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Subscription Credit Facilities: Certain ERISA Considerations

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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).

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