

# Fund Finance Market Review

TRENDS AND DEVELOPMENTS IN THE SUBSCRIPTION CREDIT  
FACILITY AND FUND FINANCE MARKETS



In this Winter 2014 edition of our *Fund Finance Market Review* we discuss some of the more noteworthy trends impacting the subscription credit facility and fund finance markets, including our views of the challenges and opportunities likely to be present in 2014. We also explore some of the new and accelerating sources of capital for funds and the shifting legal and regulatory landscape affecting facility lenders. Special thanks to guest contributor, Gavin Rees, Director at Barclays, for submission of his article, “London, Paris, Stockholm, Moscow: European PE and Fund Finance Update.”

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# Winter 2014 Subscription Credit Facility Market Review

Ann Richardson Knox

Capital call subscription credit facilities (each, a “Facility”) continued their positive momentum in 2013 and had an excellent year as an asset class. As in the recent past, investor (“Investor”) funding performance remained as pristine as ever, and the only exclusion events we are aware of involved funding delinquencies by noninstitutional Investors (in many cases subsequently cured). Correspondingly, we were not consulted on a single Facility payment event of default in 2013. In addition to the very positive credit performance, the asset class seemed to enjoy significant year-over-year growth. Below we set forth our views on the state of the Facility market and the current trends likely to be relevant in 2014.

## Material Growth and Its Drivers

While the Facility market currently lacks an industry-accepted data collecting and reporting resource making it difficult to pinpoint the exact size of the market, we are confident based on our experiences as well as anecdotal reports from multiple Facility lenders (each, a “Lender”) that the Facility market expanded materially in 2013. As one available data point, the Mayer Brown LLP Facility practice was up 66% in 2013 compared to 2012, measured by volume of consummated transactions. This positive growth for Facilities in 2013 was driven by a confluence of factors, not the least of which was the uptick in the fund formation market (especially in the United States). According to Preqin data for the U.S.-based fund market, 485 closed-end real estate, infrastructure and private equity funds (each, a “Fund”) raised an estimated \$261 billion in gross capital commitments in 2013, which represents the highest levels seen in the market since 2008. This baseline growth in the number of prospective Fund borrowers clearly seeded the Facility market’s

growth, but other factors contributed extensively as well. We believe the Facility market would have expanded in 2013 even had the Fund formation market remained stagnant, as penetration into Funds that have historically not availed themselves of Facilities increased. Growth in 2013 was also supplemented by an increased recognition by Lenders of the quality of Facility collateral and, in reliance on that collateral quality, a greater comfort with customized Facility structures. Lenders clearly consummated Facilities in 2013, and included Investor capital commitments (“Capital Commitments”) in borrowing bases, that would not have satisfied underwriting requirements previously. Similarly, Funds extended many of their existing Facilities upon their maturity instead of calling capital and paying them off, in many cases even well after the termination of their investment periods. This continuity of use of Facilities throughout a Fund’s life cycle clearly contributed to 2013 growth as well.

## Challenges

2013 was not all roses and champagne for the Facility market however, as certain very real challenges emerged. Fund formation was not up uniformly across the globe; Europe and Asia still report very challenging fundraising environments for Funds, especially for relatively new fund sponsors (each, a “Sponsor”). These challenges resulted in the deferral and in some cases impracticability of potential Facilities. For Lenders, spread tightening had a very real impact on internal returns, as virtually every amend and extend consummated in 2013 priced flat to down from its precedent. And Facility structures trending downward on the credit spectrum created challenges for virtually every Lender in terms of internal credit approvals and policy adjustments. But on the whole and despite these challenges, 2013 was a very positive year for the Facility market.

## Key Trends

In our Summer 2013 Subscription Credit Facility Market Review, we identified four key trends that were impacting the Facility market: (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.<sup>1</sup> We think these trends hold. They bear repeating here because they will continue to have a material impact on the Facility market in 2014 and beyond.

But there are a number of additional trends that either presented or accelerated in the second half of 2013 that we believe will become increasingly relevant in the Facility market in the year ahead, including the following: (i) an improving global fund formation market, which will drive Facility

growth in 2014, especially in international sub-markets; (ii) an influx of new market participants in particular Facility sub-markets, bringing different structuring standards and mixing up existing competitive balances; (iii) an expansion of Investor interest in Facilities, including the exercise of influence into Facility terms and structure; (iv) Lender recognition of the positive historical credit performance of Facilities and a resulting comfort in expanding traditional frameworks and going further down the credit spectrum; (v) a constantly evolving regulatory environment for Lenders coupled with real difficulty applying promulgated regulation to Facilities; and (vi) continuing stress on some of the largest Investors—municipal pension funds—and accelerating interest in procuring defined contribution plan monies for Funds. We analyze each below.

### ► An Improving Global Fund Formation Market

We are seeing increased Fund formation activity globally, including in Europe and Asia which have been somewhat slower to emerge from the crisis. Based on 4th Quarter 2013 experiences and certain recent macroeconomic data, we are optimistic this positive trend will continue into 2014. According to Preqin data, non-North American based and focused Funds raised approximately \$144.4 billion in capital in 2013, up slightly from 2012. Additionally, according to Preqin surveys, 34% of all expected Fund launches in the market are targeted with a geographic focus in Asia. Thus, our expectation is that a moderate to healthy increase in consummated Funds will lead to additional expansion of the Facility market in 2014, perhaps with the biggest growth occurring outside of the United States.

### ► New Market Participants

The Facility market has for some time noted the efforts of new entrants (Lenders, law firms, etc.) trying to establish themselves in the space, each with different strategies and often with varying levels of success. In 2013 however, certain new entrant movements occurred or accelerated that have the potential

to be disruptive to the historical competitive dynamics, at least at the margins. For example, multiple European Lenders are investing in and building their capabilities in the United States. Unlike some of their new entrant predecessors, these Lenders have real, demonstrable execution capabilities, if primarily in a different sub-market. Similarly and in reverse, many of the dominant US Lenders are increasingly attentive to Europe and Asia, recognizing the positive opportunities those sub-markets may hold. Several US-based Lenders had demonstrable success in 2013, at least in Europe. As Lenders emigrate in both directions, they bring their historical Facility structures and underwriting guidelines to the new sub-market. As a result, Funds are increasingly finding themselves with term sheets for Facilities that are no longer distinguishable only by Lender name and pricing. Funds are now weighing significant structural variation (a traditional borrowing base vs. a coverage ratio, as a simple example) in their Facility proposals.

Along a parallel path, multiple regional US Lenders are expanding beyond their historical geographies and middle-market Fund roots, often in efforts to keep up with the growth of their Fund clients. Many of such regional Lenders have increased their Facility maximum hold positions to levels comparable to that offered by the money center Lenders, at least for certain preferred Funds. In fact, several of the regional Lenders made substantial progress increasing their relevance in the greater Facility market in 2013. As their Facility structures and underwriting parameters often differ from a traditional Facility, they are also altering the competitive landscape. Correspondingly, variances in Facility structure dictate the syndication strategy and prospects for a particular Facility, adding additional complexity to a transaction.

#### ► Expansion of Investor Influence Into Facilities

Investor recognition and consideration of Facilities is increasing, and Investors are taking a more active look at how Facilities are structured and what their delivery obligations are in connection with a Facility. Investor

side letters (“Side Letters”) now routinely incorporate provisions addressing the Facility, often displaying Investor efforts to carve back their delivery obligations to Lenders. We often see entire Side Letter sets with a limitation that Investors only need deliver financial statements made publicly available. Further, a few tax-exempt Investors have inserted themselves into Facility structuring, insisting that the parallel fund they invest through be only severally liable for borrowings under the Facility so as to preserve a more favorable tax structuring analysis with respect to the separation between the multiple parallel funds. Whether facilitated through the work of the Institutional Limited Partners Association or just via greater investing experience, Investors appear increasingly aware of the Facilities their Funds are entering.

#### ► Extension of Credit Guidelines

No doubt partly in response to both the excellent historical credit performance of Facilities and the competitive landscape, Lenders are increasingly willing to go further down the risk continuum than they have in the recent past. While this has been true for some time now with respect to the historical requirements for delivery from Investors of acknowledgment letters (“Investor Letters”) and legal opinions, we are now seeing a greater acceptance of less than ideal Fund partnership agreements (“Partnership Agreements”). Many Lenders are no longer requiring a near-verbatim recital of a historical form Investor Letter in the Partnership Agreement, but instead are accepting less explicit authorization and acknowledgment language. Similarly, Lenders are increasingly finding ways to get comfortable including municipalities with sovereign immunity issues, certain sovereign wealth funds and fund of funds in a borrowing base that have historically been excluded. We have also seen some shifting in view on Investor withdraw/cease funding rights in relation to a Fund’s breach of its representations regarding placement agents and political contributions, with some Lenders now willing to partially accept this risk, at least in limited concentration



scenarios. Further, we have seen a relatively significant expansion in the underwriting consideration of Fund assets, both in terms of supporting more aggressive borrowing bases and for mitigating other perceived credit weaknesses in a particular Facility, such as a tight overall limitation. Notably, many Lenders are now actively considering NAV-based facilities or hybrid variations (especially for Funds later in the life cycle), and we expect these trends to continue as Lenders look for higher yielding opportunities.

Importantly, in our view, we think the data supports these trends. We see this as a rational expansion based on the greater availability of positive historical Investor funding and Facility performance data; we have not yet seen many Facilities consummated which we deemed unduly risky or reaching.

### ▶ The Regulatory Environment

Lenders are, and have been since the crisis, facing a regulatory environment as challenging as we have seen in a generation. Many of the regulations emanating from the crisis are now moving to the finalization and implementation stages, and Lenders are having to adapt. Moreover, additional regulations continue to be proposed. Virtually every post-crisis law and regulation that has been proposed or implemented is not express as to Facilities, and judgment must be applied to determine the appropriate impact. For example, the Volcker Rule's application to Facilities, whether a Facility constitutes a "securitization" under the European securitization risk retention regulation CRD 122a and what outflow rate is appropriate under the recently proposed US Liquidity Coverage Ratio requirements are all occupying significant time at present.<sup>2</sup> We think it is quite possible some of these regulations will lead Lenders to offer structural variations to their Facilities, such as uncommitted Facilities or uncommitted Tranches within Facilities, as a means of counteracting some of the regulatory capital burdens accompanying changing regulation. We expect the regulatory environment will be increasingly relevant in 2014, as Lenders adapt to the shifting landscape.

### ▶ Municipal Pensions

Municipal pension funds ("Municipal Pensions") in the United States, often the flagship Investors in Facilities, are under ever-increasing economic pressures. Despite the relatively robust performance of the equity markets in the United States and the significant rebound in many real estate markets in 2013, the outlook for Municipal Pensions to meet their prospective funding obligations seemed to get bleaker on a real-time basis last year. Many states are actively making efforts to enact reform, but such reforms are severely limited by constitutional protections for earned and accrued benefits, let alone political gridlock. The initial holding by the U.S. Bankruptcy Court for the Eastern District of Michigan that Detroit has the ability to alter its pension obligations under Chapter 9 of the U.S. Bankruptcy Code combined with Illinois' massive funding deficiencies and reform struggles have furthered the uncertainty.<sup>3</sup> We expect Municipal Pensions to occupy the headlines throughout 2014 and for a considerable period of time to come. We think these funding deficiency challenges are ultimately (although not promptly or easily) solvable, and we expect a major part of any solution will include a greater emphasis on defined contribution plans ("DC Plans") for employees going forward. As a result, our expectation is that the credit profile of many Municipal Pensions will continue to trend negatively in 2014 and that Sponsors will be increasing their speed of pursuit of a Fund product for DC Plans. We forecast breakthroughs in this regard in 2014 and think Facility market participants should all be thinking about how the connection between DC Plans and Funds could best be structured to positively impact the Facility market.



## ► Additional Trends

In the coming years, we also expect to see healthy growth in the volume and frequency of commitments to Funds by sovereign wealth funds and in the use of separate accounts by Investors.<sup>4</sup> Preqin estimates show that in 2013 sovereign wealth funds surpassed the \$5 trillion mark for total assets under management, a number which is up more than \$750 billion from 2012 and nearly \$2.5 trillion since 2008. Meanwhile, 19% of Investors surveyed by Preqin currently invest through separate accounts, as opposed to only 7% a year ago. 64% of those surveyed indicated that separate account commitments will become a permanent part of their investing strategy going forward. Thus, including sovereign wealth funds in Facility borrowing bases and single Investor exposure when lending to separate accounts will become increasingly relevant for Lenders going forward.

## Conclusion

We project a robust Facility market in 2014 building on the growth and positive momentum experienced in 2013, but with challenges at the margins. We expect the number of Facilities consummated will continue to grow at a solid clip as fundraising improves, the product further penetrates the private equity asset class and a greater number of existing Facilities get refinanced. But we expect that Fund structural evolution, Investor demands and competitive dynamics will continue to challenge Facility structures and ultimately drive Facilities somewhat further down the credit continuum. ◆

## Endnotes

- 1 For a copy of our Summer 2013 Subscription Credit Facility Market Review, please go to <http://www.mayerbrown.com/Summer-2013-Subscription-Credit-Facility-Market-Review-07-29-2013/>.
- 2 For an in-depth review of applying the Liquidity Coverage Ratio to Facilities, please see Mayer Brown's Legal Update, Capital Commitment Subscription Facilities and the Proposed Liquidity Coverage Ratio, available at <http://www.mayerbrown.com/Capital-Commitment-Subscription-Facilities-and-the-Proposed-Liquidity-Coverage-Ratio-12-20-2013/>.
- 3 For more information about the initial holdings in the Detroit, Michigan bankruptcy proceeding, see Mayer Brown's Legal Update, Detroit, Michigan, Eligible to File Chapter 9 Bankruptcy, available at <http://www.mayerbrown.com/Detroit-Michigan-Eligible-to-File-Chapter-9-Bankruptcy-12-13-2013/>.
- 4 For more information regarding separate accounts, please see Mayer Brown's article, Separate Accounts vs. Commingled Funds: Similarities and Differences in the Context of Credit Facilities, available at <http://www.mayerbrown.com/Separate-Accounts-vs-Commingled-Funds-Similarities-and-Differences-in-the-Context-of-Credit-Facilities-07-29-2013/>.



# Management Fee Credit Facilities

Kristin Rylko

As the subscription credit facility market matures,<sup>1</sup> lenders seeking a competitive advantage are expanding their product offerings to private equity funds (a “Fund”) from traditional capital call facilities made to closed-end Funds to other financing products, including lines of credit to open-ended Funds, separate-account vehicles and net asset value facilities.<sup>2</sup> Another emerging product gaining traction in the market with some Fund sponsors (a “Sponsor”) is a so-called management fee credit facility (a “Facility”). A Facility is a loan made by a bank or other financial institution (a “Lender”) to the general partner (the “General Partner”) of the Fund or a Sponsor-affiliated management company or investment advisor (collectively, the “Management Company”) of a Fund, and has a collateral package that is distinct from other types of security arrangements commonly associated with Fund Financings.

The basic collateral package for a Facility consists of the General Partner’s or Management Company’s, as applicable, right to receive management fees (“Management Fees”) under the Fund’s limited partnership agreement (the “Partnership Agreement”) or other applicable management or investment advisory agreement (the “Management Agreement”), and rights related thereto, together with a pledge over the deposit account into which the Management Fees are paid (the “Collateral Account”). A control agreement among the General Partner or Management Company, the Lender and the depository bank would be needed to perfect the Lender’s security interest in the Collateral Account. Additionally, since the General Partner, the Management Company or another Sponsor-affiliated entity (a “Special Limited Partner”) generally has an equity investment in the Fund, the security for a

Facility may also include a pledge by such entity or other Sponsor-affiliated investing entity’s right to receive distributions from the Fund and, in some instances, its limited partnership interest.

## Background

In a typical Fund structure, the General Partner or the Management Company receives Management Fees as compensation for evaluating potential investment opportunities, providing investment advisory services and attending to the day-to-day activities of managing the Fund.<sup>3</sup> The Management Fee also covers operating expenses (such as overhead, travel and other general administrative expenses) as well as salaries for the Management Company’s investment professionals and other employees. The Management Fee payable by an Investor is often determined by multiplying a

percentage<sup>4</sup> times such Investor's capital commitment. In addition, some Management Fee structures include a component that is based on the Fund's performance so as to provide additional incentive to the General Partner or the Management Company to maximize the Fund's performance.

Facilities are becoming increasingly popular for a number of reasons. First, Sponsors may find a Facility attractive because it provides the Sponsor (or applicable affiliated entity) with immediate capital to smooth its cash flow and pay operating expenses in between the typically quarterly or semiannual payments of the Management Fees it receives. Second, post-economic downturn, Investors are increasingly interested in seeing Sponsors make larger investments in the Funds they manage to increase their "skin in the game" and further align the Sponsor's and Investors' interests in maximizing Fund performance. By leveraging the income stream from future expected Management Fees, a Facility may help enable a Sponsor or its Special Limited Partner to make a larger commitment to a Fund than it otherwise may be able to commit. Also, to the extent a Sponsor or its Special Limited Partner is an Investor in a Fund, a Facility may be drawn on short notice to permit the Sponsor or Special Limited Partner to honor a capital call prior to receipt of cash from the principals or employees that ultimately constitute the Sponsor or Special Limited Partner. From the Lender's perspective, aside from earning revenue from the fees and interest income generated by a Facility, providing a Facility to a Fund is also a chance for the Lender to broaden its relationship with the Sponsor and develop a deeper understanding of the Sponsor's business and its potential financing needs. This in turn may lead to opportunities for a Facility Lender to provide other products such as subscription credit facilities, net asset value facilities, portfolio-company level financings or perhaps even private wealth products to the Sponsor's principals.

While there are many potential benefits to both a Sponsor and a Lender associated with a Facility, it

is important to note that a Facility is best-suited for established Sponsors that have significant Fund management experience and a proven track record of receipt of the Management Fees, ideally from a diverse platform of Funds. Management experience and an uninterrupted history of receiving the Management Fees are important because the Lender is ultimately looking to the Management Fees as the source of repayment of the Facility in underwriting the risk associated with lending to a particular Sponsor.

Even though Management Fee performance history and management experience of a particular Sponsor may make it an ideal candidate for a Facility, as more fully described below, not all Funds will have Partnership Agreements, Management Agreements or Management Fee structures that are suitable for a Facility. Further, some Partnership Agreements limit the General Partner's or Special Limited Partner's right to pledge its equity interest in the Fund, although, a pledge of any distributions associated with such equity interest may be possible. Thus, the Partnership Agreement and/or Management Agreement must be carefully analyzed to confirm that the intended collateral can be granted to the Lender and the Lender will be able to adequately enforce its rights against the collateral.

### Structure and Loan Documentation

Facilities are typically structured as revolving lines of credit to the General Partner or Management Company (depending on the Fund's structure), secured by a pledge by the General Partner or the Management Company of its right to receive the Management Fees and the account into which such Management Fees are paid. If the Sponsor group has made an investment in the Fund through a Special Limited Partner or other affiliated entity, the collateral package may also include a pledge of the right to receive distributions from the Fund and the account into which such distributions are paid. If the Sponsor manages more than one Fund, the collateral package may include Management Fee

streams from multiple Funds and the right to distributions from those Funds.

The basic loan closing documentation for a Facility will typically consist of (i) a credit agreement, (ii) a security agreement pursuant to which the General Partner or the Management Company assigns its rights under the Partnership Agreement or the Management Agreement, as applicable, to receive and enforce the payment of Management Fees and proceeds thereof, (iii) a pledge of the Collateral Account into which Management Fees are to be paid, (iv) a control agreement covering the Collateral Account to perfect the Lender's security interest therein and permit the blocking of such account by the Lender, (v) a security agreement from the Special Limited Partner or other Sponsor-affiliated entity pledging its right to receive distributions from the Fund, if it is the part of the collateral package, together with a pledge of the deposit account into which such distributions are to be paid and a control agreement covering such account, (vi) Uniform Commercial Code financing statement(s) filed against the applicable pledging entities, and (vii) and customary opinion letters, certified constituent documentation of the Fund and pledging entities, evidence of authority and related diligence items.

In addition to the traditional collateral package, it is not uncommon for a Lender to receive a personal guaranty by one or more of the principals in the General Partner, the Management Company or Sponsor to support the Facility. The extent of such a guaranty is often negotiated, and it is not unusual for a principal's guaranty to be limited to a capped amount based on its pro rata ownership percentage of the underlying Fund and the related outstanding balance of the Facility, as opposed to a more traditional unlimited (or joint and several) guaranty of the Facility. A guaranty may also be delivered by the Special Limited Partner, the General Partner or the Sponsor, depending on the structure of the Facility and the identity of the borrower under the Facility.

The terms of a Facility will typically include customary representations, warranties, affirmative and negative covenants and events of default that a Lender would expect to see in any secured financing, along with a few provisions that are tailored to address the unique features of a Facility's collateral package. Such provisions may include a requirement that the General Partner or the Management Company receive a minimum amount of Management Fee income, or that the amount of Management Fees received does not fall below a certain specified percentage of the aggregate commitments of the Fund's Investors. A Facility will normally include limitations on amending the Partnership Agreement or the Management Agreement, and prohibitions on terminating or waiving the General Partner or the Management Company's right to receive payment of Management Fees. Additionally, so that the Lender can monitor the Fund's overall performance (and have advance warning of potential performance issues that may give rise to a reduction in Management Fees or Investors balking at paying Management Fees), a Facility will usually require regular financial reporting and may also include a minimum net asset value test with respect to the Fund's investments or a similar financial covenant with respect to the General Partner, Management Company or Special Limited Partner, as applicable, and its investment in the Fund. Some Facilities that include a pledge of distribution rights may contain a maximum loan-to-value or similar metric measured by looking at the Special Limited Partner's pro rata share of the underlying portfolio investments in the Fund.

### Partnership Agreement & Management Agreement Diligence

As part of due diligence for any Facility, a Lender must carefully review the Partnership Agreement and Management Agreement for any restrictions on the right of the General Partner or the Management Company to pledge its right to receive Management Fees or the Special Limited Partner's ability to

pledge its right to distributions. For example, a potentially problematic, though not uncommon, restriction is that the General Partner or Special Limited Partner cannot pledge its economic interest in the Fund, which would include its equity interest, without the consent of a certain percentage of the other Investors in the Fund. Some Partnership Agreements allow for such pledges without the consent of the other Investors while others do not. To the extent Investor consent is required, it may be an impediment to entering into a Facility.

In addition, the Partnership Agreement or the Management Agreement should be reviewed to determine how Management Fees are paid, and whether they may vary over time. For example, the Management Fee may decrease upon termination of the period in which the Fund is permitted to make new investments. It is important for the Lender to understand whether Management Fees are paid by the Investors directly to the General Partner or the Management Company, or if Management Fees flow through the Fund and/or the General Partner (or another affiliated entity) to the Management Company, as applicable, so that the relevant Fund-related entities are included within the scope of the collateral documents to minimize potential leakage, if necessary.

Some Partnership Agreements provide for Management Fee offsets, whereby receipt by the Sponsor, its principals, employees or other affiliates of advisory, break-up or other similar fees and income related to the investment activities of the Fund may reduce the amount of the Management Fee. The Partnership Agreement and the Management Agreement should be reviewed to determine if such offsets exist, and the Lender should consider whether the loan documentation should prohibit the General

Partner or the Management Company from applying any discretionary offsets if possible. Alternatively, the Lender may consider requesting that any such advisory fees or other income or proceeds that may be offset against Management Fees be included as part of the collateral package in addition to Management Fees if the Fund's documents permit it.

In underwriting a Facility, Lenders will want to keep in mind that while the Partnership Agreement and the Management Agreement will dictate whether a Facility is permissible and how and when Management Fees are to be paid, exogenous events may occur that could affect the payment of Management Fees. For example, in the late 2000s during the market downturn, Sponsors with troubled Funds in fact suspended or eliminated their Management Fees. Even though such activities would be prohibited by the loan documentation for a typical Facility, it is important for Lenders to consider the overall investment and economic environment in which a Fund operates, as market conditions may stress the underlying underwriting assumptions of a Facility.

### Conclusion

While Management Fee Facilities have not been very common to date, they are becoming increasingly popular and offer an opportunity for a Lender to kick off or expand its relationship with a Fund Sponsor. With a careful review of the relevant operating and constituent documentation of a Fund, it may be possible to structure a Management Fee Facility to offer a seasoned Fund Sponsor increased liquidity while satisfying a Lender's underwriting criteria. Please don't hesitate to contact any of the authors with questions regarding these Facilities, including the various structures that can be implemented in connection with their establishment. ♦



## Endnotes

- 1 A subscription credit facility, also known as a capital call facility, is a loan made by a bank or other credit institution to a private equity fund, for which the collateral package is the unfunded commitments of the limited partners in the fund (the “Investors”) to make capital contributions when called by the fund’s general partner (as opposed to the underlying investment assets of the fund). For a more detailed description of the subscription credit facility market and features of the subscription credit facility product in general, please see Mayer Brown’s Fund Finance Markets Legal Update “Summer 2013 Subscription Credit Facility Market Review.”
- 2 For an in-depth analysis of certain alternative Fund financing products, please see Mayer Brown’s Fund Finance Market Legal Updates “Structuring a Subscription Credit Facility for Open-Ended Funds,” “Separate Accounts vs. Commingled Funds: Similarities and Differences in the Context of Credit Facilities” and “Net Asset Value Credit Facilities.”
- 3 Depending on the Fund’s structure, Management Fees may be paid by the Investors through the Fund or GP to the Management Company or directly to the Management Company.
- 4 Historically, the percentage has usually ranged from 1.5% to 2% per annum.

# Foreign Investor Capital: Collateral Enforceability and Minimization of Risk

Due to previous challenges in the United States fundraising market for sponsors of real estate, private equity and other investment funds (each a “Fund”), many Fund sponsors have sought to expand their sources of capital to include investors domiciled outside of the United States (“Foreign Investors”). As such, Fund sponsors are increasingly requesting that the unfunded capital commitments of these Foreign Investors be included in the borrowing availability (the “Borrowing Base”) under the Fund’s subscription credit facility (a “Subscription Facility”).

While traditionally Funds have not chosen their lenders solely based upon whether such lender would include Foreign Investors’ capital commitments in the Borrowing Base, it is becoming a more critical factor. Consequently, understanding and addressing collateral enforceability issues related to Foreign Investors has become increasingly important for lenders. Below we set out our views on common concerns regarding collateral enforceability and some possible solutions for minimizing such risk.

## Subscription Credit Facilities and Foreign Investors

A Subscription Facility, also frequently referred to as a capital call facility, is a loan made by a bank or other credit institution (a “Lender”) to a Fund. The defining characteristic of such Subscription Facility is the collateral package, which is comprised not of the underlying investment assets of the Fund, but instead by the unfunded capital commitments (“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’s general partner (the “General Partner”). The loan documents for the Subscription Facility contain provisions securing the rights of the Lender, including a pledge of (a) the unfunded Capital Commitments of the Investors, (b) the right of the 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 (c) the account into which the Investors fund Capital Contributions in response to a Capital Call. Such rights of the Fund and its General Partner are governed by the Fund’s constituent documents, including its limited partnership agreement or operating agreement (collectively, the “Constituent Documents”).

Lenders have become comfortable with this collateral package because of (i) their ability to select high-credit quality Investors whose Capital Commitments comprise the Borrowing Base, and (ii) in the event that an Investor fails to fund its

Capital Commitments, ability to enforce payment of its Capital Contributions in and under the laws of the United States. However, as the momentum toward including Foreign Investors in the Borrowing Base increases, Lenders are facing new challenges, including (i) the ability to determine the credit quality of Foreign Investors and (ii) the ability to enforce the payment of Capital Contributions from these Foreign Investors.

### Key Issues

The three primary collateral enforceability issues that arise in connection with Foreign Investors include (i) as with all Investors, obtaining financial and other information during the due diligence process necessary to properly assess such Foreign Investor's creditworthiness; (ii) obtaining jurisdiction in the courts of the United States over such Foreign Investor; and (iii) enforcing judgments issued by a court of the United States against such Foreign Investor.

### Due Diligence

The Subscription Facility due diligence process typically includes obtaining and reviewing (i) the Constituent Documents of the Fund; (ii) the form subscription agreements ("Subscription Agreements") executed by each Investor detailing, among other things, such Investor's willingness to be bound by the terms and conditions of the Constituent Documents and disclosing, among other things, certain information of such Investor; and (iii) other side agreements ("Side Letters" and, together with the Subscription Agreements, the "Subscription Documents") detailing alterations or exceptions, if any, to the Fund's partnership agreement and/or the form of Subscription Agreement.

For Investors domiciled in the United States ("US Investors"), Lenders have typically included in the Borrowing Base investment-grade, non-investment grade and non-rated institutional Investors. Assessment of the credit quality of such Investors has been relatively uncomplicated. Conversely, with

regard to Foreign Investors, Lenders have been reluctant to assess their credit quality, often citing lack of financial information, which Foreign Investors are reluctant to provide for confidentiality reasons.

Nevertheless, Fund sponsors are becoming more aware of the need to obtain financial information from their Foreign Investors and are raising the matter earlier in the solicitation process. We anticipate that acquiring financial information from Foreign Investors whom the Fund would like included in the Borrowing Base will become a more customary part of the overall diligence process. However, many Foreign Investors have and are continuing to push back on requests for non-public information. It is not uncommon for a Foreign Investor to negotiate such a provision in its Side Letter with the caveat that it will cooperate with reasonable information requests from the Fund sponsor if necessary in connection with obtaining a Subscription Facility. Lenders will almost certainly require financial information from the Foreign Investor (or its parent entity) before giving the Fund full Borrowing Base credit for such Investor (credit that is typically at a 90% advance rate). Where the Foreign Investor is a subsidiary or special purpose vehicle owned by a parent entity with substantial credit quality, a guarantee or comfort letter providing direct credit linkage to the parent will often be required by Lenders before giving full Borrowing Base credit to the subsidiary or special purpose vehicle. Lenders are more often than not gaining comfort regarding credit quality from most Foreign Investors by obtaining financial and/or other information regarding such Foreign Investors from publicly available sources. We have also seen, and expect to see more, Lenders cooperating with their foreign affiliates to obtain additional information. Lenders relying on such information are often giving creditworthy Foreign Investors some Borrowing Base credit (at times at a 60-65% advance rate), which are often subject to tight concentration limits (both individually and as a class of Foreign Investors) and sometimes even

skin-in-the-game tests aimed to limit the Lenders' risk and overall exposure to this class of Investor. We expect to see the treatment of Foreign Investors develop over the coming years as the information becomes more transparent and these Investors become more critical to a Fund's Borrowing Base.

### Jurisdictional Issues

Foreign Investors can take the form of either individuals or entities, including governmental pension plans, state endowment funds, sovereign wealth funds and other instrumentalities of foreign governments ("Governmental Investors"). Such Governmental Investors are becoming more prevalent and are often some of the largest Investors in the Investor pool. For Lenders, the common concern with including such Investors in the Borrowing Base has been whether certain sovereign immunity rights, rooted in the common law concept that "the King can do no wrong," could provide a defense against enforcement of such Investor's obligation to make Capital Contributions after an event of default. Although sovereign immunity in its purist form could shield a governmental entity from all liability, Governmental Investors must be evaluated on a case-by-case basis to ascertain if any sovereign rights apply and, if so, whether such Investor has effectively waived its immunity.<sup>1</sup>

With regard to Foreign Investors generally, some Lenders have been reluctant to include such Investors due to concern with litigating and enforcing judgments in a United States court. A United States court's ability to hear a case involving allegations against a foreign person or entity is governed by the laws of the applicable state and the Constitution. The laws of most, if not all, states provide that parties to a contract may select their governing law and venue for litigating disputes arising under such contract. For this reason, most, if not all, Subscription Documents and Constituent Documents include these provisions. Most often, either New York or Delaware is selected as the

governing law and venue under these documents. Furthermore, most, if not all, Constituent Documents include provisions that would allow the General Partner (or Lender in the case of a default and failure of such Foreign Investor to fund its Capital Contribution) to liquidate the applicable Foreign Investor's partnership interest or offset damages against distributions that would otherwise be payable to the Foreign Investor.

Lenders can additionally gain comfort by obtaining Investor consent letters, also commonly referred to as Investor letters or Investor acknowledgments ("Investor Letters"), wherein such Foreign Investor would confirm its unconditional obligation to fund its Capital Contribution, in accordance with the Subscription Documents and Constituent Documents. These letters could also address forum, venue and sovereign immunity provisions directly in favor of the Lenders.

To the extent that forum and venue selection provisions are included in the Subscription Documents, Constituent Documents or Side Letters, the Lender can seek to enforce such provisions against a defaulting Foreign Investor, as assignee of the General Partner's rights, under the collateral documents of the Subscription Facility. Such Lender could file a lawsuit or arbitration claim directly against such Foreign Investor in the applicable United States court or tribunal. While service of process on such Foreign Investor is always a concern when filing such a lawsuit or arbitration claim, Lenders could gain comfort by requesting in an Investor Letter (i) the designation of a United States entity to accept service of process and/or (ii) the express waiver of any objection as to adequacy of such service of process, so long as it has been effected. Similarly, as Fund sponsors become more aware, it is likely that such Fund sponsors will include comparable provision in Subscription Documents and Side Letters. Alternatively, the inclusion of arbitral provisions in Subscription Documents, Constituent Documents or Side Letters

would avoid recognition and enforcement issues in most instances and would mitigate sovereign immunity claims in the case of most Governmental Investors. Immunity concerns (except to the extent otherwise covered in the Foreign Investor's Subscription Documents, Side Letters or Investor Letters) could additionally be overcome via the Foreign Sovereign Immunities Act of 1976 and the exceptions included within Sections 1605-1607 thereof, including an exception for commercial activity that has a nexus to the United States.

### Enforcement of Judgments

If a judgment is obtained against a Foreign Investor in a United States court, it may be difficult for the Lender to enforce such judgment against such Investor in the United States, unless such Foreign Investor has assets in the United States that are not otherwise subject to immunity. Therefore, the concern for many Lenders is whether such judgment could be enforced against such Foreign Investor in its country of domicile. While there is currently no treaty between the United States and any other country regarding recognition and enforcement of judgments, the United States is a party to some multilateral treaties requiring the recognition and enforcement of arbitral awards. For this reason, it is generally advisable to include submission to arbitration provisions in Subscription Documents, Side Letters and Investor Letters, as applicable, in which Foreign Investors are a party.

To the extent that enforcement is sought in the Foreign Investor's country of domicile, the law of such country will determine whether any judgment is enforceable. Most countries with developed legal systems do have laws that provide for the recognition of legitimate judgments issued abroad. If the amount of damages does not appear excessive, foreign countries will typically consider, among other matters, whether (i) the court had proper jurisdiction, (ii) the defendant was properly served or otherwise had sufficient notice, (iii) the proceedings were fraudulent or otherwise fundamentally unfair, and (iv) the judgment violates the public policy of such foreign country. As with most litigation involving foreign parties, local foreign counsel should be consulted as to the particular laws of the applicable country.

### Conclusion

As fundraising challenges persist, Funds will continue to seek additional sources of capital, including Foreign Investor capital. As Lenders adapt to meet the changing needs of their clients, we expect to see the Capital Commitments of Foreign Investors being included in the Borrowing Bases of more Subscription Credit Facilities. Those Lenders that can quickly and effectively evaluate the creditworthiness of these investors will be well-positioned to receive additional opportunities from their Fund clients. ♦

### Endnotes

- 1 "Sovereign Immunity Analysis in Subscription Credit Facilities," Mayer Brown Legal Update, November 27, 2012.

# London, Paris, Stockholm, Moscow: European PE and Fund Finance Update

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## 2012 VS. 2013

In 2012, growth in the European PE sector, in contrast to its more vigorous US counterpart, remained pedestrian. The Eurozone sovereign debt crisis continued to concern North American investors, austerity economics dampened economic growth prospects, and disparities in asset valuations between PE buyers and institutional sellers made deployment of capital difficult. Raising new commitments was hampered by the weight of dry powder in existing funds, and divestment levels remained low, limiting the amount of capital that could be returned to investors (total exit value in Europe was 34% down on 2011, compared with 18% globally). Europe held on to its #2 PE position more due to a cooling of the Asia-Pacific region than any renewed vigour across the Old World.

2013, however, seems to have witnessed an improvement. First and final closings have become more frequent, with funds raised also by managers outside of the gilded top 20 firms. Credit markets in Europe are active (the “refinancing cliff” has been managed, leverage multiples have soared), and IPO (\$18bn for Q1-Q3 2013, 3x that for the same period in 2012) and PE-backed buy-out (\$27bn in Europe in Q2 2013, compared with \$29bn in North America) activity has rebounded. Signs of recovery are apparent in various European economies, including the UK, and business sentiment is turning positive.

Managers have plugged the holes left by nervous US investors with commitments from Northern European, Asian and Middle Eastern investors, as well as establishing dual-currency (EUR and USD) fund structures. While the dual-currency approach does not fundamentally alter the risks associated with investing in Eurozone-focussed funds—and also creates administrative and hedging headaches for the manager—it can provide succour to foreign investors concerned with the fate of the Euro.

## Winners and Losers

The performance of European funds has been chequered. A growing disparity has emerged between the performance of top-quartile players and the remainder, which points toward a continued shake-out of managers. Investors, particularly those from North America with continuing reservations about the fate of Europe, will only be successfully wooed by teams with compelling track records, management stability and the ability to turn unrealised gains into distributions.

Certain PE sectors (distressed debt, infrastructure, mid-market buy-out) and geographies (Scandinavia, Northern Europe and the UK, where in 2012 the value of new fund-raising and exits increased to £5.9bn and £7.2bn respectively) gained momentum, whilst others—notably Southern Europe—remain a bridge too far for investors seeking yield (though optimism remains



unabashed: despite only €1bn being committed to Italy- and Spain-focussed funds since 2010, 15 buy-out firms with this focus intend to come to market in 2014, seeking an aggregate €4bn of capital). As in the US, investors are seeking creative ways to invest in PE on their terms, through separate accounts, investor “clubs” or direct sponsorship. Some managers are settling on “stop-gap” funds—comprising smaller total commitments from friendly repeat investors—to help keep the lights on for the next two years, in the hope that conditions improve to allow for a fully fledged fund-raising down the road.

### Luxembourg Re-invented

The UK remains the hub for European PE managers. In 2012, 53% of total investments from London-based PE firms were invested in Continental Europe. By extension, the vast majority of European fund structures remain English, Guernsey or Jersey limited partnerships. However, this dominance will come under pressure with the introduction in 2013 of the Luxembourg “special limited partnership” structure, established with the express intent of mirroring the well-understood Anglo-Saxon LP/GP model in the AIFM-compliant Grand Duchy. Meanwhile, in France, law firms are successfully striving to establish bridging facility structures for FCPR funds, which will place lenders in a position comparable to that where they lend to UK limited partnerships.

These breakthroughs will incentivise European managers (perhaps with no connection to the UK other than the domicile of its fund vehicles) to contemplate establishing new funds in Luxembourg or France. This may, in turn, increase the level of continental European bank involvement in the PE funds finance market, which has, to this point, been underweight.

### Competition Intensifies

The differences between the US and European fund finance markets have become less distinct, with subscription facility structures becoming increasingly harmonised. Over the last five years, the London fund finance market has seen an influx of North American players, such that competition is as likely to come from a New York- or Charlotte-based bank as one of the three or four large UK banks active in this sector. Furthermore, given the slower fund raising pace in Europe, the funds finance market has, if anything, become more competitive than in the US, with a gaggle of providers chasing more limited opportunities.

The UK banks’ ability to provide for the broad needs of European PE firms and their investee companies has been challenged by the deep pockets and innovative approaches to subscription facility structures of US players. Competition is made more intense by the tendency of managers to favour bilateral solutions and, where clubs of banks are formed, for the manager itself to do the match-making. Also, a number of managers with significant London presences have been bought by US entities (BlackRock/MGPA, Rockefeller Group/Europa, ARES/AREA), further enticing to these shores US lenders with strong ties to the acquiring organisations. However, the ability to deliver soup-to-nuts onshore and offshore solutions to fund managers and their administrators, paired with a full-service European investment bank offering, is still a significant additional string-to-the-bow for certain UK banks.

Given the tendency for UK facilities to be bilateral rather than syndicated, and for managers to exercise more loyalty to traditional banking partners, customisation of fund facilities has always been par for the course in Europe. However, banks in the European market have increasingly looked beyond cookie-cutter subscription lines towards more

esoteric approaches to bridging facilities, such as incorporating non-institutional investors into borrowing bases, hybrid structures where a proportion of the borrowing base is derived from fund NAV, or post-investment period NAV lines to cover residual liquidity or trade finance needs.

Furthermore, banks that can provide debt to fund managers to ease their co-investment requirements will be able to insulate themselves somewhat from the increasingly competitive pressures in the subscription line market, albeit the risk they are taking on is a different one.

#### A Better 2014...

The European PE sector has been buffeted to a greater extent than the North American PE sector since the financial crisis, though—as in the US—the funds finance market has proven resilient, both in terms of fund performance and supply of credit to funds. 2013 has seen a number of hopeful signs suggesting that the sector is ready to follow the US out of its lull, which will present additional opportunities to banks active in this sector. Cheers/santé/skaal/budem to that. ♦

# Capital Commitment Subscription Facilities and the Proposed Liquidity Coverage Ratio

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On November 29, 2013, the Board of Governors of the Federal Reserve System (FRB), the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC, and collectively, the Agencies) published in the Federal Register a notice of proposed rule making (the Proposed Rule) to strengthen the liquidity positions of large financial institutions.<sup>1</sup> The Proposed Rule creates for the first time a standardized liquidity requirement in the form of a minimum liquidity coverage ratio (LCR) and generally follows the liquidity ratio requirement as revised and adopted by the Basel Committee on Banking Supervision of the Bank of International Settlements (Basel LCR) earlier this year.

The Proposed Rule's LCR (US LCR) aims to require banking organizations with \$250 billion or more in total assets and certain other large or systemically important banking or other institutions (Covered Banks) to hold sufficient high-quality liquid assets (HQLA) to meet the Covered Bank's liquidity needs for a thirty (30) day stress scenario.<sup>2</sup> As with many of the statutory and regulatory requirements emanating from the financial crisis, applying the requirements of the US LCR to capital commitment subscription credit facilities (each, a Facility) requires both seasoned familiarity with Facility structures and reasoned judgment as to the application.

## The Basic LCR Ratio

Both the Basel LCR and the US LCR are in the form of a minimum ratio, the numerator of which consists of the value of the Covered Bank's HQLA and the denominator of which consists of the Covered Bank's expected total net cash outflows over a

thirty (30) day period. For both the Basel LCR and the US LCR, the minimum LCR requirement is 100% (i.e., that the LCR equals or exceeds 1.0). For the numerator, assets that constitute HQLA are generally unencumbered liquid assets without transfer restrictions that can reasonably be expected to be converted into cash easily and quickly. The Proposed Rule provides categories of HQLA and sets forth qualifying criteria and haircuts for less immediately liquid HQLA. The US LCR denominator is the total net cash outflows, which is defined as total expected cash outflows minus total expected cash inflows, during the stress period. Under the US LCR, Covered Banks would be required to hold sufficient HQLA to cover the highest daily amount of cumulative net cash outflow for the stress period. Total expected cash outflows are calculated by multiplying the outstanding balances of various categories or types of liabilities (such as the undrawn portion of a revolving tranche of a Facility) by the predicted rates at

which they are expected to be drawn down. Determining the drawdown of the undrawn portion of a Facility for purposes of calculating the US LCR's cash outflows will be the primary focal point for Facilities under the Proposed Rule.<sup>3</sup>

## Cash Outflow Framework

### Committed Credit Facilities and Liquidity

**Facilities.** The US LCR specifies outflow rates that are intended to approximate cash outflows for particular funding obligations during severe liquidity stress. The outflow rates were reportedly developed by taking into account supervisory experience and observation from the recent financial crisis. Outflow rates are categorized by the particular type of funding obligation and Facilities will be classified in the category titled "Commitment Outflow Amount," which includes both committed "credit facilities" and "liquidity facilities" (terms explicitly defined in the Proposed Rule). The distinction has a material impact on outflow rates, as liquidity facilities are given significantly higher outflow rates than credit facilities. Under the US LCR, a "liquidity facility" is defined as "a legally binding agreement to extend funds at a future date to a counterparty that is made *expressly for the purpose of refinancing the debt of the counterparty when it is unable to obtain a primary or anticipated source of funding.*" (Emphasis added.) The definition goes on to articulate examples of liquidity facilities, including "an agreement to provide liquidity support to asset-backed commercial paper by lending to, or purchasing assets from, any structure, program or conduit in the event that funds are required to repay maturing asset-backed commercial paper." On the other hand, a "credit facility" is defined as "a legally binding agreement to extend funds if requested at a future date, including a general working capital facility such as a revolving credit facility for general corporate or working capital purposes." While virtually all Facilities offer their closed-end real estate and private equity fund borrowers (each, a

*Fund*) a certain degree of liquidity (as does every corporate revolver), we think Facilities are more appropriately categorized as "credit facilities" for the reasons discussed below; however, we admit this determination is not unequivocally clear from the proposed US LCR related text. In our experience, Facilities are typically not made "*expressly for the purpose of refinancing the debt of the counterparty*" as required by the definition of a liquidity facility.<sup>4</sup> Facilities are not standby liquidity to cover a Fund's inability to issue commercial paper, obtain other short-term "debt" or the like. Rather, Facilities are established to provide general working capital to a Fund, a concept that is expressly carved out of the definition of liquidity facility: "[...]liquidity facilities exclude facilities that are established solely for the purpose of general working capital, such as revolving credit facilities for general corporate or working capital purposes."

**Outflow Rates.** Outflow rates on committed credit facilities and liquidity facilities are stratified by borrower classification, as the Agencies have assumed that financial institutions will be highly interconnected and most impacted during a stress period and therefore most likely to draw down all available funds. Thus, for example, a Covered Bank's outflow rate is 10% for a committed credit facility and 30% for a committed liquidity facility where the borrower is a "wholesale customer or counterparty that is not a regulated financial company, investment company, *non-regulated fund*, pension fund, investment adviser, or identified company, or to a consolidated subsidiary of the any of the foregoing" (such excluded entities being *Specified Financial Borrowers*). (Emphasis added.) In contrast, the outflow rate for Specified Financial Borrowers is 40% for a committed credit facility and 100% for a committed liquidity facility.<sup>5</sup> We expect that a majority (but not all) of private equity Fund borrowers will be Specified Financial Borrowers since they will satisfy the definition of "non-regulated fund," which is: "any hedge fund or private equity fund whose investment adviser

is required to file SEC Form PF (Reporting Form for Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors), and any consolidated subsidiary of such fund....” Under SEC Rule 204(b)-1, adopted under the Investment Advisers Act of 1940 (Advisers Act), and in CFTC Rule 4.27, adopted under the Commodity Exchange Act, most investment advisers of private equity funds (Sponsors) holding in excess of \$150 million in assets under management are required to file Form PF. However, there are exceptions, including real estate funds that rely on the exception from the definition of “investment company” under Section 3(c)(5)(C) of the Investment Company Act of 1940, and venture capital funds whose advisers are relying on the “venture capital fund adviser” exemption from registration under the Advisers Act. We estimate that a fair portion, perhaps even a majority, of the typical real estate Fund Facility borrowers will be exempt from filing Form PF, including most core real estate Funds. However, those real estate Funds sponsored by multi-asset class Sponsors, such as those that also sponsor private equity Funds, are likely to be required to file, and hence, “non-regulated funds.” Thus, based on the above, our expectation is that the majority of Facilities will be classified as committed credit facilities to Specific Financial Borrowers under the Proposed Rule, drawing an outflow rate of 40%, but that the Facilities with Fund borrowers exempt from filing Form PF would only be subject to a 10% outflow rate.

## Facility Considerations under the Proposed Rule

**General Considerations.** Under the Proposed Rule, Covered Banks will be required to comply with the US LCR requirement by January 1, 2017, with phased-in compliance of 80% by January 1, 2015 and 90% by January 1, 2016. Thus, current Facilities with a typical three (3) year tenor will likely become subject to the US LCR if the Proposed Rule is adopted as proposed. Consequently, even in a current Facility, Facility lenders (Lenders) might want to consider including or adding the following:

- (1) The stated purpose of providing working capital to the Fund should be express in the Facility documentation. If a Facility is expressly offered only to provide short term, bridge capital while awaiting the receipt of capital contributions from the Fund’s limited partners, a Facility runs the risk of confusing the Agencies and unintentionally appearing closer to extending monies “for the purpose of refinancing the debt of the counterparty when it is unable to obtain a primary or anticipated source of funding” (and hence being classified a liquidity facility). Because Facilities “that have aspects of both credit and liquidity facilities would be classified as liquidity facilities for the purposes of the proposed rule,” Lenders should steer clear from any ambiguity as to intent.
- (2) Lenders should confirm via representation whether their Fund borrowers are required to file Form PF under SEC Rule 204(b)-1, as a lower outflow rate may be available in the event the Fund borrower satisfies an exception to the reporting requirement.
- (3) Lenders should pay close attention to the structure of their Fund borrowers and any alternative investment vehicles or portfolio companies a Fund borrower may wish to have join the Facility. Because different borrowers have different classifications under the US LCR, a Lender would not want to unknowingly increase its outflow rate by permitting the joinder of a new Fund entity that resulted in an unexpected, increased outflow classification.

**Structural Solution.** There is a potential Facility structuring solution that would provide relief to the 40% outflow rate for Lenders, although they would require material changes and concessions from Fund borrowers. The outflow rates apply only to “committed” credit facilities, not uncommitted credit facilities. As a portion of the Facility



market currently operates on an uncommitted basis, offering uncommitted Facilities (or perhaps separate committed and uncommitted tranches), would result in a 0% outflow rate on any uncommitted portion.

### Real-World Cash Outflow

We believe the 40% outflow rate for Facilities under the US LCR is in complete and total contrast with the actual experience realized by Lenders during the crisis. In fact, based on anecdotal reports from many different Lenders, Facility utilization on a portfolio-wide basis never increased in a material way throughout the entire crisis, let alone during any thirty (30) day stress period. Borrowing under a Facility creates immediate negative arb for a Fund if it must hold the borrowed cash and not promptly deploy it into an investment. At the height of the crisis, Funds were in large part nervous about acquisitions because pricing marks were hard to come by. Most sat patiently and waited, and did not borrow extensively under their Facility. In fact (and ironically), some Lenders were frustrated with low unused commitment fee pricing because many Facilities were so undrawn for so long that Lenders were challenged to meet their own return projections on their Facilities. For Funds, internal rate of return (IRR) is extremely important, and paying interest on large amounts of undeployed cash can materially undermine IRR. The 40% outflow rate is, in our opinion, divorced from actual experience during the financial crisis and very conservative. It does not “reflect aspects of the stress event experienced during the recent financial crisis,” as the Agencies intend, and we expect that multiple Lenders could provide clear and convincing data supporting a lower outflow rate. However, we are very sympathetic to the Agencies here, as Facilities are a largely under-the-radar lending product in a completely private market, and the Agencies cannot possibly be expected to be familiar with Facility performance characteristics without extensive industry input.<sup>6</sup> The Agencies have explicitly requested comments on the Proposed Rule by January 31, 2014. In light of the disconnect between actual

Facility utilization during the crisis and the proposed 40% outflow rate, Lenders should consider what impact the US LCR and a 40% outflow rate will have on their Facility portfolio. They should consider how it will impact their capital requirements, internal cost of capital, and what if any impact it will have on the unused commitments fees they will need to pass along to Funds. We expect that the actual impact of the US LCR will vary significantly for different Lenders. These and other factors should be considered in determining whether a comment letter to the Agencies may be appropriate.

### Endnotes

- 1 For an in-depth review of the Proposed Rule, please see Mayer Brown LLP’s Legal Update, “The US Banking Regulators Propose a Liquidity Coverage Ratio For Large Banking Organizations and Systemically Important Non-Banks,” available at <http://www.mayerbrown.com/The-US-Federal-Reserve-Board-Proposes-a-Liquidity-Coverage-Ratio-For-Large-Banking-Organizations-and-Systemically-Important-Non-Banks-10-30-2013/>.
- 2 Under the US LCR, the specified stress period for standard Covered Banks is thirty (30) calendar days, while the stress period for certain smaller Covered Banks (those with total assets in excess of \$50 billion) is reduced to twenty-one (21) calendar days. This Legal Update focuses on the thirty (30) day stress period but recognizes the twenty-one (21) day period will be relevant for certain Covered Banks.
- 3 Particular business segments within a Covered Bank may have additional issues in connection with a Facility, such as the outflow rates for deposits from fund depositors, derivative exposures to a fund borrower, etc.
- 4 However, at least with respect to those Facilities that are merely providing short-term funding in anticipation of capital call proceeds, they are, at least potentially in the view of the Agencies, an extension of funds to a counterparty “when it is unable to obtain a primary or anticipated source of funding.”
- 5 The outflow for any committed facility to a special purpose entity, whether credit or liquidity, is 100%.
- 6 We also suspect that Facilities may be one of the very few lending products to financial institution-type borrowers that did not experience high outflow rates during the crisis. Thus, the default assumption by the Agencies that financial institution-type borrowers will be most likely to face liquidity constraints and hence draw down on all available funding sources may be predictably and understandably overbroad in this context.



# Infrastructure Funds Primer

Nadav Klugman

Infrastructure funds are private equity vehicles that invest in a wide range of assets—including assets that could be described as transportation, energy and utility, communications, and “social” infrastructure, and investments that may be specific to a particular asset or in a company that develops such assets or is otherwise involved in their operation. Like other private equity funds, they have limited lifespans, typically five to ten years. They often attract capital commitments from investors with appetites for relatively stable, long-term cash flows, many of which have liabilities stretching over several decades. General partners of infrastructure funds are often able to leverage those commitments during the investment period.

In recent years, institutional investors have felt increased pressure to search for higher returns and diversify from traditional asset categories such as public equities and fixed income instruments. After slumping in 2011, fund-raising by infrastructure funds improved significantly in 2012 and 2013, with capital raised in the first three quarters totaling \$19 billion.<sup>1</sup> Despite an increase in the average fundraising lifecycle,<sup>2</sup> not only did capital commitments to infrastructure funds continue to grow, investors indicated that they were looking to expand their infrastructure allocation.

Pension funds are notably increasing their exposure. The Alaska Retirement Board committed \$300 million to two infrastructure funds—\$200 million to IFM Global Infrastructure Fund and \$100 million to J.P. Morgan Infrastructure Investments Fund—and has a long-term infrastructure target allocation of 12.5% within the real assets portfolio, or 2.125% of total plan assets.<sup>3</sup> The

Kentucky Teachers’ Retirement System committed \$100 million to IFM’s Global Infrastructure Fund,<sup>4</sup> and the Missouri Education Pension Trust committed \$75 million to Alterna Core Capital Assets Fund II.<sup>5</sup> The \$420 million Chicago Park Employees’ Pension Fund entered the infrastructure space by committing \$10 million each to infrastructure funds managed by Ullico Investment Co. and Industry Funds Management.<sup>6</sup> There is, however, considerable room for growth among pension funds. According to a new report from the Organization for Economic Co-Operation and Development (OECD), unlisted equity and debt infrastructure investments for the 69 survey respondents amounted to only 0.9% of total respondent assets.<sup>7</sup>

This growth is being driven by renewed demand for stable, long-term returns in a lower-yield environment, and a variety of “infrastructure” asset classes are filling that demand. With respect to power production, renewables have been popular, and the

largest independent power producers were able to take operating assets into the public markets in ways that provide attractive exit opportunities. In 2013, Pattern Renewable Energy and NRG publicly listed “yieldcos,” which aggregate the cash equity return from utility-scale power projects that have debt and tax equity financing. Several other renewable energy developers are in the process of evaluating if such a structure would benefit them.

In the transportation space, several states moved forward with initiatives to facilitate private investment in toll roads and other similar assets, and successful project completions in recent years leads some to believe that future formations of such partnerships are likely. Virginia is moving ahead with a series of PPP toll road procurements following the successful completion of its I-495 Express Lanes project, which at \$2 billion was delivered on time and on budget. In November 2013, the New Jersey Turnpike Authority put out a request for proposals seeking bids for toll collection services, including management of the electronic tolling system and the toll collectors.<sup>8</sup> MAT Concessionaire, LLC (MAT) received a 35-year concession agreement, which includes 55 months for design and construction, for the Port of Miami tunnel project, one of the first to make use of availability payments. Design and construction costs are currently at \$663 million. MAT will be paid \$156 million in milestone payments during construction and a \$350 million payment upon final acceptance of the construction works. The majority of MAT’s equity is being provided by a Meridiam infrastructure fund.

A number of infrastructure funds are also seeking to satisfy the need for debt as an alternative to traditional bank and bond financing at the project level.<sup>9</sup> Of the 1,700+ active investors in the infrastructure asset class tracked by Preqin, as of February 2013, 285 were actively considering debt investment opportunities. Darby Overseas Investments has raised three debt funds totaling \$442 million, and Allianz Global Investors is

currently working on a £1 billion UK-focused debt fund that will provide debt financing to a wide range of both economic and social infrastructure projects.<sup>10</sup>

While investor appetite for the various infrastructure asset classes continues to grow, so have fundraising challenges for a variety of reasons, first among them the record number and aggregate target of all funds in market.<sup>11</sup> (A consequence of the crowded fundraising environment is the increasing use of placement agents to assist in the fundraising process, and with reason—over the past two years, infrastructure funds that have used placement agents have been more likely to meet or exceed fundraising targets and to reach financial close.<sup>12</sup>) Investors indicate that the most attractive managers are those with cohesive and concise plans, a focus on high cash yield and defensive and predictable investments, a healthy deal pipeline, and, most importantly, strong past performance.<sup>13</sup> (Globally, the top ten infrastructure fund managers account for 45% of capital raised by infrastructure funds in the last ten years, and the largest firm, Macquarie Infrastructure and Real Assets, raised over six times the amount raised by the tenth largest firm, LS Power Group, but that percentage has dropped in recent years as more firms have entered the asset class.<sup>14</sup>) Current portfolios of infrastructure fund limited partners demonstrate a preference for regional-focused funds, but there is increasing preference for geographic diversification as well.<sup>15</sup>

Further increasing pressure on fund managers is the trend for large, sophisticated institutional investors to bypass infrastructure funds entirely and make direct investments.<sup>16</sup> While the motivations vary—to avoid paying fund management fees and lower carrying costs, increase control over asset disposition decisions, deploy additional capital, and avoid the disposition of assets that could continue to generate steady returns—making direct investments requires significant investments in manpower and the development of a variety of

skills. In addition to performing upfront technical, legal, regulatory, and financial diligence, such investors need project management and asset divestiture expertise. While only the largest and most sophisticated investors are able to execute such a direct investment strategy effectively, direct investments and co-investments are increasingly utilized,<sup>17</sup> and investors are conditioning fund commitments on the ability to retain control of key investment decisions, including investment horizons.<sup>18</sup>

In assessing infrastructure investments, investors and fund managers face a variety of concerns that are less relevant in other asset classes. In particular, the stability of the applicable regulatory regime, and the possibility of changes in law that may materially impact investments, are often critically important inquiries. For investments in emerging markets, the risks of adverse action by local governments come to mind fairly readily, but such actions have major impacts in developed markets as well. The renewable sector provides particularly clear examples. Spanish solar tariffs were reduced retroactively, Germany's were cut prospectively, and elections in Ontario, Canada, were in large part a referendum on the province's renewable energy programs. In the United States, key federal tax incentives have repeatedly been renewed and extended only on short-term bases, and there is concern about the deferral of state renewable mandates and the implementation of reliability and market-efficiency mandates by quasi-governmental grid operators. Other infrastructure asset classes present similar concerns. The privatization of government-owned assets generally requires express legislative or municipal authorization, which can be heavily conditioned, and is often subject to intense public scrutiny that may lead to renegotiation, as occurred last summer with respect to the City of Chicago's parking concession.

Infrastructure funds face uncertainties less relevant to funds than investments in other asset classes—for example, the significant risk of

statutory and regulatory change affecting existing and target assets, the prevalence of pension and sovereign investors that have strong motivations to bypass the fund structure in favor of direct and co-investments, and the range of expertise needed to diligence and manage such a broad category of assets. Their recent growth, and the momentum of that growth, suggests that the industry is able to turn such challenges into opportunities. We expect that it will continue to do so, and that the financing structures the industry utilizes will continue to evolve as well.

## Endnotes

- 1 *The Preqin Quarterly Update: Infrastructure* (Preqin, New York, N.Y.), Oct. 2013.
- 2 *Infrastructure Fundraising: Time on the Road*, Infrastructure Spotlight (Preqin, New York, N.Y.), Oct. 2013, at 2.
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# Detroit Eligible to File Chapter 9 Bankruptcy

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On December 5, 2013, Judge Steven Rhodes of the US Bankruptcy Court for the Eastern District of Michigan held that the city of Detroit had satisfied the five expressly delineated eligibility requirements for filing under Chapter 9 of the US Bankruptcy Code<sup>1</sup> and so could proceed with its bankruptcy case. The court also found that the city had filed its bankruptcy petition in good faith, going so far as to hold that the city should not have been required to engage in prepetition negotiations with creditors when any such negotiations were doomed to fail from the start.<sup>1</sup>

Several creditors and other parties in interest, including representatives of Detroit's pension funds, have already appealed Judge Rhodes' decision and have sought authorization to have that appeal heard directly by the Sixth Circuit Court of Appeals, instead of the intervening district court. A hearing on the direct appeal request has been set for December 16, 2013.

In making his ruling, among other issues of import, Judge Rhodes held that (i) the city could alter its pension benefits in bankruptcy, notwithstanding certain otherwise protective Michigan state constitutional provisions (the court had earlier indicated that it would put off a decision on this issue until a plan altering pensions was actually proposed), and (ii) the city was authorized to file bankruptcy under Michigan state law despite both US and state constitutional challenges, and despite a Michigan state court ruling to the contrary. Additionally, in dicta Judge Rhodes suggested that Detroit may have been better off filing for bankruptcy years ago.

## Pension Obligations

A key issue in Detroit's bankruptcy filing has been the ability of the city to alter its pension obligations under Chapter 9, obligations that are protected by the Michigan state constitution.<sup>2</sup> Prior to issuing his eligibility opinion, Judge Rhodes had indicated some unwillingness to rule on this particular issue prior to the city's proposal of an actual plan. This would have left the city, and other parties in interest, in the unenviable position of spending thousands, if not millions, of dollars on plan negotiations, only to see those negotiations go for naught to the extent the court were to later rule that that the plan's proposed alteration of pension obligation was impermissible.

Additionally, without a clear ruling, pension fund representatives were likely to remain entrenched in their views that pension obligations were unalterable in bankruptcy, thus causing them to refuse to negotiate with the city.

Recognizing these exigencies and the need for a ruling on the pension issue sooner rather than later, Judge Rhodes reconsidered his initial view and issued a ruling holding that Detroit was permitted to alter its pension obligations in bankruptcy. In particular, Judge Rhodes held that, while the Michigan state constitution stated that such rights could not be “diminished or impaired,” in a US bankruptcy case, it could not afford them any more extraordinary protection than a typical contractual right which also may not be “impaired.” In fact, Judge Rhodes pointed out, the reason that pension rights were enshrined in the Michigan state constitution was to recognize them as contractual rights, since, prior to an amendment to the Michigan state constitution, whether pension obligations even qualified as contractual rights was very much in doubt.

Judge Rhodes held that, while neither the State of Michigan nor the City of Detroit could unilaterally alter Detroit’s pension obligations outside of bankruptcy, the federal government, in the form of US Bankruptcy Court, could. As Judge Rhodes noted, “impairing contracts is what the bankruptcy process does.” To the extent the state guaranteed Detroit’s pension obligations or provided security for them, Judge Rhodes’ opinion implied that his analysis may have been different. Michigan law, however, was clear that pension obligations were ordinary contractual obligations and were thus subject to impairment in a properly authorized Chapter 9 proceeding.

### Specific Authorization to File

In a related ruling, and for reasons similar to those noted above, Judge Rhodes also held that Detroit’s bankruptcy filing was “specifically authorized” under state law, as required by Bankruptcy Code section 109(c)(2). In so ruling, Judge Rhodes overruled objections by several parties, as well as a contrary opinion from a Michigan state court, that such authorization was unconstitutional under the

US and Michigan state constitutions in that it did not provide for the protection of accrued pension benefits.

While again acknowledging that Michigan and Detroit did not have the right to alter pension rights, or any other contractual rights, under the contracts clause of the United States constitution outside of bankruptcy, and that therefore, the state could not authorize the city to do so, Judge Rhodes noted that such impairment is expressly permitted during, and is in fact one of the primary purposes for, bankruptcy proceedings. The state of Michigan’s authorization of Detroit’s Chapter 9 filing, through the process established under the state’s emergency manager law was therefore proper, even to the extent that it could result in the impairment of the city’s pension obligations. As Judge Rhodes noted, the Michigan legislature could have elected to prevent Michigan municipalities from filing under Chapter 9 but did not. Instead, it chose to let them file, knowing full well that in Chapter 9, pension obligations could be altered.

For similar reasons, Judge Rhodes also rejected the argument, put forward both by several objecting parties and a contrary Michigan state court opinion, that the Michigan law permitting the appointment of an emergency manager for the city of Detroit, and the filing of a chapter 9 petition, was unconstitutional under Michigan state law. As an initial matter, Judge Rhodes held that the state court opinion was void in that it was issued after Detroit’s bankruptcy petition had been filed in violation of the automatic stay. Judge Rhodes described the state court judgment as a perfect example of the “chaotic and disorderly race to judgment” that the automatic stay is specifically meant to avoid. Judge Rhodes further noted that he believed the Michigan Supreme Court would agree that Michigan’s emergency manager law was constitutional, even if a Chapter 9 filing could lead to alteration of a city’s pension obligations.



## Good Faith

An additional issue addressed in Judge Rhodes' ruling focused on Detroit's "good faith" leading up to its bankruptcy filing. In particular, two of the five express eligibility factors (i.e., whether the city desired to effect a plan to adjust its debts and whether the city negotiated with its creditors in good faith) depend on the city's good faith intent, as does the more general question of whether the petition itself was filed in good faith.

While finding that Detroit had demonstrated the requisite intent to satisfy all of these requirements, Judge Rhodes did note certain questionable actions by the city. For instance, in describing the city's discussions with creditors in the weeks prior to its filing, the court refused to accept that they were indeed good faith negotiations in which the city truly expected to succeed, pointing for instance to the presentational, rather than conversational, method in which they were presented and the short time frames in which creditors were required to respond. Similarly, the court quoted from a bevy of emails which indicated that Detroit had in fact set itself on a course for a bankruptcy filing years ago, its protestations to the contrary notwithstanding.

According to Judge Rhodes, whether or not the negotiations themselves could be described as having been conducted in good faith, much of this was simply unnecessary. With respect to negotiations with creditors, Detroit may have been better served by accepting (and publicly stating) that negotiations with hundreds of thousands of creditors was impractical; indeed, Judge Rhodes noted that he was satisfied that when Congress enacted the impracticability provision, which permits a municipal bankruptcy filing in spite of no good

faith negotiations with creditors if such negotiations are impractical, "it foresaw precisely the situation facing the City of Detroit." More generally, Judge Rhodes noted that, with its worsening financial crises, Detroit "could have, and probably should have, filed for bankruptcy relief long before it did, perhaps even years before" and that putting off that filing in order to engage in what it viewed as the necessary processes likely did more harm than good.

## Conclusion

As the largest municipality to file under Chapter 9, decisions rendered in Detroit's bankruptcy case will impact the municipal debt market for years to come. One can already see the long-term potential impact from this recent eligibility opinion both from the big-ticket items, such as the bankruptcy court's ruling on the ability of municipalities to alter long-term pension obligations, and the smaller items, such as if and when a city should consider filing. All in all, Judge Rhodes' first major decision in the case appears to provide a guideline for municipal filings in the future.

## Endnotes:

- 1 Judge Rhodes held that the city was: (i) a "municipality" as defined by the Bankruptcy Code; (ii) specifically authorized to file for bankruptcy protection under state law; (iii) "insolvent" as defined by the Bankruptcy Code; (iv) desired to effect a plan to adjust its debts; and (v) not required to negotiate in good faith with its creditors in advance of its bankruptcy filing since such negotiations were impractical.
- 2 See Article IX, Section 24, Michigan Constitution ("The accrued financial benefits of each pension plan and retirement system of the state and its political subdivisions shall be a contractual obligation thereof which shall not be diminished or impaired thereby.").

# Sixth Circuit Rules that Collateral Proceeds Do Not Include Accounts

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The US Court of Appeals for the Sixth Circuit has ruled that a lender's security interest in accounts was not perfected because a reference to "proceeds" in the lender's UCC financing statement did not expressly refer to "accounts." The Sixth Circuit surprisingly interpreted the definition of "proceeds" in Article 9 of the Uniform Commercial Code to exclude "accounts"<sup>2</sup> (despite and without reference to provisions of UCC Article 9 to the contrary). While the Sixth Circuit's stated basis for this decision is questionable, this decision illustrates the risk of a security interest not being perfected when the collateral description in a UCC filing does not match the collateral description in the related security agreement.<sup>3</sup>

In *1st Source Bank v. Wilson Bank & Trust et al.*, 2013 WL 5942056 (No. 13-5088, Nov. 7, 2013), the Sixth Circuit settled a priority dispute between 1st Source and a group of other secured lenders over their respective security interests in accounts receivable of two debtors.

The security agreements in favor of 1st Source granted security interests in, among other things, tractors, trailers and accounts, as well as the proceeds of the agreed-upon collateral. 1st Source's UCC financing statements filed against the debtors described the collateral, in relevant part, as specific pieces of equipment and several types of collateral, "together with all present and future attachments, accessories, replacement parts, repairs, additions and exchanges thereto and therefore [sic], documents and certificates of title, ownership or origin, with respect to the equipment, and all proceeds thereof, including rental and/or lease receipts." The UCC financing statement collateral descriptions,

however, unlike the security agreements, did not use the terms "accounts," "accounts receivable" or other similar language.

The other lenders' UCC financing statements were filed later than 1st Source's UCC financing statements. However, unlike 1st Source's UCC financing statements, their UCC financing statements expressly included in their identified collateral "all accounts receivable now outstanding or hereafter arising."

Applying Tennessee law, the Sixth Circuit ruled that 1st Source did not have perfected security interests in the accounts receivable because accounts receivable were not included in the reference to proceeds in 1st Source's UCC financing statements against the debtors. Accordingly, 1st Source's unperfected security interests were junior to the perfected security interests of the other lenders.

1st Source argued that the proceeds referred to in its UCC financing statements included the

accounts. The Sixth Circuit rejected that argument on the basis that the terms are separately defined in UCC Article 9 and that the general term proceeds does not subsume the specific term accounts.

That assertion lacks support in UCC Article 9 itself: “Proceeds” clearly may consist of “accounts.” The priority rules stated in UCC Section 9-324 with respect to inventory collateral and its proceeds make key distinctions depending on whether the proceeds are accounts.<sup>4</sup> Moreover, many general UCC Article 9 collateral category terms encompass more specifically defined UCC Article 9 collateral category terms. For example, the term “goods” includes, among other collateral categories, “inventory” and “equipment,”<sup>5</sup> the term “instruments” includes “promissory notes”<sup>6</sup> and the term “investment property” includes, among other collateral categories, “security,” “security entitlement” and “securities account.”<sup>7</sup>

We note that the Sixth Circuit approvingly cited in its decision a line of cases that impose a limited reading of the UCC Article 9 definition of proceeds to the effect that it does not include property earned by a debtor from the debtor’s use of collateral that remains in the debtor’s possession (as contrasted with property received by the debtor from the sale, lease or other disposition of collateral by the debtor to another party).<sup>8</sup> While such a limited reading is in itself controversial due to the existence of arguments that accounts arising from use of collateral may indeed fit within the definition of proceeds, the Sixth Circuit’s expression of its ruling in this case is more troublesome in suggesting that accounts can never be proceeds of other collateral because the UCC Article 9 definition of “proceeds” does not include accounts.

Unfortunately, because the 1st Source decision was decided by a Federal Circuit Court, and may be followed by other courts, the decision may well need to be dealt with by secured creditors in litigation and otherwise. The UCC definition of “proceeds”

has been used by bankruptcy courts in determining under Section 552 of the Bankruptcy Code whether a pre-petition security interest extends to certain property of the debtor arising post-petition, as the Bankruptcy Code does not contain its own definition of proceeds.<sup>9</sup> This means that the 1st Source holding may have an impact in bankruptcy cases as well as in cases decided outside of bankruptcy.

As a result, creditors whose interests are secured by property—and their counsel—may wish to consider listing accounts arising from the sale, lease, other disposition or use of such property specifically as original collateral in their security agreements and financing statements.<sup>10</sup>

## Endnotes

- 1 Defined in UCC Section 9-102(a)(64). The definition reads as follows:  
“Proceeds”, except as used in Section 9-609(b), means the following property:  
(A) whatever is acquired upon the sale, lease, license, exchange, or other disposition of collateral;  
(B) whatever is collected on, or distributed on account of, collateral;  
(C) rights arising out of collateral;  
(D) to the extent of the value of the collateral, claims arising out of the loss, nonconformity, or interference with the use of, defects or infringement of rights in, or damage to, the collateral; or  
(E) to the extent of the value of collateral and to the extent payable to the debtor or the secured party, insurance payable by reason of the loss or nonconformity of, defects or infringement of rights in, or damage to, the collateral.
- 2 Defined in UCC Section 9-102(a)(2).
- 3 But, in certain cases of a security interest covering all personal property of a debtor, mismatched collateral descriptions do not pose that risk where the UCC filing collateral description uses a supergeneric collateral description (such as “all personal property”) as expressly authorized by UCC Section 9-504(2). In contrast, a supergeneric collateral description is not permitted for the collateral description in the granting provision of the security agreement. See UCC Section 9-108(c). (A grant of a security interest in all personal property may, in certain circumstances, be accomplished by listing all UCC Article 9 collateral category terms in the granting provision of the security agreement. See UCC Section 9-108(b).)

## Sixth Circuit Rules that Collateral Proceeds Do Not Include Accounts .....

- 4 See Official Comments 8 and 9 to UCC Section 9-324.
- 5 See UCC Sections 9-102(a)(44), (48) and (33).
- 6 See UCC Sections 9-102(a)(47) and (65).
- 7 See UCC Section 9-102(a)(49).
- 8 See, e.g., *In re Gamma Center, Inc.*, 489 B.R. 688 (Bankr. N.D. Ohio 2013), in which the court held that proceeds of equipment only included proceeds of sale of the equipment instead of proceeds of the use of the equipment, and *In re Las Vegas Monorail Co.*, 429 B.R. 317 (Bankr.D.Nev.2010), in which the court held that rider fees were not proceeds of a monorail franchise.
- 9 See Collier on Bankruptcy, ¶552.02[1].
- 10 If the Sixth Circuit had found, to the contrary, that 1st Source did have senior perfected security interests in the accounts, this case would have presented the difficult issue of whether a senior perfected secured party may recover (on the basis of a conversion claim or otherwise) from a junior perfected secured party the proceeds of accounts collected by the junior perfected secured party.

# Bankers' Bonus Cap: Where Are We Now?

Andrew Stanger  
Christopher Fisher

We covered the forthcoming bankers' bonus cap, as contained in the Fourth Capital Requirements Directive (CRD IV), in detail, and discussed the other remuneration provisions of CRD IV, in our July 2013 legal update. In summary, the bonus cap will restrict the variable remuneration of relevant staff to a maximum of the amount of their fixed remuneration, or, with shareholder approval, two times the amount of their fixed remuneration, and will thus represent a major change to the remuneration structures of many affected institutions.

The provisions apply to banks, and some MiFID investment firms, headquartered in the European Economic Area (EEA), even in respect of staff not located in the EEA, and also to the EEA subsidiaries of institutions headquartered outside the EEA.

This update contains a brief summary of the main developments in relation to the bonus cap, and other remuneration provisions of CRD IV, since we put out our July update, focussing on implementation in the UK.

## [July 2013 - FCA Consultation on CRD IV for Investment Firms](#)

On 31 July 2013 the FCA put out a consultation paper (CP13/6) on their proposed changes to the FCA Handbook as a result of the implementation of CRD IV. The proposed changes cover the remuneration provisions of CRD IV, other than those that relate to the bonus cap.

Largely, the changes are effected by copying out the wording of CRD IV into the Remuneration Code (SYSC19A of the FCA Handbook) without change, although the accompanying guidance is updated to reflect the changes. One interesting point from the changes relates to the new requirement to ensure that any of the total variable remuneration (not just deferred variable remuneration) is subject to malus or clawback arrangements (SYSC19A.3.51A). There has been no addition to the guidance to indicate that firms in proportionality level three (broadly, firms that previously fell in proportionality tiers three and four) may disapply this rule – although the existing guidance states that it will normally be appropriate for such firms to disapply the rules on retained shares, deferral and performance adjustment. It is not clear whether this is an oversight, or it is intended that this provision should not be disapplied by those firms, or they are waiting for guidance to be produced by the European Banking Authority (EBA) on the point.

Shortly afterwards, in August, the PRA produced a consultation paper on the implementation of CRD IV (CP5/13), although this does not address remuneration issues.

### July 2013 – EBA Consultation on Draft Regulatory Standards for Instruments Used for Variable Remuneration

The European Banking Authority (EBA) published a consultation paper dated 29 July 2013 on the classes of instruments that are appropriate to be used for the purposes of variable remuneration under Article 94(2) of CRD IV.

One of the requirements of CRD IV (Article 94(1) (1)) is that a substantial proportion, and in any event at least 50%, of any variable remuneration shall consist of a “balance” of shares or share-linked instruments, and “where possible” other instruments qualifying as Additional Tier 1 instruments or Tier 2 instruments (as defined in the Capital Requirements Regulation) or “other instruments which can be fully converted to Common Equity Tier 1 instruments or written down, that in each case reflect the credit quality of the institution as a going concern and are appropriate for the purposes of variable remuneration”.

The directive mandates the EBA to prepare draft regulatory technical standards (RTS) on classes of instruments that satisfy these requirements for instruments other than shares and share-linked instruments.

A full summary of the proposals is beyond the scope of this alert, but we would highlight the following points:

- to ensure that instruments reflect the credit quality of the institution as a going concern, strict-minimum triggers for write-down and conversion of instruments are proposed;
- to ensure that instruments are appropriate for the purposes of variable remuneration, instruments should have a sufficient maturity to cater for

deferral and retention mechanisms, and distributions should adequately reflect market conditions for comparable instruments;

- to meet this latter concern, a significant portion, being not less than 60%, of the instruments should be issued publicly or privately to other investors, or if instruments are used for the sole purpose of variable remuneration, a cap should be set on the distributions paid. The EBA will finalise the draft RTS at the beginning of 2014, taking into account consultation responses and the opinion of the Banking Stakeholder Group, and submit them to the European Commission by 31 March 2014. The Commission then has to decide whether to adopt or amend the RTS, and the Council or European Parliament can veto it. It could thus take some months before these procedures are concluded and the relevant legislation adopted and published.<sup>1</sup>

### September 2013 – UK Legal Challenge

On 25 September the UK government lodged a legal challenge with the European Court of Justice on the bonus cap.

The bonus cap was strongly resisted by the UK during the negotiations for CRD IV, and the government does not think the bonus cap provision, which was implemented without any assessment of its impact or supporting evidence, is “fit for purpose” –to improve stability across the banking system. The challenge also covers various legal issues regarding the compatibility of the bonus cap with the EU Treaty and the powers delegated to the EBA, which the government believes go well beyond its remit of setting technical standards. It is important to note that the UK’s legal challenge does not give institutions an excuse to delay the implementation of the bonus cap. The challenge does not suspend the coming into force of the bonus cap provision, and it will not be resolved until long after the bonus cap becomes effective: it can take around two years for the Court of Justice to hear a legal challenge. The UK will be implementing the bonus cap, as required by European law, by the beginning of 2014.



However, the challenge does give a strong indication of the UK government's view, and there is the expectation that this may be reflected in a lenient interpretation of the bonus cap in the UK by the relevant regulators.

### October 2013 – PRA and FCA Consultation on the Bonus Cap

Following the announcement of the UK Government's legal challenge, and in recognition of the fact that the challenge will not delay implementation, the PRA and FCA issued consultation papers in relation to changes to their respective Remuneration Codes to accommodate the bonus cap in the UK (and, for the PRA, all the CRD IV remuneration provisions). The approach has generally been to do the minimum possible to comply with the directive, and, as for the earlier FCA consultation, the proposed rule changes largely copy out the CRD IV wording without amendment. Any discretions left to member states have been exercised so as to give maximum flexibility.

The PRA consultation paper includes no new guidance on how the proportionality principle may apply to permit firms to disapply the bonus cap. Their original proportionality guidance (LSS8/13) published in April 2013 states that it may be appropriate for BIPRU limited licence firms and BIPRU limited activity firms to disapply the ratios between fixed and variable components of total remuneration (see paragraph 32 of the guidance), in the context of the CRD III requirement for firms to set appropriate ratios.

The FCA, however, does include proposed guidance on the application of proportionality to the bonus cap (see paragraphs 2.13 to 2.21 of their consultation paper). Given that all relevant firms currently prudentially regulated by the FCA fall into proportionality level 3, the effect of this guidance would be that all firms would generally be able to disapply the bonus cap, unless they are treated as being level 1 or 2 because they are part of a group—in which case the group is likely to be PRA-regulated.

For more details, see the FCA's CP13/12 and the PRA's CP8/13.

### October/November 2013 – FCA Regulated Firms Remaining on CRD III Rules

CRD IV contains a discretion for regulators to allow certain limited-licence investment firms to remain on CRD III rules (BIPRU). The FCA has, following the July 2013 consultation, decided to exercise this discretion, and in October wrote to potentially affected firms, which, if they would meet the relevant criteria going forward, could notify the FCA of this and remain on the CRD III rules.

As some firms which the FCA did not contact may also benefit from this discretion, the FCA published details on its website on 19 November 2013 of the criteria to be met, and the process to be followed if a firm considers those criteria are met, in order to remain on the CRD III rules.

### October 2013 – EBA Consultation on Discount Rate

The EBA published a consultation paper dated 23 October 2013 containing draft guidelines on the applicable notional discount rate for variable remuneration, provided in Article 94(1)(g)(iii) of CRD IV.

Under Article 94, member states may allow institutions to apply a discount to up to 25% of variable remuneration for the purposes of calculating the bonus cap, provided that the variable remuneration discounted is in the form of instruments that are deferred for a period of not less than five years. The EBA is mandated to prepare and publish guidelines on the discount rate to be applied by 31 March 2014.

The draft guidelines set out a proposed methodology for applying the discount, and in particular contain a formula for calculating the discount rate to be applied. This formula is based on the inflation rate, the interest rate for EU government bonds, the number of years over which the instruments are deferred, the number of years in any additional

retention periods and the number of years in the vesting period of the tranche concerned.

The formula will need to be applied separately to each element of deferred variable remuneration (with each tranche of an award with a different vesting date being treated separately), so this could lead to a substantial amount of calculation.

The requirement for an award to be deferred over a period of at least five years does not prevent tranches of that award vesting prior to five years, although vesting cannot be faster than on a pro-rata basis. For a retention period to affect the discount rate, it needs to be at least two years.

It is beyond the scope of this alert to consider the detail of the formula. The draft guidelines contain various examples applying the formula: one of these shows that for an award which vests after five years and has a two-year retention period, the unadjusted value of the award is discounted by a little over a half, from €20,000 to €9,228.

Assuming the 25% portion of the variable remuneration was discounted down to zero (it wouldn't be far off this if awards were deferred for the ten years suggested by the Parliamentary Commission on Banking Standards), this would give a theoretical maximum for variable remuneration of two and two-thirds times fixed remuneration.

### What's Next?

The revised Remuneration Code provisions (from both the PRA and FCA) will be finalised in December, as they will come into force on 1 January 2014. It is anticipated that the text will be published in time for a final review by interested parties.

However, there will still be missing pieces of the jigsaw after the commencement date. In particular:

- the EBA is due to deliver the draft RTS on identified staff (following the consultation process started in May 2013) to the European Commission

by 31 March 2014: it will then be some time before the RTS is adopted (with or without amendments);

- the EBA is also due to deliver the RTS on appropriate instruments (referred to above) by 31 March 2014, and again it will be some time before the RTS is adopted;
- the final guidelines on the discount rate are to be published by 31 March 2014; and
- we understand that the EBA will revise the Guidelines on Remuneration Policies and Practices originally published by its predecessor body, CESR, towards the end of 2014: no draft of these revisions has yet been published.

Given that the bonus cap provisions apply to bonuses paid in relation to services or performance from the year 2014 onwards (so, generally, the 2015 bonus round will be the first affected), firms should be able to work with this timetable.

In the longer term, the European Commission, in close conjunction with the EBA, is required to review and submit a report on the remuneration provisions of CRD IV to the European Parliament and the European Council by 30 June 2016. This report is to take into account international developments, and have particular regard to the provisions' efficiency, implementation and enforcement, and the impact of the bonus cap in relation to competitiveness and financial stability and also in relation to staff working for non-EU subsidiaries.

The UK government's legal challenge, which may well cover similar ground to this report, could be underway at the same time as the EBA's review. It remains to be seen whether one will influence the other.

### Endnotes

- 1 It is not uncommon for it to take approximately five months from the EBA submitting its draft legislation to the Commission to it being published in the Official Journal of the EU, but the process could take as long as ten months.

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