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Article

Feeder Funds

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A feeder fund ("Feeder") is an investment vehicle, often a limited partnership, that pools capital commitments of investors and invests or "feeds" such capital into an umbrella fund, often called a master fund ("Master"), which directs and oversees all investments held in the Master portfolio. A Master/Feeder structure is commonly used by private equity funds or hedge funds ("Funds") to pool investment capital. The Master's profits may be split on a pro rata basis among its Feeders in proportion to their investment. A Feeder is a separate legal entity from the Master and is relevant to both lenders and Funds when discussed in the context of lending relationships, particularly in structuring a subscription-backed credit facility ("Facility").

Investment managers choose to form Feeders for a variety of reasons. For example, Feeders offer flexibility with respect to investor tax status, ERISA status, minimum capital investments, fee structures or other administrative features that can be tailored to the specific needs of any investor. In this article, we will focus on certain tax, ERISA and aggregation issues as they relate to the Master/Feeder structure of Funds.

Tax Concerns[2]

Tax-exempt investors and foreign investors are two significant sources of capital in the United States and both groups invest heavily in Funds. Most tax-exempt investors will want to minimize or eliminate the realization of unrelated business taxable income ("UBTI") with respect to their investments. Similarly, most foreign investors will want to minimize or eliminate the realization of effectively connected income ("ECI") and structure their investments in a manner that does not require them to file US income tax returns. If a Fund makes its investments in or through pass-through entities, the Fund's tax-exempt investors may realize UBTI or its foreign investors may realize ECI and have to file US tax returns if the Fund is engaged in a trade or business in the United States.

In order to attract UBTI- or ECI-sensitive investors, many Funds offer Feeders through which such investors may participate in the Master's investments. Properly structured, these Feeders operate to "block" UBTI and ECI with minimal tax leakage. Although Feeders formed to act as blockers are usually formed in a low tax jurisdiction (such as the Cayman Islands), the domicile and precise structure and tax classification of the Feeder will depend on the nature of the Fund and its investments, as well as the tax structuring objectives and/or regulatory requirements applicable to the prospective investor(s). A variety of UBTI and ECI blocking strategies exist, including the use of debt and equity to capitalize the Feeder and forming separate Feeders for each fund investment. In addition, tax treaties may reduce the overall tax cost of a Feeder formed for foreign investors. Each approach to the structuring and implementation of Feeders to accomplish tax objectives carries with it advantages and

disadvantages that a Fund sponsor should discuss with its tax advisors.

ERISA Concerns[3]

Once a Fund or a Feeder accepts investors that are subject to the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), or Section 4975 of the Internal Revenue Code of 1986, as amended (the "Code"), the entity could itself become subject to the fiduciary and prohibited transaction rules under ERISA and Section 4975 of the Code if the assets of such Fund or Feeder are deemed to be "plan assets" of such investors. The rules governing when the assets of an entity are treated as plan assets are generally set forth in Section 3(42) of ERISA and a regulation, known as the "plan asset regulation," published by the US Department of Labor.[4] The plan asset regulation sets forth a number of exceptions on which a Fund may rely to avoid plan asset treatment. The exceptions most commonly relied upon for Funds are the "less than 25% exception" and the "operating company" exception.[5]

In a Master/Feeder structure, it may be difficult for a Feeder to satisfy an exception to holding plan assets because (i) the Feeder may be too passive to qualify as a "venture capital operating company" ("VCOC") or a "real estate operating company" ("REOC") and (ii) investment by benefit plan investors in the Feeder may be too significant to satisfy the less than 25% exception. In such a case, a Fund manager may permit the Feeder to operate as a plan asset vehicle that is subject to Title I of ERISA and/or Section 4975 of the Code. The Master, which will aggregate capital from all of its Feeders and investors, may still be able to rely on the less than 25% exception or may be able to qualify as a VCOC or REOC. If a Feeder is operated as a plan asset vehicle, such Feeder is typically "hard-wired" to invest in the Master, so that all investment activities will take place (and all fees and expenses will be calculated) at the Master level. Accordingly, although the Feeder may be subject to ERISA, the manager of the Feeder will not be acting as an ERISA fiduciary with respect to the investment of the Feeder's assets.

If a Master satisfies one or more exceptions under the plan asset regulation, it would not be subject to the prohibited transaction rules of ERISA and Section 4975 of the Code. A plan asset Feeder, however, would nonetheless be subject to such prohibited transaction provisions.

Except where specifically exempted by statute or by the US Department of Labor, ERISA and Section 4975 of the Code impose prohibitions on specified transactions between benefit plan investors and a wide class of persons (alternately referred to as "parties in interest" or "disqualified persons") who, by reason of position or relationship, might be in a position to influence a plan fiduciary's exercise of discretion. One of the specified transactions is any loan or other extension of credit.

With respect to lenders, financial institutions often have relationships with benefit plan investors that cause them to become parties in interest or disqualified persons, as applicable, such as providing trustee, custodian, investment management, brokerage, escrow or other services to such benefit plan investors. A party in interest or disqualified person that enters into a nonexempt prohibited transaction with a benefit plan investor is subject to initial excise tax penalties under the Code equal to 15 percent of the amount involved in the transaction and a second tier excise tax of 100 percent of the amount involved in the transaction if the transaction is not timely corrected. In order to correct the transaction, the transaction must be unwound, to the extent possible, and the benefit plan investor must be made whole for any losses. In addition, if a transaction is prohibited under

ERISA, it may not be enforceable against the benefit plan investor.

In the case of a plan asset Feeder, there may not be a prohibited transaction exemption available to permit an extension of credit between such Feeder and a lender that is a party in interest or disqualified person. In such circumstances, a cascading pledge structure, which is described in more detail below, may be used to avoid an extension of credit transaction between a plan asset Feeder and a lender.

High Net Worth Individuals

Feeders may also allow Funds to tap into an increasingly relevant investor segment: high net-worth individuals ("HNWI"). A HNWI is defined as an individual that has investible assets in excess of $1 million and these individuals are increasingly seeking the opportunity to invest in Funds.[6] Minimum capital requirements for Funds are customarily in amounts that even HNWI may have difficulty satisfying, often requiring a minimum capital commitment of $5 million. In an effort to bridge the gap between the traditional minimum capital requirements that Funds require and the desire of HNWI to have access to the investment portfolio that Funds offer, Feeders that aggregate the capital commitments of HNWI ("HNW Aggregator Funds") have become an increasingly popular investment vehicle.

A HNW Aggregator Fund may be organized by a private bank or brokerage firm; it allows HNWI to commit assets held in a traditional brokerage or retirement account in amounts as little as $50,000 to an investment that will ultimately be aggregated with similar commitments from other HNWI and pooled into a HNW Aggregator Fund. The popularity of such HNW Aggregator Funds can be seen in the increased level of capital pouring into them. In the 12 months ending September 2014, Blackstone raised $10 billion through such HNW Aggregator Funds run by brokers and through its other retail offerings, out of a total of $54.8 billion Blackstone raised. This represented a sharp increase from 2011, when Blackstone raised just $2.7 billion through these channels out of a total of $49.5 billion. Sensing the growing demand for the HNW Aggregator Fund product, the broker-dealer arms of financial institutions, such as Goldman Sachs, Citibank, Morgan Stanley and Merrill Lynch, are offering opportunities for HNWI to participate in such Feeders.

Challenges Facing Lenders and Funds in a Facility with a Feeder

The variety of Feeders (and their related investors) that ultimately invest in a Master have important implications for both lenders and Funds in structuring a Facility where the borrowing base is directly correlated to the lender's reliance on the ability of investors to fund capital commitments. In a typical Facility, for instance, a lender will advance cash to a Fund on the basis that the Fund can make a capital call with respect to the capital commitment of its investors in order to satisfy its repayment obligations. The borrowing base of the Fund will be calculated based on such lender's view of the probability that the investors in such Fund (and therefore the ability of the investors in each Feeder) will make capital contributions when required by the Fund.[7]

When developing a borrowing base formula for any given Fund, a lender will be focused on the sufficiency of the "know-your-customer" ("KYC") and financial reporting information that it receives with respect to the investors in a Feeder. As part of the diligence process that all lenders undertake when establishing a Facility with any borrower, a lender will customarily gather KYC and financial information that allows such lender to make

both regulatory and commercial decisions regarding a potential borrower. Such information may include the tax status of such entity or individual, sources of income or funds for purposes of repayment of any obligations owing to the lender, the intended use of any loan proceeds and the assets, liabilities and financial strength of the investor. The ability of a lender to collect KYC and financial information is critical for such lender not only to ensure compliance with any regulations applicable to it, such as the Foreign Corrupt Practices Act of 1977 or the Foreign Account Tax Compliance Act, but also to properly underwrite the investor pool forming the borrowing base.

Gathering KYC and financial information with respect to investors in an HNW Aggregator Fund may present additional challenges to both lenders and Funds. Collecting KYC information with respect to HNWI in a Feeder requires lenders (and to a certain extent, the Fund itself) to rely primarily on the HNW Aggregator Fund sponsor (i.e., the broker-dealer that has established the Feeder comprised of HNWI) to provide KYC information with respect to relevant HNWI. The HNW Aggregator Fund sponsor must be able to properly gather KYC information that the lender will rely on to make a commercial decision about the liquidity and financial strength of such HNWI and their ability to meet capital commitments to the HNW Aggregator Fund, but also to ensure that such lender is in compliance with applicable regulations. In some cases, lenders rely on HNW Aggregator Fund sponsors to make representations with respect to HNWI creditworthiness. Lenders may find it difficult to place such a high reliance on a third-party HNW Aggregator Fund sponsor to provide such critical information.

An additional area of concern for lenders with respect to Feeders is the ability to directly enforce capital calls related to the investors that comprise such Feeder. In a typical Facility, if a Fund defaults on its obligations to the lender, the lender has the ability to enforce the Fund's rights to make capital calls on investors in the Feeder. The ability of a lender, however, to exercise this right when facing a Feeder may be limited, if not entirely restricted, due to the relationship that the Feeder has with the Fund and/or the Fund sponsor. A Feeder may be unwilling or unable to grant a lender the ability to enforce capital calls related to the capital commitment of its investors. Removing this important security feature from the remedies available to a lender in the event of a default by a Fund creates uncertainty for a lender when relying on investors in a Feeder as a source of repayment under a Facility.

Potential Structures for Feeder Funds in Subscription Facilities

There are a few different approaches that can be taken with respect to integrating a Feeder into a Facility. The specific approach can be determined by Funds and lenders, with input from experienced legal counsel, depending on a number of factors, including the borrowing base needs of the Fund. Below, we detail a few common approaches.

Treat as a Non-Included Investor and Disregard. A lender and Fund may choose to exclude a Feeder from the borrowing base under a Facility and disregard the capital commitment of the investors in such Feeder for purposes of repaying any obligations thereunder. This approach, while not preferable from the standpoint of a Fund, might be the easiest solution if the Fund determines that the borrowing base would not be significantly increased by the inclusion of such Feeder, or that any increase in the borrowing base is not desirable given the Fund's anticipated borrowing needs.

Treat as an Included Investor with a Reduced Advance Rate. Instead of electing to exclude a Feeder from the borrowing base entirely, the concerns of a lender may be mitigated by negotiating a lower advance rate against the capital commitment of any investor that is included in a Feeder. For example, a lender under a Facility may advance against the commitments of an HNW Aggregator Fund based upon representations of the sponsor of such HWN Aggregator Fund as to the identity and financial strength of the investors.

Add to the Facility as a Loan Party. Beyond borrowing base concerns related to Feeders, lenders and Funds will also need to consider how best to structure the security package to accommodate the Feeder and give borrowing base credit to the investors in such Feeder. The security package that a lender may receive in connection with a Facility that includes Feeders will typically be structured as that of a direct guarantor or a cascading pledge.

Direct Guarantor. In a direct guarantor structure, each Feeder will make a direct guaranty in favor of the lender of the obligations of the Master, as borrower, under the Facility. This approach will create privity between the lender and each Feeder with respect to the obligations under the Facility. Documenting this security structure will require a guaranty issued by each Feeder in favor of the lender and creates joint and several liability among the Master and the Feeders for the Facility obligations. In the event that a default occurs under a Facility, the lender would have the ability to call on the investors of each direct guarantor Feeder to repay the obligations of the Master.

Cascading Pledge. The ability of a Feeder to give a direct guaranty to a lender under a Facility may not be permitted in some instances, specifically in instances where the assets of a Feeder constitute plan assets under ERISA (as discussed in greater detail above) and prohibit such a direct transaction with the lender under such facility or where there may be tax concerns related to a Feeder. In such instances, a cascading pledge structure may be used instead, whereby each Feeder will separately pledge its rights with respect to the capital call commitments of its investors to the Master, or to any intermediate entity. In turn, the Master will pledge its assigned rights of enforcement to the lender. Such a structure will avoid any direct transaction between the Feeder and the lender under a Facility.

The documentation of a cascading pledge structure typically includes separate security agreements between each Feeder and the Master, with a back-to-back security arrangement between the Master and the lender. The cascading pledge structure will only result in several liabilities on behalf of the individual Feeders, and will ultimately give the lender enforcement rights with respect to the capital commitments of all the relevant investors. In a cascading pledge structure, the obligations of the Feeder will be limited solely to the amount of the capital commitment of such Feeder to the Master or applicable intermediate entity and will not be directly tied to any obligations incurred by the Master (or any other Feeder) under the Facility.

A properly structured security package will allow a Fund to fully leverage the capital commitments of all investors in Feeders and allow lenders to rely on the capital call commitments of all investors in Feeders to secure the obligations of the Master under a Facility.

Conclusion

The growing complexity of Funds and their increased reliance on Feeders requires that lenders and Funds recognize the dynamics of the capital call commitments for investors in Feeders and the implications Feeders can have

on the borrowing base and security structure of any Facility. Experienced legal counsel can assist both lenders and Funds in balancing the needs of a lender for adequate security and diligence with respect to investors against the ability of a Fund to utilize the available borrowing base of investors in Feeders to the fullest extent. Properly structuring and documenting these types of Facilities can facilitate and meet the needs of both lender and Fund.

Endnotes

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[2] This article is not intended to be used, and should not be used, for tax advice under US tax law.

[3] For a general description of ERISA issues related to lending to real estate, private equity and other investment funds, please see our *Fund Finance Market Review*, Summer 2013.

[4] See 29 C.F.R. § 2510.3-101. For ease of reference, references to the "plan asset regulation" should be deemed to include Section 3(42) of ERISA.

[5] The "less than 25% exception" is available for an entity if less than 25 percent of each class of equity interests in the entity are owned by "benefit plan investors" (as defined under ERISA). A privately offered investment fund relying on the operating company exception will typically do so by seeking to qualify as either a "real estate operating company" or a "venture capital operating company" (each as defined under ERISA).

[6] Form ADV requires each investment adviser to state how many clients of such investment adviser are "high-net-worth individuals." The Form ADV Glossary of Terms explains that a "high-net-worth individual" is an individual with at least $1 million managed by the reporting investment adviser, or whose net worth the investment adviser reasonably believes exceeds $2 million (or who is a "qualified purchaser" as defined in section 2(a)(51)(A) of the Investment Company Act of 1940).

[7] For a more detailed description of the subscription facility market and features of the subscription-backed credit facility product in general, please see our article "Summer 2013 Subscription Credit Facility Market Review," in *Fund Finance Market Review*, Summer 2013.

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