowing Base in the first instance. For example, in the above hypothetical, a majority of the 50% of Investors that default on the initial Capital Call could all be excluded Investors, thereby triggering the Overcall Limitation on the obligation of the Included Investors to fund the Overcall. That is, the actual advance rate against the Unfunded Commitments of the Included Investors is materially higher from what the Lender contemplated for the Facility as a result of the Overcall Limitation. And the repayment proceeds are still insufficient, despite ample Unfunded Commitments from Included Investors, a Borrowing Base far in excess of the Loans outstanding and an all-in implied advance rate of only 25%. The Borrowing Base, its structured advance rate and concentration limits, simply do not completely protect against Overcall Limitation risk, even when structured tightly.

MARKET RESPONSE

Lenders in the Facility market of course have taken a concerned view of Overcall Limitations. Fortunately, they present infrequently and when they do, Funds and Investors have been relatively amenable to comments from the Lender to explicitly carve the Facility out from their restrictions. However, there are from time to time situations where a particular Fund sponsor (a "Sponsor") has a fully closed Fund with Overcall Limitations and amending the Fund Documentation is not commercially feasible. In these cases, Lenders often have to make a determination as to whether they can get comfortable with the Overcall Limitations or if they are unable to proceed with the Facility.

Evaluating and Mitigating Overcall Limitations Generally

It is extremely difficult for a Lender to craft an overarching policy position as to which Overcall Limitations are acceptable and which are not, as the impact of Overcall Limitations requires case-by-case analysis and cannot be viewed in a vacuum. For one thing, they are articulated slightly different in each Fund's Fund Documentation, so their actual application can differ. Additionally, the ramifications of such limits differ extensively based on the constituency of the overall Investor pool in a Fund. An Overcall Limitation's potential impact is of greater concern to a Lender where a Fund is comprised of only three Investors versus a Fund with a very granular pool of Investors. Similarly, where a Fund is comprised of 50% high net worth individual Investors compared to one that has all rated, institutional Investors, such concerns may be heightened. At a minimum, a Lender must determine the Fund's Inflection Point to better understand the implications of a particular Overcall Limitation and the practical risk presented. For example, with a Percentage of Prior Call Overcall set at 50%, and hence an Inflection Point of 33.3%, a Lender would want to evaluate both the largest Investors (to see how many and which individual Investors could default before exceeding 33.3%) as well as the credit wherewithal and granularity of the bottom 33.3% (based on credit risk) of the Investor pool (to evaluate the likelihood of defaults exceeding the Inflection Point). Some Funds may have a single Investor whose Capital Commitment as a percentage of the whole is itself in excess of the Inflection Point, in effect creating the potential for single counterparty exposure risk. Additionally, the analysis is often clouded when a Fund has had its first but not its final Investor close, as the Lender is forced to try to perform a credit analysis without the full information required to accurately analyze the actual Investor pool.

Structuring for Concentration-Linked Overcalls

CHALLENGES ANALYZING CONCENTRATION-LINKED OVERCALLS

Concentration-Linked Overcalls are particularly difficult to analyze because they turn on the size of the Investment as a percentage of the aggregate Capital Commitments, and hence, they can either be a virtual non-factor or a complete contractual prohibition on Overcalls, depending on the size of the Investment at issue. For example, if the linked Concentration Limit is 15%, and the Investment at issue is only 3% of the aggregate Capital Commitments, the Concentration-Linked Overcall is of almost no practical effect whatsoever. Of course, if the Investment is 14.5% of the aggregate Capital Commitments, there is precious little overcollateralization or margin for error.

The concept is further complicated in several additional ways. First, Concentration Limits are not typically a simple test of Investment acquisition cost to aggregate Capital Commitments, they are normally a test of Capital Contributions called or to be called with respect to an Investment to the aggregate Capital Commitments. So, for example, if a portion of the Investment acquisition cost is to be financed with asset-level leverage, that portion is only relevant to the extent the financing is subsequently replaced with Capital Contributions (which, of course, can be challenging to forecast perfectly at the time of acquisition of the Investment). Further, Investments often include "Follow-on Investments," and Fund Documentation is often not explicit as to whether Capital Calls to fund "Follow-on Investments" should be bundled with Capital Calls for the initial Investment for purposes of a Concentration-Linked Overcall. Additionally, Funds often have multiple categories of aggregate Concentration Limits, each of which has to be calculated, tracked and abided by. These aggregate Concentration

Limits and the related tracking are less transparent to a Lender, as a Lender cannot perfectly determine whether any particular Investment fits within a Concentration Limit with certainty and must largely rely on the Sponsor's categorization. And finally, there is timing mismatch between the moment in time when the Fund borrows under the Facility to finance an Investment and the subsequent time when the Fund actually makes the Capital Call. In this circumstance, at the time of funding, the Lender in effect has to rely on a Fund's good faith belief as to how much capital it will be calling in the future with respect to the Investment.

USE OF LOAN PROCEEDS LIMITATION

If a particular Concentration-Linked Overcall applies to Capital Calls to repay debt (and not just to Capital Calls to fund Investments), to get comfortable with the limitation Lenders may want to consider structuring limitations on the use of Facility proceeds. For example, if a Fund has a Concentration Limit for individual Investments of 15%, a Lender may want to prohibit the use of Loan proceeds to acquire large Investments that come close in size to the 15% level to ensure that the Lender will have an adequate cushion of Overcalls on non-Defaulting Investors. So, for example, the Lender could set a percentage (the "Maximum Percentage") at the threshold of its comfort level under the circumstances to always ensure an available Overcall cushion between the Maximum Percentage and the 15%, and restrict the use of Loan proceeds with respect to Investments that are in excess of the Maximum Percentage. Setting the Maximum Percentage will depend on the particular Fund, Sponsor and Investor pool, but suppose, for example, that the Lender would be comfortable under the circumstances with a 33.3% Inflection Point (as if there was a Percentage of Prior Call Overcall framework set at 50%). In such a case, the Lender could set the Maximum Percentage as the mathematical equivalent of the 50% Percentage of the Prior Call Overcall for each Concentration Limit. For a 15% Concentration Limit, the math is simple and the Maximum Percentage would be 10%. Hence, the Fund could use Loan proceeds under the Facility for Investments in which less than 10% of the aggregate Capital Commitments would be called, but would be prohibited from using Loan proceeds for Investments in excess of 10% of aggregate Capital Commitments. For the Fund's aggregate Concentration Limits, the Maximum Percentage would float such that each level was set at the 33.3% Inflection Point.

ADDITIONAL MITIGANTS

Setting the Maximum Percentage requires care and consideration of all the relevant criteria for the particular Fund. It also requires a high degree of confidence in the Sponsor, as the Lender will be relying on the Fund to accurately predict anticipated Capital Call amounts for Investments, accurately classify Investments for purposes of aggregate Concentration Limits, and accurately address the potential impact of subsequent Follow-on Investments. These reliances may, in certain circumstances, require increased due diligence on Sponsors, thus potentially limiting the use of this structure to only highly-experienced, trusted Sponsors with demonstrated track records. Additionally, in certain circumstances, additional asset-level mitigants and "skin in the game" requirements may be appropriate to bring a particular Facility with a Concentration-Linked Overcall back to the intended credit profile. Examples include (i) covenants to periodically call capital to ensure the earlier detection of Defaulting Investors and because Investors periodically investing fresh equity are less likely to be willing to forfeit such equity by defaulting, (ii) minimum net asset value requirements to buffer the secondary source of repayment, and (iii) asset-level leverage limitations to reduce volatility with respect to the equity position of the Fund. In addition, Lenders may want to exercise greater control over transfers by non-Included Investors since the Lenders have exposure to all Investors when Overcall Limitations are applicable.

IN PRACTICE

In practice, many Funds do not actually acquire a large number of Investments that bump up against their Concentration Limits, and therefore, the use of proceeds limitation has been an acceptable work-around for both Lenders and Funds in certain Facilities. Further, to the extent the Fund wants to acquire an Investment in excess of the applicable Maximum Percentage, it would not be prohibited from doing so with equity; rather, it is only prohibited from doing so with Facility proceeds. Similarly, if a Fund desires to make additional Investments which would put it above the Maximum Percentage with respect to a particular aggregate Concentration Limit, it can do so by simply paying down the Loan related to the initial Investment prior to consummating such additional Investment.

Conclusion

While Overcall Limitations are still relatively rare in Fund Documentation, when applicable they become an important focus of the underwriting analysis for Lenders considering a Facility. Lenders must evaluate not just the Borrowing Base for such Facility, but the Sponsor, the Fund and the Investors as a whole, to adequately understand the risks of Investor defaults exceeding the Inflection Point. Fortunately, Investor default numbers have historically been many multiples shy of even the tightest Inflection Points and with structural mitigants many Lenders are able to find solutions to enable Funds (at least those formed by well-established Sponsors) to benefit from Facilities. Funds considering the possibility of a Facility should, whenever possible, avoid or narrowly tailor Overcall Limitations to scope out Capital Calls to repay a Facility, as their inclusion, even when accommodated, results in greater due diligence time, expense and legal costs and, most importantly, less favorable Facility terms and pricing.

Endnotes

1 In this Legal Update, we discuss Overcall Limitations in the context of Defaulting Investors, but the concept is also often equally applicable with respect to any Investors that are excused from participating in any particular Investment under the terms of the applicable Fund Documentation.

2 An Overcall Limitation in any Fund Documentation must be examined individually, as there are many slight variations to the examples provided herein, any of which could impact its prospective applicability to, or impact on, a Facility.

3 From time to time, we have seen Overcall Limitations surface in side letters of individual Investors as well. While not as dramatic as a Fund-wide Overcall Limitation, individual Investor Overcall Limitations present interesting wrinkles for Lenders as well.

4 Some Concentration-Linked Overcalls apply only with respect to Capital Calls to make an Investment and not with respect to Capital Calls to repay indebtedness. Some formulations can be ambiguous as to whether they would apply with respect to a Capital Call to repay loans under a Facility ("Loans") if the Loans were used to acquire an Investment. Hence, again, any particular Overcall Limitation must be analyzed individually.

5 We assume all non-Defaulting Investors fully fund the Overcall. It is of course theoretically possible that certain non-Defaulting Investors fail to fund the Overcall leading to successive Overcalls.

6 Note that we are by no means saying that the Lender will definitively take a loss in this xircumstance. Facilities are full-recourse obligations of the Fund and the Fund very well may be able to satisfy its payment obligation by the liquidation of Investments. Additionally, the Fund and ultimately the Lender will have claims against the Defaulting Investors which may also result in repayment proceeds and transfers of Defaulting Investors' positions may produce creditworthy substitute Investors.

Structuring a Subscription Credit Facility for Open-End Funds

MARK C. DEMPSEY AND FRANK A. FALBO

A subscription credit facility (a "Facility"), also frequently referred to as a capital call facility, is a loan made by a bank or other credit institution (the "Lender") to a private equity fund (the "Fund"). The defining characteristic of such Facilities is the collateral package, which is composed not of the underlying investment assets of the Fund, but instead by the unfunded commitments (the "Capital Commitments") of the limited partners in the Fund (the "Investors") to make capital contributions ("Capital Contributions") when called from time to time by the Fund's general partner.

The loan documents for the Facility contain provisions securing the rights of the Lender, including a pledge of (i) the Capital Commitments of the Investors, (ii) the right of the Fund's general partner to make a call (each, a "Capital Call") upon the Capital Commitments of the Investors after an event of default accompanied by the right to enforce the payment thereof, and (iii) the account into which the Investors fund Capital Contributions in response to a Capital Call.

The number of Facilities is rapidly growing due to the flexibility they provide to Funds (in terms of liquidity and consolidating Capital Calls made to Investors) and the reliability of the Capital Commitment collateral from the Lender's perspective. As the Facility market continues to grow and evolve, both Lenders and Fund sponsors seek to put in place Facilities for fund structures that vary from the typical closed-end Funds that have historically dominated the Facility market. As recovery from the financial crisis continues, Investors are increasingly investing in open-end Funds due to the Investors' interest in increased liquidity due to the availability of voluntary Investor redemptions in open-end Funds. Historically, Lenders have not pursued open-end Funds for Facilities because of concerns surrounding the transient nature of the Capital Commitments in those Funds. As discussed below, however, with a few structural tweaks, Facilities can be provided to open-end Funds, offering Lenders the same comforts of a traditional Facility while providing Funds convenient and cost-effective fund-level financing. Such financing can be used for leveraging investments, liquidity and bridging Capital Calls. This newsletter provides background on how open-end Funds generally differ from a typical closed-end Fund, and proposes solutions for structuring a Facility for open-end Funds.

Background

While there are many types of open-end Funds, there are a number of common characteristics that generally distinguish an open-end Fund from a typical closed-end Fund. These include: the long-term fund-raising period during which it can accept additional Capital Commitments and close in new Investors, the extended or perpetual investment period during which it can make Capital Calls, and most important and potentially concerning for purposes of Facilities, the increased flexibility for Investors to redeem their interests. Unlike a closed-end Fund, where redemption and withdrawal rights are generally not available to Investors, or, to the extent that they are available to Investors, are generally limited to specific legal or regulatory issues, Investors in an open-end Fund are generally free, subject to notice and timing restrictions, to redeem their interests in the Fund. True open-end Funds by their nature permit redemption of equity at the election of the Investor (and, in some circumstances, the remaining unfunded Capital Commitment of the redeeming Investor may be cancelled). It is important to note that some open-end Funds require Investors to fully fund all Capital Contributions concurrently with closing into the fund and, thus, do not retain the concept of an unfunded Capital Commitment. A traditional Facility would not be feasible for such a Fund. For purposes of this newsletter we will focus on structuring issues related to the expanded redemption and withdrawal rights of Investors in open-end Funds that retain unfunded Capital Commitments.

Structuring and Documentation Concerns

A Facility for an open-end Fund should contain a representation, warranty, covenant and an event of default package that is generally consistent with that seen in Facility documentation for a closed-end Fund. The collateral package would also be similar, if not identical, to that for a closed-end Fund. As a gating issue, it is important to review the constituent documents of the open-end Fund to ensure that the timing of requests for redemption and the timing for satisfying redemptions allows for Capital Calls to be made and the proceeds thereof applied to make any mandatory prepayment that would result from any such redemption. Notwithstanding the generality of the foregoing, there are a few structural changes that should be noted in a Facility for an open-end Fund.

COLLATERAL ISSUES

As discussed above, the collateral and expected source of repayment in a Facility is the Capital Commitments of the Investors. Given the nature of open-end Funds, the potential fluidity with respect to the Investors and, therefore, the collateral for the Facility raise potential concerns. Notwithstanding the issues related to a changing pool of Investors, with a careful review of the Fund's constituent documentation and attention to the redemption timing and mechanics, a Facility could be structured to address a Lender's concerns while still providing flexibility (in terms of liquidity and consolidating Capital

Calls made to Investors) to an open-end Fund. As described in more detail below, the Facility documentation can address the foregoing concerns with some minor changes, including additional exclusion events, mandatory clean-up calls, additional events of defaults and/or additional covenants.

An exclusion event tied to any request by an Investor to redeem its interest in the Fund must be structured so as to remove any such requesting Investor from the borrowing base while also allowing sufficient time to make a Capital Call to cure any resulting borrowing base mismatch in the time period between receipt of such request from an Investor to the time the Investor has been redeemed from the Fund. Tying the exclusion event to a request for redemption, rather than to an actual redemption, is important not only for timing concerns, but also because an Investor that has redeemed its equity in a Fund, even if it is not also seeking to cancel its unfunded Capital Commitment, may not be as concerned by the defaulting investor penalties in the constituent documents of the open-end Fund as an Investor that still has equity at stake. Additional Lender protection can be obtained by requiring cleanup calls (to reduce amounts outstanding under a Facility) in advance of each regularly occurring redemption window under the constituent documents of the open-end Fund. An event of default can be added that is triggered upon a threshold percentage of Investors requesting redemption of their interests in the Fund. Such event of default can be structured to be cumulative or with respect to any redemption window. A net asset value covenant can be inserted to provide additional early warning of any Fund problems.

ADDITIONAL REPORTING

Because of the potential for changes in the Investor base and the collateral package associated with an open-end Fund, Facilities should be structured to provide additional reporting as to borrowing bases and Investor events, including notice of redemption requests, cues of Investors seeking admission to the Fund and net asset values. Additional delivery of borrowing base certificates and notices of redemption requests should coincide with the time periods under the constituent documents of the open-end Fund such that the Lender can properly monitor borrowing base changes and anticipate any necessary mandatory prepayments resulting from Investor redemptions, while maintaining time to issue any necessary Capital Calls before the effectiveness of any requested redemptions. Tracking redemption requests and Investor cues should provide a Lender with an early indication of underlying problems with a Fund.

We note that reporting and documentation required in connection with a Facility for an open-end Fund may be more administratively burdensome than a Facility in a typical closed-end Fund. Beyond the additional reporting with respect to borrowing bases and Investor redemptions discussed above, deliverables (such as constituent document changes, new side letters and subscription agreements) with respect to additional Investors can continue for a longer period than in a typical closed-end Fund. Moreover, given the increased potential for Investor turnover, it may be burdensome for both Lenders and Fund sponsors to negotiate and obtain investor letters and opinions from Investors. Lenders may want to consider addressing any additional administrative burden related to an open-end Fund Facility by increasing the administrative fees under the Facility. Even with an incremental increase in fees or the interest rate, a Facility still likely provides cheaper liquidity than many asset-level financings.

FACILITY TENOR

Because of its long-term nature, there are a number of options to structure the tenor of a Facility for an open-end Fund. Since open-end Funds typically are not subject to limited investment periods during which they may make Capital Calls for investments and repay Facility obligations, there are more options available to Lenders and Fund sponsors in terms of the tenor of the Facility. Some open-end Funds prohibit initial Investors from redeeming their interests and/or withdrawing from the Fund for a predetermined period of time (often one or two years). Such lock-out periods help the Fund achieve and maintain a critical size during its ramp-up period. During the early stages of such an open-end Fund, a Facility could be structured with a tenor equal to any applicable redemption lock-out period for the Investors. A Facility of this type would look very similar to a Facility for a typical closed-end Fund. Secondly, a Facility could have a longer tenor, even in excess of five years or more, to match the long-term investment period and life-span of an open-end Fund. Although rare in this market, such a long-term tenor is regularly seen in other leveraged lending products. Lastly, a Facility could be structured with a 364-day tenor, subject to any number of one-year extensions, allowing the Lender and Fund sponsor to re-evaluate their respective needs on an ongoing basis during the life of the Fund.

Conclusion

While Facilities for true open-end Funds have to date been relatively rare, the opportunity is ripe for new market entrants. With a careful review of an open-end Fund's constituent documentation and some modifications to the Facility documentation, a Facility can be structured to provide the traditional benefits of a Facility for an open-end Fund while still addressing a Lender's standard Facility credit criteria. Please contact any of the authors with questions regarding open-end Funds and the various structures for effectively establishing Facilities for such entities.

Separate Accounts vs. Commingled Funds: Similarities and Differences in the Context of Credit Facilities

TODD N. BUNDRANT AND WENDY DODSON GALLEGOS

The use of managed accounts as an investment vehicle has been widely publicized of late with institutional investors such as the California State Teachers' Retirement System and the New York State Common Retirement Fund (referring to such vehicles as "separate accounts"), and the Teacher Retirement System of Texas and the New Jersey Division of Investment (referring to such vehicles as "strategic partnerships") making sizeable investments with high-profile private equity firms such as Apollo Global Management, LLC, Kohlberg Kravis Roberts & Co. and the Blackstone Group.[1]

Regardless of name, these tailored investment vehicles represent a significant trend, with 32% of surveyed fund managers indicating they were intending to invest more from separate accounts during 2013.[2] And although structurally divergent from commingled real estate or private equity funds ("Funds"), these separate accounts share a common objective with Funds: to produce strong returns with respect to invested capital in the most efficient manner possible.

In many situations, accessing a credit facility can facilitate achieving investment objectives. This is quite clear in the context of Funds establishing subscription credit facilities, also frequently referred to as a capital call facility (a "Facility"). These Facilities are popular for Funds because of the flexibility they provide to the general partner of the Fund in terms of liquidity and the efficiency associated with consolidating the number of capital calls made upon limited partners. These benefits would equally apply to institutional investors establishing separate accounts with private equity firms and, despite fundamental differences between separate accounts and Funds, a separate account may be structured to take advantage of the flexibility afforded by a similar credit facility.

Definition of "Separate Account"

The term "separate account" has been used generically to describe an arrangement whereby a single investor provides virtually all of the necessary equity capital for accomplishing a specified investment objective. It is important, however, to distinguish a "separate account" from a joint venture or partnership in which there is an additional party (frequently the investment manager) with an equity interest in the owner of the investment. The equity provided (or earned) by the investment manager may be slight in comparison to the equity capital provided by the institutional investor. However, despite the imbalance of economic interests, these joint ventures and partnerships involve two or more equity stakeholders and generally require careful consideration with respect to many of the same issues which arise in the context of Funds (whether such Fund includes just a few, or a few hundred, investors). And confusion arises when these joint ventures and partnerships are incorrectly referred to as a "separate account."

In fact, a separate account ("Separate Account") is an investment vehicle with only one (1) commonly institutional investor ("Investor") willing to commit significant capital to a manager (which may also simultaneously manage a Fund or Funds ("Manager")) subject to the terms set forth in a two (2) party agreement (commonly referred to as an Investment Management Agreement or the "IMA"). The IMA is structured to meet specific goals of the Investor, which may be strategic, tax-driven or relate to specific needs (such as excluding investments in a particular type of asset or market). As a result, it is not atypical for a Separate Account to be non-discretionary in terms of investment decisions made by the Manager (with Investor approval being required on a deal-by-deal basis). Separate Accounts can also be tailored to match the specific investment policies and reporting requirements of the Investor.

Separate Accounts vs. Commingled Funds

Aside from fundamental differences such as the number of investors and the potential lack of Manager discretion in making investment decisions (described above), several key distinctions exist between Separate Accounts and Funds. Notably, fees paid to the Manager under Separate Account arrangements are typically lower than those paid to a Manager operating a Fund (in part because of the leverage maintained by an Investor willing to commit significant capital to a Separate Account), and any performance fees must be carefully structured to ensure they do not violate applicable law relating to conflicts of interest.

The popularity of Separate Accounts may be attributable to the greater flexibility they provide to the Investor. In addition to Investor input related to investment decisions, IMAs are sometimes structured to be terminable at will upon advance notice to the Manager (although there may be penalties associated with early termination), while termination of a Fund Manager ordinarily requires the consent of a majority or supermajority of the other limited partners, and oftentimes must be supported by "cause" attributable to the action (or inaction) of the Manager. However, there are also significant costs and trade-offs associated with this flexibility, including that the Investor must identify and agree upon terms with a suitable Manager, and the time commitment and expertise required by the Investor to be actively involved in analyzing and approving investment recommendations made by the Manager.

Likewise, the Manager will require a sizeable commitment to the Separate Account to overcome the inefficiency of a Separate Account as compared to operating a Fund with a larger pool of committed capital, more beneficial fee structures, and discretion over investment decisions.

Benefits of Credit Facilities for Separate Accounts

Notwithstanding the differences between Separate Accounts and Funds, Investors and Managers alike would benefit from access to a credit facility in connection with a Separate Account. To begin with, credit facilities provide a ready source of capital so that investment opportunities (once approved) can be quickly closed. Timing considerations are critical in a competitive environment for quality investments, particularly if internal Investor approvals are difficult to obtain quickly. The liquidity offered by a credit facility can decrease Investor burden and shorten the overall investment process by eliminating the need for simultaneous arrangement of funding by the Investor. The closing of an investment through a credit facility minimizes administration by both the Investor and Manager, as funding of the obligations to the Separate Account can be consolidated into a routine call for capital (instead of multiple draws taxing the human capital of both the Manager and Investor executing the objectives of the IMA). And, perhaps most importantly from the Investor's perspective, a credit facility may eliminate the need to continually maintain liquidity for the capital required to fund investments contemplated by the Separate Account

Although alternatives exist (including asset-level financing arrangements), many Funds have established Facilities for purposes of obtaining liquidity, flexibility and efficiency in connection with portfolio management. The most common form of Facility is a loan by a bank or other credit institution (the "Creditor") to a Fund, with the loan obligations being secured by the unfunded capital commitments (the "Unfunded Commitments") of the limited partners of the Fund. Under a Facility, the Creditor's primary and intended source of repayment is the funding of capital contributions by such limited partners, instead of collateral support being derived from the actual investments made by the Fund. The proven track record of Unfunded Commitments as collateral has generally enabled Creditors to provide favorable Facility pricing as compared to asset-level financing, although many Funds utilize both forms of credit in order to increase overall leverage of the investment portfolio.

Assuming the Investor is a creditworthy institution, the IMA can be drafted to take advantage of the flexibility afforded by a Facility by including certain provisions found in most Fund documents supporting the loan.[3] More specifically, the IMA should expressly permit the Manager to obtain a Facility and provide as collateral all or a portion of the unfunded commitment of the Investor (the "Required Commitment") to supply a capital contribution for approved investments ("Account Contributions") contemplated by the Separate Account. Then, as part of the Investor's approval of an investment under the IMA, the Investor may elect to authorize the Manager to make a draw upon the Facility for the relevant investment(s) and cause the Required Commitment to be pledged, along with the right to request and receive the related Account Contribution when called by the Manager (a "Capital Call"), to the Creditor. If so, the Investor retains discretion with respect to both investment selection and Facility utilization and, when drawn upon the Facility, would be supported by a pledge of: (a) the Required Commitment; (b) the right of the Manager to make a Capital Call upon the Required Commitment after an event of default under the Facility (and the right of the Creditor to enforce payment thereof); and (c) the account into which the Investor is required to fund Account Contributions in response to a Capital Call. Creditors may also require investor letters from the Investor acknowledging the rights and obligations associated with this structure from time to time. As mentioned above, most Investors and Managers are familiar with these terms and recognize the benefits afforded by establishing a Facility for purposes of flexibility, efficient execution, and administration of private equity investments.

Conclusion

The number of Funds seeking a Facility is steadily increasing due to the benefits these loans provide to Investors and Managers in terms of liquidity and facilitating investment execution, while simultaneously decreasing the administrative burden associated with numerous and/or infrequent capital calls. Likewise, Creditors have benefitted from the reliability of unfunded capital commitment collateral and the low default rates associated with these Facilities.

These same attributes apply in the context of Separate Accounts and, with careful attention to Facility requirements at the onset of Separate Account formation, similar loans may be provided for the benefit of parties to an IMA. Please contact any of the authors with questions regarding these issues and the various methods for effectively establishing a Facility in connection with Separate Accounts.

Endnotes

1 "CalSTRS Joins Chorus Favoring Separate Accounts Over Funds", Pension & Investments, March 5, 2012.

2 "The Rise of Private Equity Separate Account Mandates", Preqin, February 21, 2013.

3 In the context of a Separate Account structured so the Investor dœs not maintain any form of commitment (and instead merely funds individual investments with equity capital in connection with approval and closing thereof), this Facility support structure would not apply.

Subscription Credit Facilities: Certain ERISA Considerations

LENNINE OCCHINO, TODD N. BUNDRANT AND ERIKA GOSKER

A subscription credit facility (a "Facility"), also frequently referred to as a capital call facility, is a loan made by a bank or other credit institution (the "Lender") to a private equity fund (the "Fund"). The defining characteristic of such Facilities is the collateral package, which is composed not of the underlying investment assets of the Fund, but instead by the unfunded commitments (the "Capital Commitments") of the limited partners of the Fund (the "Investors") to make capital contributions ("Capital Contributions") when called from time to time by the Fund or the Fund's general partner.

The loan documents for the Facility contain provisions securing the rights of the Lender, including a pledge of (i) the Capital Commitments of the Investors, (ii) the right of the Fund or the Fund's general partner to make a call (each, a "Capital Call") upon the Capital Commitments of the Investors after an event of default accompanied by the right to enforce the payment thereof and (iii) the account into which the Investors fund Capital Contributions in response to a Capital Call.

As recovery from the financial crisis continues, fundraising activity is up markedly, due to increases in both the Capital Commitments made by Investors to existing Funds and the number of new Funds being formed. Consequently, this activity is driving an increase in the number of Facilities sought by such Funds given (i) the flexibility such Facilities provide to Funds (in terms of liquidity and consolidating Capital Calls made to Investors) and (ii) the proven track record in regards to Capital Commitment collateral's reliability. The reliability of such collateral is due in part to the typically high credit quality of Investors in such Funds and low default rates of such Investors.

Many Funds are at least partially comprised of Investors that are subject to the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), and/or Section 4975 of the Internal Revenue Code of 1986, as amended (the "Code"). As discussed below, understanding a Fund's status under ERISA, as well as the status of individual Fund Investors under ERISA and Section 4975 of the Code, is critical from a Lender's perspective because of the prohibited transaction rules contained in these statutes.[1] A violation of the prohibited transaction rules under ERISA could result in severe consequences to the Fund and to Lenders under a Facility, including the possibility that the Facility be unwound and/or of excise tax penalties equal to 100% of the interest paid under the Facility being imposed on the Lender. Despite these potential pitfalls, ERISA issues can be effectively managed through awareness of these rules and regulations and guidance from seasoned counsel specializing in ERISA and experienced in these Facilities. This newsletter outlines some of the basic ERISA considerations of which Lenders and Fund borrowers should be aware in connection with these Facilities.

Background

ERISA was adopted by Congress to protect the interests of participants in employee benefit plans that are subject to ERISA. Concerned with the difficulty of enforcing a law based on good faith or arm's-length standards, Congress imposed:

1. fiduciary status on all persons who exercise control over employee benefit plan assets (whether or not they intend or agree to be fiduciaries);
2. stringent fiduciary standards and conflict of interest rules on such fiduciaries;
3. except where specifically exempted by statute or by the Department of Labor, prohibitions on all transactions between employee benefit plans and a wide class of persons (referred to as "parties in interest" in ERISA and "disqualified persons" in the Code)[2] who, by reason of position or relationship, might, in Congress' view, be in a position to influence a fiduciary's exercise of discretion over plan assets; and
4. onerous liabilities and penalties on both fiduciaries who breach ERISA and third parties who enter into transactions that violate the prohibited transaction rules.

ERISA Prohibited Transaction Rules

The most significant issue for a Lender to a Fund that is or may be subject to ERISA is the impact of the prohibited transaction rules under ERISA, which strictly prohibit a wide range of transactions, including loans or other extensions of credit, between an ERISA plan and a person who is a "party in interest" with respect to such plan, unless an exemption is available (as described below). Financial institutions often have relationships with ERISA plans that cause them to be parties in interest, such as providing trustee, custodian, investment management, brokerage, escrow or other services to the ERISA plan.

A party in interest that enters into a nonexempt prohibited transaction with an ERISA plan is subject to an initial excise tax penalty under the Code equal to 15% of the amount involved in the transaction and a second tier excise tax of 100% of the amount involved in the transaction, if the prohibited transaction is not timely corrected. In order to correct the prohibited transaction, the transaction must be unwound, to the extent possible, and the ERISA plan must be made whole for any losses. In addition, if a transaction is prohibited under ERISA, it may not be enforceable against the ERISA plan.

As discussed below, a Fund that accepts ERISA plan Investors could, itself, become subject to these prohibited transaction rules under ERISA. During the negotiation of the term sheet and initial due diligence for a Facility, it is critical to understand the Fund's structure, the current ERISA status of the

Fund and, if the Fund has not closed in all of its Investors and/or made its first investment, the intended ERISA status of the entities within the Fund's structure. Such information is necessary to draft appropriate representations and covenants in the loan documents. The representations and covenants will assure the Lender that either the Fund is not subject to ERISA or the Fund may rely on an exemption from the prohibited transaction rules under ERISA that will apply to the transactions contemplated by the Facility. Lenders may also require certain ERISA-related deliveries as a condition to the initial borrowing under the Facility, as well as annual deliveries thereafter.

Plan Asset Rules

A Fund that accepts ERISA Investors could itself become subject to ERISA if the assets of the Fund are deemed to be "plan assets" of such ERISA Investors. The rules governing the circumstances under which the assets of a Fund are treated as plan assets are generally set forth in Section 3(42) of ERISA and a regulation, known as the "plan asset regulation," published by the Department of Labor. Section 3(42) of ERISA and the plan asset regulation set forth a number of exceptions on which a Fund may rely to avoid being deemed to hold the plan assets of its ERISA Investors.

COMMON EXCEPTIONS TO HOLDING PLAN ASSETS

The exceptions to holding plan assets most commonly relied on by Funds[3] seeking to admit Investors subject to ERISA are the "less than 25%" exception and the "operating company" exception. Prior to permitting the initial borrowing under a Facility, a Lender may require evidence of compliance by the Fund with these exceptions in the form of a certificate from the Fund's general partner (in the case of the less than 25% exception) or an opinion of qualified ERISA counsel to the Fund (in situations involving the "operating company" exception). In addition, the Facility may require annual certificate deliveries by the Fund to confirm the Fund's continued satisfaction of the conditions of an exception to holding plan assets. Regardless of the deliveries requested by the Lender, the Facility should contain representations, warranties and covenants from the Fund to the effect that the Fund satisfies an exception to holding plan assets and will continue to satisfy such an exception throughout the period any obligations under the Facility remain outstanding.

Less Than 25% Exception

The less than 25% exception is available to a Fund[4] if less than 25% of each class of equity interests in the Fund are owned by benefit plan investors. For the purpose of the less than 25% exception, Investors that are treated as "benefit plan investors" include, among others, private pension plans, union-sponsored (or Taft Hartley) pension plans, individual retirement accounts, and certain trusts or commingled vehicles comprised of assets of such plans. Government plans and non-US plans are not subject to ERISA or Section 4975 of the Code and are not counted as benefit plan investors for the purpose of the less than 25% exception. In addition, when determining the size of the class of equity interests against which benefit plan investor participation will be measured, the interests of the Fund manager or general partner and other persons who exercise discretion over Fund investment or provide investment advice to the Fund, and affiliates of such persons, are disregarded. The percentage ownership of the Fund is measured immediately after any transfer of an interest in the Fund. Accordingly, a Fund relying on the less than 25% exception must monitor the percentage of its benefit plan investors throughout the life of the Fund.

Operating Company Exception

A Fund[5] relying on the operating company exception will typically do so by seeking to qualify as either a "real estate operating company" or a "venture capital operating company." A real estate operating company ("REOC") is an entity that is primarily invested in actively managed or developed real estate with respect to which the entity participates directly in the management or development activities. A venture capital operating company ("VCOC") is an entity that is primarily invested in operating companies (which may include REOCs) with respect to which the entity has the right to participate substantially in management decisions. It is common for real estate-targeted Funds to rely on the VCOC exception by investing in real estate through subsidiary entities that qualify as REOCs. Both VCOCs and REOCs must qualify as such on the date of their first long-term investment and each year thereafter by satisfying annual tests that measure their ownership of qualifying assets and their management activities with respect to those assets. If a Fund does not qualify as a VCOC or REOC on the date of its initial long-term investment or fails to continue to qualify as a VCOC or REOC, as applicable, on an annual testing date, the Fund is precluded from qualifying as a VCOC or REOC, as applicable, from that date forward. Accordingly, a Fund relying on an operating company exception must properly structure and monitor investments and test for compliance annually.

Certain Timing Considerations Related to Exceptions to Holding Plan Assets

To avoid the application of the prohibited transaction rules and risks described above to the transactions contemplated by a Facility, the Fund must satisfy an exception to holding plan assets at the time of the initial borrowing under the Facility and throughout the period any obligation under the Facility remains outstanding.[6] With respect to the operating company exception, the timing of the initial investment, the initial Capital Call from Investors and the initial borrowing must be carefully monitored.

As noted above, a Fund cannot qualify as a VCOC or a REOC until the date of its initial long-term investment. Accordingly, benefit plan investors typically will not make Capital Contributions to a Fund intending to qualify as a VCOC or REOC until the date such Fund makes its first investment that qualifies the Fund as a VCOC or REOC, as applicable. To call capital in advance of the initial investment, such a Fund would need to establish an escrow account to hold the Capital Contributions from its benefit plan investors outside of the Fund until the first qualifying investment is made by the Fund.

Since the escrowed funds have not been contributed to the Fund, the escrow account may not be pledged by the Fund as security to the Facility. The escrow account used for this purpose needs to satisfy certain conditions set forth in an advisory opinion issued by the Department of Labor in order to avoid causing the Fund to be deemed to hold plan assets. Depending on the facts and circumstances, a Fund may not be able to make an affirmative representation in the Facility documents that it does not hold ERISA plan assets until the date on which the Fund makes its initial investment that qualifies the Fund for an operating company plan asset exception.[7]

PROHIBITED TRANSACTION EXEMPTIONS FOR PLAN ASSET FUNDS TO ACCESS A FACILITY

A Fund that has admitted ERISA Investors and does not satisfy the conditions of an exception to holding plan assets is subject to ERISA. An ERISA Fund would not necessarily be precluded from accessing a Facility if such Fund could rely on one of the prohibited transaction exemptions described below. As noted above, financial institutions provide a variety of services to many ERISA plans, causing such institutions to be parties in interest to such ERISA plans. Accordingly, in connection with a Facility with an ERISA Fund, it is imperative that the Facility documents contain representations and covenants from the ERISA Fund to support the conclusion that a prohibited transaction exemption is available for the transaction.

QPAM Exemption

One frequently used exemption is referred to as the "QPAM exemption."[8] This class exemption from the prohibited transaction restrictions of ERISA was granted by the Department of Labor for certain transactions between a plan and a party in interest where a qualified professional asset manager or "QPAM" has the responsibility for negotiating the terms of and causing the plan to enter into the transaction. If a loan constitutes a prohibited transaction, ERISA would preclude the ERISA plan from indemnifying the Lender for the excise taxes or other losses incurred by the Lender as a result of the violation of the prohibited transaction rules. For this reason, the Lender may require the QPAM itself to make representations and covenants confirming compliance with the QPAM exemption and to indemnify the Lender for any breach of such representations and covenants.

Service Provider Exemption

Another exemption potentially available is a statutory exemption (the "Service Provider exemption")[9] that provides broad exemptive relief from ERISA's prohibited transaction rules for certain transactions between a plan and a person who is a party in interest solely by reason of providing services to the plan, or by reason of certain relationships to a service provider, provided that the plan receives no less or pays no more than adequate consideration. The Service Provider Exemption is available for a broad range of transactions, including loans or a Facility. As noted above, one of the conditions of the Service Provider Exemption is that the plan neither receives less nor pays more than "adequate consideration." In the case of an asset other than a security for which there is a generally recognized market, "adequate consideration" is the fair market value of the asset as determined in good faith by one or more fiduciaries in accordance with regulations to be issued by the Department of Labor.[10] To date, the Department of Labor has not issued such regulations. Until applicable regulations are promulgated by the Department of Labor, Lenders may not be comfortable relying on the Service Provider Exemption.

STRUCTURING ALTERNATIVES FOR INCLUDING INVESTORS: MASTER/ FEEDER FUNDS

Certain Funds are structured with one or more feeder funds through which Investors invest in the Fund. Frequently, the feeder funds may not limit investment by benefit plan investors and may be deemed to hold the plan assets of such Investors. Accordingly, the prohibited transaction rules will apply to any feeder fund that does not satisfy the less than 25% exception to holding plan assets discussed above. The activity of such feeder funds is typically limited to investment into the master Fund, which is designed to satisfy an exception to holding plan assets. Since the Fund manager does not have discretion over feeder fund investments and transactions, the QPAM exemption would not be available for loans to the feeder fund. In such cases, the feeder funds generally do not enter into lending transactions directly, or even provide guarantees of master Fund loans. However, there are structures that can be established to make sure the Fund receives credit/ borrowing base capacity for the feeder fund. For instance, the feeder fund may pledge the unfunded Capital Commitments of its Investors to the master Fund. The master Fund, in turn, pledges those assets to the Lenders. Accordingly, the Lenders are entering into a transaction only with the master Fund, which does not hold plan assets, but the Lenders still have access to the feeder fund Capital Commitments to the extent included in the pledged assets.

Investor Consents

For various reasons, Lenders may require an Investor consent letter (also commonly referred to as an Investor letter or Investor acknowledgment), where an Investor confirms its obligations to fund Capital Contributions after a default to repay the Facility. To the extent that these Investor consents are sought from benefit plan investors, it is important to consider the ramifications of the plan asset regulation.

Even if a Fund satisfies one of the exceptions to holding plan assets set forth in Section 3(42) of ERISA or the plan asset regulation, an Investor consent directly between a Lender and a benefit plan investor could be deemed to be a separate transaction that may give rise to prohibited transaction concerns under ERISA and/or Section 4975 of the Code. Certain Lenders have obtained individual prohibited transaction exemptions from the Department of Labor to eliminate this prohibited transaction risk in connection with

Investor consents, provided the conditions of the exemption are satisfied. Each of these individual prohibited transaction exemptions assumed that the assets of the Fund were not deemed to be ERISA plan assets. Without an individual prohibited transaction exemption, it is essential that the Investor consents with benefit plan investors be structured so that such Investors are merely acknowledging their obligations under the governing documents of the Fund. Investor consents carefully drafted so Investors are acknowledging obligations arising under the Fund documentation (instead of being styled as an agreement between such Investor and the Lender) should not be viewed as "transactions" with the Lender for prohibited transaction purposes under ERISA or Section 4975 of the Code.

Loans Funded With Plan Assets

Typically Facilities are funded out of general assets of one or more Lenders, and not with ERISA plan assets. However, it is important to note that if a loan were funded in full or in part from, or participated to an account or fund comprised of ERISA plan assets, the ERISA prohibited transaction considerations discussed above would be triggered, regardless of whether the borrower Fund is deemed to hold plan assets. For this reason, borrowers often request Lenders to represent and covenant that the loan will not be funded with ERISA plan assets.

Conclusion

A Fund that contemplates taking advantage of the benefits associated with a Facility must be mindful of ERISA issues. Beginning with structuring the Fund with an eye towards the inclusion of ERISA Investors, through the selection and timing of Fund investments coinciding with the term of the Facility, careful consideration of the impact ERISA rules and regulations may have on the Fund can increase (or limit entirely) the available amount of the loan. Lenders must also pay particular attention to ERISA issues commencing with due diligence of the Fund and Investor documentation, through execution of final loan documents for the Facility and the necessary representations, warranties, covenants and required deliverables related thereto for purposes of limiting exposure to a violation of ERISA rules and regulations. With careful planning and attention to ERISA issues (including to those described above), the closing and execution of a Facility should not be hindered by these complex rules and regulations.

Please contact any of the authors with questions regarding these issues and the various methods for effectively establishing a Facility.

Endnotes

1 The prohibited transaction rules under ERISA are similar to the prohibited transaction rules of Section 4975 of the Code. For ease of reference, this newsletter will discuss ERISA.

2 The definition of "disqualified persons" in the Code differs from the definition of "parties in interest" under ERISA. For ease of reference, this newsletter will only refer to parties in interest.

3 In this newsletter, we discuss the Fund as though it is a single entity. If a Fund is comprised of multiple parallel funds, feeder funds and/or alternative investment vehicles, each entity that is a party to the Facility would need to satisfy an exception to holding plan assets or would need to rely on a prohibited transaction exemption in connection with the Facility.

4 For this discussion of the less than 25% test, we assume that the Fund is a single entity. If a Fund were comprised of multiple parallel funds and each parallel fund intended to rely on the less than 25% exception to holding plan assets, each parallel fund would be tested separately.

5 Again, we assume that the Fund is a single entity. If a Fund were comprised of multiple parallel funds, for example, and more than one parallel fund intends to operate as a VCOC, each such parallel fund would be tested separately.

6 We are assuming that the Lender did not fund the loan with plan assets of any benefit plan investor. See Section VI.

7 Nevertheless, a Lender may permit a Fund to make a small borrowing under the Facility (typically for purposes of paying costs and expenses incurred prior to closing of the Facility) before such initial qualifying investment, with the balance of the Facility available after the Fund demonstrates that it qualifies for an operating company plan asset exception following the qualifying investment.

8 See Class Exemption for Plan Asset Transaction Determined by Independent Qualified Professional Asset Managers, 49 Fed. Reg. 9494 (Mar. 13, 1984), amended by 70 Fed. Reg. 49,305 (Aug. 23, 2005) and 75 Fed. Reg. 38,837 (July 6, 2010).

9 See ERISA § 408(b)(17) and Code § 4975(d)(20).

10 See ERISA § 408(b)(17)(B)(ii) and Code § 4975(f)(10).

Net Asset Value Credit Facilities

ANN RICHARDSON KNOX, JASON BAZAR AND KIEL A. BOWEN

As real estate, buyout, infrastructure, debt, secondary, energy and other closed-end funds (each, a "Fund") mature beyond their investment or commitment periods (the "Investment Period"), they have often called and deployed the majority of their uncalled capital commitments ("Unfunded Commitments") on the acquisition of their investment portfolio (each, an "Investment").

As result, they often have greatly diminished borrowing availability under the borrowing base ("Borrowing Base") of a traditional subscription credit facility (a "Subscription Facility", often referred to as an "Aftercare Facility" when provided post-Investment Period). However, these post-Investment Period Funds still have significant ongoing liquidity needs, including funding follow-on Investments, letters of credit, ongoing fund expenses and the costs of maintenance and liquidation of their Investments. To address these needs, certain banks (each, a "Lender") have been working to structure financing solutions for Funds, recognizing that a fully invested Fund has inherent equity value in its Investment portfolio. Of course, lending against a Fund's equity value is a far different credit underwrite than a traditional Subscription Facility, so Lenders have historically been cautious in their approach. One solution we have seen has been to leave the Subscription Facility largely intact, but extend the Borrowing Base significantly to add borrowing availability. Under this approach, the Lender may set the advance rate for included investors ("Included Investors") to 100% with no concentration limits or even set the Borrowing Base itself equal to 100% of the Unfunded Commitments of all investors ("Investors") (i.e., not just Included Investors), but couple the increase with a covenant that the Fund must at all times maintain a certain minimum net asset value ("NAV"). The NAV covenant is typically steep from the Fund's perspective, and is designed to near fully mitigate the additional risk incurred by the Lender in connection with the more generous Borrowing Base. This Aftercare Facility approach is merely a way to extend the life of an existing Subscription Facility and, of course, provides no borrowing availability if the Fund has exhausted its remaining Unfunded Commitments. Similarly, some Funds' organizational documentation prohibits the entry of a Subscription Facility (or perhaps does not authorize the Fund to call capital to repay debt incurred after the end of the

Investment Period). These limitations therefore require Lenders to take a different approach, and one type of facility that certain Lenders are considering in these contexts is primarily based on the NAV of the Fund's Investment portfolio (hereinafter, an "NAV Credit Facility"). In this Legal Update, we set out the basic structure and likely issues that may present in an NAV Credit Facility.

Basic Structure

NAV Credit Facilities may take different forms based upon the structure of the Fund and its investments ("Investments") and the terms and structure of such facilities are typically underwritten on a case-by-case basis. However, such facilities share key structuring concerns as further described below.

BORROWING BASE

While NAV Credit Facilities may or may not explicitly articulate a Borrowing Base, they certainly have its components. Availability under an NAV Credit Facility is traditionally limited to an amount equal to the "Eligible NAV" of the "Eligible Investments," multiplied by an advance rate. The "Eligible NAV" typically equals the NAV of the Eligible Investments, less any concentration limit excesses deemed appropriate by the Lender under the circumstances. Typically the advance rates for these facilities are low in comparison to other asset-based facilities, reflective of both the lack of immediate liquidity of the Investments and the Lender's view of the Investments' likely cash flow and related value. "Eligible Investments" will typically be a subset of Investments that are not subject to certain specific adverse credit events as described below.

INVESTMENT PORTFOLIO

Many Funds that enter NAV Credit Facilities have a mature portfolio of Investments, so the Lender may assess at the outset which Investments should be included as "Eligible Investments" for the NAV Credit Facility. To the extent additional Investments may be added from time to time, Lender consent is generally required and criteria for inclusion may need to be met. Generally speaking however, "Eligible Investments" will typically be defined as those Investments that are not subject to any liens (although depending on the facility, leverage at the operating company level may be permitted and considered in the Lender's calculation of NAV) and that are not subject to certain specific adverse credit events. Assessing what credit events are relevant will turn on the particular asset class of the Investment. For example, standard eligibility criteria for Investments of a buyout fund will require that the underlying portfolio company not be in bankruptcy, not be in breach of any of its material contractual obligations, etc. Additionally, to the extent the Investment portfolio is made up of debt or equity issued by one or more third-party issuers, the status of the Investment itself as a performing or non-performing asset and the status of the issuer of such Investment may trigger the exclusion of the Investment from the Borrowing Base.

SECURITY PACKAGE

Some Lenders in certain high-quality asset classes will consider NAV Credit Facilities on an unsecured basis. But while most Lenders recognize that complete security over all the Investments is commercially challenging, there is a strong preference among Lenders towards a secured facility. Thus, while NAV Credit Facilities are not typically secured by all the underlying Investments, they are often structured with a collateral package that does provide the Lender with a certain level of comfort compared to an unsecured exposure. The collateral for these Facilities varies on a case-by-case basis, often depending on the nature of the Investments the Fund holds. In many NAV Credit Facilities the collateral includes: (1) distributions and liquidation proceeds from the Fund's Investments, (2) equity interests of holding companies through which the Fund may hold such Investments or (3) in some cases, equity interests relating to the Investments themselves. The method of obtaining the security interest in cash distributions and liquidation proceeds is similar to traditional Subscription Facilities. The Fund covenants that all cash from its Investments will be directed into (or immediately deposited into if received directly) an account that is pledged to the Lender and governed by an account control agreement. The Fund is prohibited from making withdrawals from the account unless the Borrowing Base is satisfied on a pro forma basis. Likewise, the steps needed to secure the pledge of equity are similar to equity pledges common in the leveraged loan market. Thus, in a workout scenario, the Lender could foreclose on the equity interest collateral, and either take ownership control of the interests in the holding companies or sell such equity interests and apply the foreclosure sale proceeds to its debt.

Key Issues

As with all asset-based credit facilities, NAV Credit Facilities have their share of issues and challenges. Two of the more common are: (1) the proper valuation/calculation of NAV for inclusion in the calculation of the Borrowing Base and (2) the legal challenges associated with an equity pledge, especially in the case where the pledge is the primary collateral support for the facility.

VALUATION

One of the primary challenges in an NAV Credit Facility is the Lender's comfort around the calculation of the NAV of the Investments, as Funds often invest in illiquid positions with no readily available mark. This risk may be somewhat mitigated by the Fund's historical performance track record, as well as the valuation procedures built into the Fund's organization documents (which procedures were likely blessed by the Fund's Investors at the outset of their initial investment). That said, Lenders typically require the ability to remark the Investments if they either disagree with the valuation provided by the Fund or if certain adverse credit events happen with respect to the Investments. Lenders may therefore require a third-party valuation process or even the ability to revalue the Investments themselves based on their own good faith judgment. Similarly, valuation timing is a related challenge because there is frequently a time lag between a valuation and a reporting date. Lenders often want certain covenants to report interim adverse credit events to mitigate inter-period risks.

PLEDGED EQUITY LIMITATIONS

When a pledge of holding company equity is included in the collateral package of an NAV Credit Facility, there are three primary legal challenges that Lenders may confront in an NAV Credit Facility: (1) perfection issues, (2) transfer restrictions and change of control provisions and (3) tax implications for the Fund.

Perfection Issues

The manner in which a Lender obtains a valid security interest in equity interests requires a legal analysis on how the equity interests should be categorized for perfection purposes. Equity interests in corporations are "securities" for purposes of Article 9 of the Uniform Commercial Code ("UCC") and, if such equity were represented by a certificate, the Lender would ordinarily perfect its security interest by taking possession of the certificate.[1] Portfolio companies formed as limited liability companies or partnerships raise different issues, in that the equity securities issued by such companies would ordinarily be characterized for UCC purposes as "general intangibles" (as to which the proper perfection method is the filing of a UCC financing statement); however, the UCC also permits such an entity to "opt into" Article 8 of the UCC, in which case the equity of such entity would be considered a security for UCC purposes instead of a general intangible.[2]

To the extent that obtaining a direct lien on the Investments is sought and all or part of the Investments of a portfolio company are held in street name in a securities account, the Lender may seek to obtain a securities account control agreement over the underlying account or a lien over the securities entitlement relating thereto in order to have the best means of perfection. In a case where custodial arrangements are used, the Lender will want to understand how such arrangements work.

Different perfection issues will arise if the equity to be pledged is issued by a non-US entity or is held in a non-US account. In such cases, laws of non-US jurisdictions may apply.

Transfer Restrictions and Change of Control Provisions

Lenders should be aware that the governing documents of the entity whose equity is being pledged, or even the credit agreements of the underlying portfolio companies or other Investments, may have transfer restrictions that prohibit some of the proposed collateral from being transferred or even pledged. Lenders should consider whether their counsel should review the governing documentation of the pledged equity (or the Investments) to identify such risks or if representations from the Fund will suffice. Similarly, in the case of buyout funds, because the value of the equity interest is derivative of the underlying business operations, Lenders may want to diligence material agreements (e.g. credit agreements, sale agreements, purchase agreements, etc.) of the pledged entity to identify any problematic "change of control" provisions. In the event these issues are present, a Lender could be deprived of the actual value of its pledged collateral when it sought to foreclose.[3]

Tax Implications

There can be significant tax implications for certain Funds that pledge their equity interests, including a "deemed dividend" issue in the case of certain controlled non-US entities[4] and, with respect to pledges of equity in certain non-US entities, such entities being treated as "Passive Foreign Investment Companies" ("PFICs") for US tax purposes.[5] Determining the applicability and impact of these tax concepts requires an in-depth look and understanding of both the Fund and the NAV Credit Facility. While these issues are beyond the scope of this Legal Update, there are certain structuring techniques that can be used to mitigate the impact to the Fund and the Lender.

Conclusion

As more Funds look to unlock the value of their underlying Investments to support credit facilities, we expect that Lenders will receive increased inquiries for NAV Credit Facilities. And while the underwriting process of NAV Credit Facilities is materially different from that of Subscription Facilities and requires different expertise, when structured properly, NAV Credit Facilities can offer an attractive risk-adjusted return for a Lender, while providing Funds needed liquidity and flexibility. We expect this financing market to expand in the future.

Endnotes

1 See UCC §8-103(a). A security interest in securities may be perfected by filing or by control. UCC §§9-312(a), 9-314(a). A security interest in securities perfected by control has priority over a security interest perfected by a method other than control. UCC §9-328(1).

2 See UCC §8-103(c).

3 Note that in certain instances these types of restrictions on transfer, to the extent contained in the organization documents of the issuers of the pledged equity, may be invalidated by the UCC. See UCC §9-406 and §9-408. Certain states, including Delaware and Texas, have non-uniform UCC provisions that make §9-406 and §9-408 inapplicable to equity in limited liability companies and limited partnerships. In other states, where the UCC provisions apply, the better view would seem to be that an anti-assignment provision would be completely invalidated by the UCC to the extent it applied to the pledge of an economic interest (right to receive distributions and other payments) but only partially invalidated as to a pledge of governance rights (in which case the secured party could take the pledge without causing a default under the limited partnership or limited liability company agreement, but could not enforce the pledge against the issuer, such as by having the issuer recognize the secured party as a member or partner). These issues are beyond the scope of this Legal Update, but could be relevant under the circumstances.

4 Subject to certain exceptions, a pledge of equity of a "controlled foreign corporation" (a "CFC") to secure an obligation of a US party related to such CFC may be considered a repatriation of the CFC's earnings to its shareholder and thereby taxed as a dividend. Generally, a CFC is a foreign entity (treated as a corporation for US tax purposes) the equity of which is characterized as more than 50% owned by "US shareholders." For purposes of this test, "US shareholders" are generally US persons treated as owning more than 10% of the voting equity in the foreign corporation.

5 A PFIC is generally any foreign corporation if (i) 75% or more of the income for the taxable year is passive income or (ii) the average percentage of the assets held by such corporation during the taxable year that produce passive income is at least 50%. Pursuant to the US Internal Revenue Code, if a US taxpayer pledges PFIC stock as security for a loan, the US taxpayer will be treated as having disposed of such PFIC stock (a "Deemed Disposition"). Consequently, such a Deemed Disposition may result in a taxable event for the US taxpayer.

Collateralized Fund Obligations: A Primer

J. PAUL FORRESTER

Collateralized fund obligations ("CFOs") emerged in the early 2000s as a means of applying securitization techniques developed for collateralized debt obligations ("CDOs") to portfolios of hedge fund and private equity fund investments (each, an "Investment").

CFOs allow portfolio investors, secondary funds and funds of funds (each, a "Fund Investor") an alternative and diversified capital markets financing solution and, potentially, a means of earlier monetization of their holdings. This article reviews the basic structures and features of a CFO.

The core concept of a CDO is that a pool of defined financial assets will perform in a predictable manner (that is, with default rates, loss severity/recovery amounts and recovery periods that can be reliably forecast) and, with appropriate levels of credit enhancement applied thereto, can be financed in a cost-efficient fashion that captures the arbitrage between the interest and yield return received on the CDO's assets, and the interest and yield expense of the securities (the "Securities") issued to finance them. Each of Fitch, Moody's, Standard & Poor's and DBRS, Inc. have developed CDO criteria and statistical methodologies and analyses to 'stress' a pool of specified CDO assets to determine the level of credit enhancement required for their respective credit ratings for the Securities issued to finance such pools.

These same concepts apply for CFOs and a number of CFOs were consummated prior to the financial crisis.

In a CFO, a bankruptcy-remote special purpose entity (the "CFO Issuer") purchases (or acquires directly) and holds a diversified portfolio of Investments. To finance the purchase, the CFO Issuer issues tranches of Securities secured by these assets. The majority of the Securities issued are debt instruments, with only a small portion consisting of equity in the CFO Issuer. Each tranche (other than the junior most tranche) has a seniority or priority over the other tranches, with "tighter" collateral quality tests that when triggered divert all interest and principal proceeds that would otherwise be allocable to more junior tranches to only the more senior tranches. This tranched capital structure allows an investor in the Securities to determine its preferred risk/return investment and an opportunity in the junior CDO tranches for enhanced returns due to the leveraged structure of the CFO.

Credit enhancement in the CFO is provided through overcollateralization, primarily through eligibility criteria and concentration limits. The rating agency methodologies in certain transactions have (at least in part) required that Investments be seasoned for some minimum tenor and that they be sponsored by fund managers (“Sponsors”) with a history of favorable performance. In addition, the rating agencies have required concentrations around “diversity” of Investment by style (i.e., early/late stage venture, buy-out, mezzanine, special situation, etc.), by industry and by commitment “vintages.” In addition, one pre-crisis CFO even had an unusual two-tier overcollateralization test that became more stringent if a trailing 12 month-volatility of the portfolio test exceeded certain specified levels. As with similar asset classes, the rating agency requirements for CFOs will inevitably change and evolve as the agencies gain more experience with them.

CFOs contain two primary structuring challenges. First, since many Investments will not have specified or consistent periodic payments (and may themselves be leveraged with senior secured and mezzanine debt), the dividends and other distributions on such Investments are difficult to predict and model. Thus, the capital structure of the CFO Issuer cannot not include significant current interest or other payment obligations (i.e., the CFO Issuer must issue zero coupon Securities) or must include a liquidity facility, cash flow swap or other similar arrangement to “smooth” cash flows to ensure timely payment of CFO liabilities. In addition, the typical private equity Investment requires an investor (in this case, the CFO Issuer) to commit to make capital contributions to the Investment in a maximum amount from time to time when called. As a result, unless such Investment is fully funded prior to being acquired by the CFO Issuer, the capital structure of the CFO must include available capital with sufficient flexibility (such as a revolving credit facility or a delay-draw tranche) to allow the CFO Issuer to make the required capital contributions.

Coming out of the financial crisis, we are seeing increased interest in CFOs. Fund Investors are attracted to the diversification of funding source, as well as the potential for longer term financing availability in the capital markets compared to the bank markets. CFOs allow such Fund Investors to realign their portfolios, freeing up capacity for additional Investments with favored Sponsors or rebalancing portfolios to desired Investment styles, industries or vintages. In addition, CFOs may offer certain institutional Fund Investors an opportunity for regulatory capital relief, as an Investment portfolio can be “exchanged” for CFO Securities that in the aggregate require such Fund Investor to hold less capital under applicable regulatory requirements since the senior tranches will be highly rated. Although we do not currently see an active market for the equity portion of CFOs, if it were to develop, CFOs could certainly provide an alternative liquidation solution to the more standard portfolio secondary sale. While we do not forecast a major uptick in the CFO market in the latter half of 2013, we do expect issuance to gradually increase to its pre-crisis levels, as investors look for attractive and more tailored opportunities. We see this as a positive for the market generally, as they offer increased liquidity, diversification and the potential to improve the transparency of their underlying Investment markets.

Benchmark Rate Reform: Orderly Transition or Potential Chaos?

J. PAUL FORRESTER

In the wake of several widely reported LIBOR and other benchmark rate manipulation scandals reflected in headline-grabbing stories of litigation and official inquiries and investigations,[1] followed in some cases by eye-popping related settlements,[2] policymakers have responded with varied attempts at benchmark rate reforms, which as of early April 2013 remain a work-in-progress.

Notably, the International Organization of Securities Commissions (IOSCO), issued a consultative paper in January 2013 that received more than 55 comments. On April 15, IOSCO issued a consultation report titled "Principles for Financial Benchmarks," which includes specific principles for governance, regulatory oversight and dealing with conflicts of interest.

Probably the most important pending benchmark rate reform as a practical matter is the implementation of the Final Report of The Wheatley Review of LIBOR and its 10-point plan for comprehensive reform of LIBOR (Wheatley Plan).

The value of potentially affected transactions (estimated in the Final Report to be in excess of $300 trillion) affirms the importance of appropriate LIBOR reform as well as the need to implement that reform in a way that does not unduly disrupt affected transactions or the related market. Unfortunately, some early practical experience with the implementation of point #6 of the Wheatley Plan—requiring that the British Bankers Association (BBA) cease compiling and publishing LIBOR for those currencies and tenors for which there is insufficient trade data to corroborate submissions—provides evidence that suggests market participants face a real risk of disruption.

Consistent with the Wheatley Plan, secondary legislation came into force in the United Kingdom amending the Regulated Activities Order and making the "administering of, and providing information to, specified benchmarks" a regulated activity under the UK Financial Services and Markets Act 2000. Currently, the only specified benchmark is BBA LIBOR, although recently reported investigations of possible manipulation of the ISDA swap rate[3] suggest that others soon may be added.

Also, as contemplated by point #6 of the Wheatley Plan, the BBA, after public consultation, announced in late 2012 a timetable for the discontinuance of compilation and publication of LIBOR for certain currencies and maturities (see Annex 1 to the BBA feedback statement), including a complete discontinuance of BBA LIBOR quotations for Australian dollars, Canadian dollars, New Zealand dollars, Danish krone and Swedish krona and the elimination of certain maturities (including two-week and nine-month) for euro, United States dollars, yen, sterling and Swiss francs. Certain of these discontinuances have already occurred, with the remainder scheduled to become effective in May 2013. ISDA has recently published commentary on these discontinuances, which includes a link to a form amendment letter.

Many lenders and borrowers have begun considering how their credit agreements are affected by these discontinuances. At this point, there does not appear to be market consensus about how best to deal with the discontinuance of LIBOR for interest period tenors and currencies. We can, however, suggest several steps that market participants should take.

Examine Existing Credit Facilities

Many credit agreements contain provisions that protect lenders from having to extend LIBOR loans in circumstances where a LIBOR quotation is not available. The following provisions should be reviewed carefully.

DEFINITION OF INTEREST PERIOD

Many definitions of "Interest Period" in credit agreements provide that interest periods of nine months are available to borrowers, but only if "available to" all relevant lenders. The fact that LIBOR is not being quoted by the BBA does not necessarily mean that it is not available to a lender. Credit agreements that currently provide that a nine-month interest period is available to the borrower if all relevant lenders agree or consent would deal with the issue more clearly.

DEFINITION OF LIBOR

Many credit agreements contain several alternatives for calculating LIBOR. The first (and preferred) alternative in most cases is a reference to the BBA rate, often as published on a specified data service. If such rate is not available, many definitions then provide for a variety of fall-back alternatives, including the following : (i) the agent determining a rate based on an average of rates for deposits for such interest period in the relevant currency offered to major banks in the interbank market; (ii) the LIBOR rate being set at the average rate for deposits for such interest period in the relevant currency offered to a set of specified reference banks (most often, several banks that are members of the lending syndicate); and (iii) the LIBOR rate being set at the rate for deposits for such interest period in the relevant currency offered to the agent. LIBOR definitions applicable to non-US dollar currencies may in certain cases refer to alternate, non-BBA benchmark rates. Alternatives other than referring to the BBA rate may be more cumbersome to work with, but they may allow for the possibility of continuing to borrow and fund loans in a currency or tenor for which the BBA has discontinued its rate.

MARKET DISRUPTION PROVISIONS

A common provision in many credit agreements is the so-called "market disruption" or "Eurodollar disaster" clause, which generally provides that if the credit agreement agent determines that "adequate and reasonable means" do not exist for ascertaining LIBOR for a requested borrowing for a particular interest period, or if a requisite number of lenders advise the agent that LIBOR for an interest period will not adequately and fairly reflect the cost to such lenders of making or maintaining their loans included in such borrowing for such interest period, the lenders are not obligated to fund such borrowing at LIBOR and (in the case of US dollar-denominated borrowings) that such borrowing will instead bear interest at the base rate.

It is possible that the market disruption clause might be invoked by lenders in a situation where, for example, the credit agreement permitted borrowings in a tenor that had been discontinued by the BBA, but where it was possible to determine LIBOR for such tenor under the credit agreement's LIBOR definition by virtue of an alternative to the BBA quotation set forth in such definition. In a proper case, the lenders might determine that the rate set by the reference banks did not adequately and fairly reflect the cost of lending by such lenders and therefore invoke the market disruption clause. Of course, invoking the market disruption provision may raise reputational and competitive issues for the lender doing so, especially if other lenders are not doing so.

It may be that certain market disruption clauses are too broad because they do not distinguish between the remedies that should be applied in a situation where a particular interest period is unavailable and situations where LIBOR is generally unavailable for all interest periods: for example, certain language may state that if adequate and reasonable means do not exist for ascertaining LIBOR for a requested nine-month interest period, that LIBOR borrowings of all tenors are unavailable. A potential workaround in such situations might be for the borrower to cease requesting borrowings in discontinued tenors, which may technically avoid triggering such a result.

The market disruption clause typically provides that in cases where borrowings in non-US dollar currencies are affected, the interest rate applicable to the borrowing is not the base rate but is instead a cost of funds rate. For example, under the Loan Market Association's form facility agreement, upon a market disruption event, each lender in a syndicated credit facility is to send to the agent a rate equivalent to the cost to that lender of funding its participation in the borrowing "from whatever source it may reasonably select." This could obviously lead to a situation where the borrower becomes obligated to pay several different interest rates for the loans comprising a single borrowing, which could be administratively burdensome, among other things. Alternatively, some credit agreements provide for the borrower and the lenders to negotiate a substitute interest rate in the event LIBOR becomes unavailable. The outcome of any such negotiation would of course depend on whether there was an appropriate substitute on which the parties might agree.

Possible Changes Going Forward

As noted above, we are not aware of a consensus approach dealing with these issues. We expect that credit agreement language on definitions of LIBOR and interest period, and the market disruption clause, may change to eliminate some of the issues set forth above. It is possible that certain of the discontinued tenors may no longer be used, at least as widely as they were before. For the discontinued currencies, other non-BBA benchmark rates will likely be used, such as CDOR for Canadian dollars or BBSW for Australian dollars, and, in fact, the BBA has suggested (but expressly declined to endorse) several possible local alternatives in the BBA feedback statement.

With respect to discontinued tenors, it may be possible to deal with such a situation by interpolating between two tenors that continue to be quoted, as suggested by ISDA for swaps.

With time the market is likely to identify and adopt substitute benchmark rates for those that are discontinued; however, it is unclear how much time this will take and, between then and now there will likely be issues of the kind that we describe (and undoubtedly others) that will require the attention of senior managers and counsel.

Endnotes

1 See, for example: "The Worst Banking Scandal Yet?," Bloomberg, July 12, 2012 and "Taking the L-I-E Out of Libor," Bloomberg, July 9, 2012.

2 Over $2.5 billion so far for Barclays, RBS and UBS with Swiss, UK and US regulators.

3 See, for example: "CFTC Said Probing ICAP on Swap Price Allegations: Credit Markets," Bloomberg, April 9, 2013.

Court Rejects PBGC Position That an Investment Fund Is Part of a Controlled Group for Purposes of Pension Liabilities of a Portfolio Company

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Late in 2012, in *Sun Capital Partners v. New England Teamsters* ("Sun Capital"),[1] a federal district court in Massachusetts (the "District Court") held that certain private equity funds were not trades or businesses that could be held jointly and severally liable for the pension obligations of a portfolio company in which such funds had invested.

In so holding, the District Court rejected a 2007 ruling of the Appeals Board of the US Pension Benefit Guaranty Corporation ("PBGC") that a private equity fund was engaged in a trade or business and, therefore, a member of one of its portfolio companies' controlled group for purposes of pension liabilities to the PBGC. The District Court's decision in the Sun Capital case was also a departure from a 2010 Michigan district court decision that examined similar facts and issues and found the PBGC Appeals Board's reasoning persuasive.[2]

While the decision in *Sun Capital* is an encouraging development, the issue is far from settled. Accordingly, as discussed below, in structuring their investments, private equity funds must continue to be mindful of the potential for controlled group liabilities for the pension obligations and liabilities of their portfolio companies.

Background

Under the Employee Retirement Income Security Act ("ERISA") and the Internal Revenue Code (the "Code"), all employees of trades or businesses, whether or not incorporated, that are under common control are treated as being employed by a single employer for purposes of applying various employee benefit requirements and imposing various employee benefit liabilities. As the guarantor (up to statutory limits) of participants' accrued benefits under private pension plans, the PBGC will seek to recover from the members of a controlled group the liabilities it has incurred as a result of an underfunded pension plan's termination. Under ERISA, withdrawal liability to multiemployer pension plans is also imposed on a controlled group basis. In addition, the PBGC lien that arises on the date of an underfunded plan's termination applies to all assets of a controlled group that includes the sponsor of the underfunded plan, and all members of a controlled group are liable for the payment of contributions to pension plans.[3]

The liability of a controlled group member for pension obligations under ERISA is joint and several. Because of this joint and several liability, the PBGC or a multiemployer plan may seek to recover against any member of the controlled group, including a private equity fund if it is deemed to be part of a controlled group. The PBGC need not look first to the actual sponsor of an underfunded pension plan for recovery.

Applicable regulations provide that trades or businesses are under common control if they are part of one or more chains of trades or businesses connected through ownership of a controlling interest with a common parent. In general, a controlling interest means stock possessing at least 80 percent of the combined voting power of all classes of stock entitled to vote, or at least 80 percent of the total value of all classes of stock of a corporation, or ownership of at least 80 percent of the profits interests or capital interests of a partnership.

THE APPEALS BOARD RULING

As noted above, in 2007 the PBGC Appeals Board ruled that a private equity fund (the "Fund") that owned an 80 percent controlling interest in a portfolio company was a "trade or business" and therefore a member of the portfolio company's controlled group for purposes of pension liabilities to the PBGC. As a member of the portfolio company's controlled group, the Fund (along with other portfolio companies owned 80 percent or more by the Fund) was held to be jointly and severally liable to the PBGC for the unfunded pension liabilities that the PBGC had assumed following the portfolio company's bankruptcy.

Under the Supreme Court case of *Commissioner v. Groetzinger*,[4] a person will be deemed to be engaged in a trade or business if (i) its primary purpose is to produce income or profit and (ii) its activities are performed with continuity and regularity. In its decision, the PBGC Appeals Board concluded that the Fund constituted a trade or business under the Groetzinger test because (i) the stated purpose of the Fund was to make a profit (its partnership tax returns stated that it was engaged in investment services) and (ii) it attributed the activities of the Fund's advisor and general partner to the Fund, which received consulting fees, management fees and carried interest, thereby satisfying the "continuity and regularity" test of *Groetzinger*. The PBGC Appeals Board distinguished two Supreme Court cases[5] and a Fifth Circuit opinion[6] holding that passive investment activities do not constitute a trade or business, finding that those cases dealt with individuals managing their own personal investments.

SUN CAPITAL

In *Sun Capital*, a multiemployer pension plan ("Multiemployer Plan") sought to recover approximately $4.5 million in withdrawal liability from two investment funds (the "Sun Funds") established by Sun Capital Advisors following the bankruptcy of Scott Brass, Inc. ("Scott Brass"), a portfolio company whose employees were covered by the Multiemployer Plan and that, prior to its bankruptcy, had made contributions to the Multiemployer Plan pursuant to a collective bargaining agreement. The Sun Funds together owned 100 percent of the equity interests in Scott Brass; Sun Fund IV held a 70 percent ownership interest and Sun Fund III held a 30 percent interest. The Sun Funds defended against the Multiemployer Plan's claims on the grounds that they were passive investors and therefore not trades or businesses and not under common control with Scott Brass.

In ruling that the Sun Funds were not trades or businesses, the District Court found that the Appeals Board had misread *Groetzinger* and had incorrectly limited *Higgins* and *Whipple*. In applying *Groetzinger* and finding that the Fund had engaged in investment activities with regularity and continuity (and, accordingly, was no mere passive investor), the District Court found that the Appeals Board incorrectly attributed the activities of the Fund's investment advisor and its general partner to the Fund itself. It also found no basis for limiting *Higgins* and *Whipple* to individuals, noting court cases and IRS rulings to the contrary.

The Multiemployer Plan also sought to hold the Sun Funds liable for its portfolio company's withdrawal liability under ERISA § 4212(c)[7], which imposes liability on parties to a transaction if a principal purpose of the transaction is to evade or avoid liability. The Multiemployer Plan argued that the Sun Funds' decision to invest in Scott Brass at a 70 percent/30 percent ratio was itself sufficient to trigger liability under ERISA §4212(c). In rejecting this theory, the District Court found that while the Sun Funds may have considered potential withdrawal liability when structuring their initial investments, it was not their principal purpose and that their structuring was not aimed at avoiding or evading a known or impending withdrawal liability. In reaching that conclusion, the District Court also distinguished between transactions that would evade or avoid withdrawal liability that is a predetermined certainty (such as a sale transaction involving a company for which withdrawal liability already exists) from transactions that minimize a prospective future risk of withdrawal liability.

The District Court also addressed the Multiemployer Plan's claim that regardless of whether or not the Sun Funds constituted trades or businesses, they should still be jointly and severally liable as partners of Scott Brass. The Multiemployer Plan argued that because ERISA, the Multiemployer Pension Plan Amendments Act of 1980 and applicable federal tax regulations do not recognize limited liability companies, Scott Brass should be considered an unincorporated organization and, by default, a partnership with liabilities extending to its partners (e.g., the Sun Funds). Rejecting this argument, the District Court concluded that Delaware law (and not federal law) was applicable and that under Delaware law, the Sun Funds, as members of a limited liability company, would not be personally responsible for any debt, obligation or liability of Scott Brass.

The Multiemployer Plan has appealed the District Court's decision in *Sun Capital*, and there are no federal appellate court decisions addressing this issue. The issue remains unsettled, and the PBGC has given no indication that it has changed its views on the issue. Accordingly, until there is more clarity regarding the application of ERISA's controlled group liability to private equity investment funds, such funds and their advisors should take controlled group liability considerations into account in structuring their investments. The lowest level of risk is, of course, an investment in a portfolio company in which the private equity fund's ownership percentage is always less than 80 percent, with unrelated entities or investors holding the remaining interests. If that is not feasible, consideration should be given to spreading the ownership interest among two or more funds.

Endnotes

1 No. 1:10-cv-10921-DPW, 2012 WL 5197117, (D. Mass. Oct. 18, 2012).

2 *Board of Trustees, Sheet Metal Workers' National Pension Fund v. Palladium Equity Partners, LLC*, 722 F. Supp.2d 854 (E.D. Mich. 2010). In this case (referred to herein as "Palladium"), two multiemployer pension plans brought an action against three private equity funds and their common advisor alleging that the funds were liable for the withdrawal liability of bankrupt portfolio companies in which the funds invested. The *Palladium* court found the PBGC Appeals Board's reasoning "persuasive" and described it as being "faithful to the general rule that no matter how large an investor's portfolio or how much managerial attention an investor pays to his investments, investing alone dœs not constitute a 'trade or business.'" The *Palladium* court described the standard coined by the Appeals Board as an "investment plus" standard. In applying this standard to the facts at hand, the *Palladium* court found that the private equity funds' activities might support a conclusion that the "investment plus" standard had been met. However, due to unresolved factual matters, the *Palladium* court did not reach a conclusion on the question.

3 Other liabilities or actions determined on a controlled group basis include liability under transactions in which a principal purpose of the transaction is to evade liability for unfunded pension benefits where the plan terminates within five years of the transaction (determined on the date of plan termination), liability for PBGC premiums, and the ability of a portfolio company to terminate an underfunded pension plan.

4 480 U.S. 23 (1987).

5 *Higgins v. Commissioner*, 312 U.S. 212 (1941) and *Whipple v. Commissioner*, 373 U.S. 193 (1963).

6 *Zink v. United States*, 929 F.2d 1015 (5th Cir. 1991).

7 29 U.S.C. §1392(c).

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