Global Legal Insights

Fund Finance

2017

First Edition

Contributing Editor:
Michael C. Mascia

global legal group

FUND FINANCE association

CONTENTS

Country chapters

ERISA issues in subscription credit facilities

Paul Borden, Geoffrey Peck & Steven Bleiberg
Morrison & Foerster LLP

Introduction

A subscription credit facility is a credit facility made to a private equity or other investment fund that is secured by the fund's rights with respect to uncalled capital commitments of the investors in the fund. The Employee Retirement Income Security Act of 1974, as amended (ERISA), imposes duties on fiduciaries holding benefit plan assets. This includes banks, funds and other entities that manage ERISA plan assets. This article explores ERISA issues that lenders should consider in subscription line transactions.

Overview of ERISA

ERISA is a federal law that was adopted in 1974 [P.L. 93-406, 93d Cong., 2d Sess. (1974), codified at 29 USC §§1101 *et seq*.]. The purpose of ERISA is to protect the interests of employee participants in employee benefit plans and their beneficiaries by mandating standards of conduct and responsibilities that apply to plan fiduciaries and other persons or entities that are responsible for managing and administering employee benefit plans. The protections provided to participants of employee benefit plans include standards of competence for the investment of plan assets and the operation of the plan, as well as rules to prevent parties who have some involvement with the plan from dealing with the plan to the detriment of the plan's participants.

Employee benefit plans are defined under ERISA to include "employee welfare benefit plans" (plans that provide for medical, disability, day care or similar benefit programs) and "employee pension benefit plans" (plans that provide retirement income). The employee benefit plans covered by ERISA ("Plans") are generally those maintained for the benefit of employees of a specific employer in the United States. ERISA does not apply to governmental plans, church plans, or plans maintained outside of the United States primarily for the benefit of non-resident aliens, although as a practical matter many government plans follow rules similar to those of ERISA.

As mentioned above, ERISA was passed to provide protections for employee benefit plans. These benefit plans exist because, in addition to cash compensation, employees often receive benefits from their employers such as pensions or retirement health benefits. In order to fund these benefits, employers set up accounts that are often managed by advisors. If there is a shortfall in funds, the company's retirees may not receive the benefits that they were expecting. The ERISA rules are intended to avoid these funds becoming unavailable due to any self-dealing or actions by the managers of these retirement funds that are not in the interests of the employees.

Concerns for subscription line lenders – Prohibited transactions

One of the significant concerns in subscription credit facilities is the application of ERISA's prohibited transaction rules. [ERISA Section 406; Section 4975 of the Internal Revenue Code of 1986, as amended.] Plans are often investors in private equity or real estate funds that are borrowers under subscription credit facilities. However, these ERISA prohibited transaction rules apply only to transactions between a Plan and a "party in interest" (such as a fiduciary or service provider) to the Plan. Therefore, the prohibited transactions rules are a concern only in situations where (1) either the borrower or an investor in the borrower is a Plan, and (2) a lender is a party in interest to such Plan. A lender that engages in a prohibited transaction is subject to penalties under ERISA and related sections of the Internal Revenue Code. Under the Internal Revenue Code the penalty could, in some instances, be equal to 100% of the loan amount. As a result, while there are limited situations in which ERISA issues will create a problem for a lender, the penalties can be onerous.

If it is clear that none of the lenders in a deal is a party in interest to any Plan investing in the borrower, and will not be a party in interest to any of the Plans investing in the borrower during the term of the loan, then the lenders do not need to worry about the subscription line credit facility being a prohibited transaction. However, most large banks have affiliates that routinely serve as fiduciaries or service providers to ERISA plans, and it is often difficult for banks to keep track internally as to whether the bank is a party in interest to a particular Plan. For this reason, and because the identity of all of the lenders and investors may not be known at the time a facility is entered into, the credit agreement is usually drafted with the assumption that the lenders are parties in interest to all Plans.

The two main circumstances in which ERISA considerations arise in subscription credit facility transactions are: (1) the making of the loan by the lender to the borrower; and (2) capital calls made by the lender directly to an investor that is a Plan following an event of default by the borrower.

Parties in interest and prohibited transactions

"Parties in interest" to a Plan generally include the following:

(i) fiduciaries (and their affiliates) to the Plan;

(ii) service providers to the Plan;

(iii) the employer sponsoring the Plan;

(iv) a union having members covered by the Plan;

(v) a direct or indirect owner of 50% or more of the interests of an entity described in (iii) or (iv);

(vi) any spouse, ancestor, lineal descendent, or spouse of a lineal descendant of an individual described in (i), (ii), (iii) or (v);

(vii) an entity, 50% or more of which is controlled, directly or indirectly, by an entity described in (i), (ii), (iii) (iv) or (v); and

(viii) a 10% or more shareholder or partner of any of (ii), (iii), (iv), (v) or (vii).

While the above is a relatively long list, a lender is most likely to fall under items (i) and (ii), fiduciaries and service providers. A service provider for a plan is not defined in ERISA beyond a person who provides services to a plan or an affiliate of such person. This category includes investment fiduciaries, record-keepers, and trustees.

In general, a fiduciary is any a person "with respect to a plan to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan" [ERISA Section 3(21)(A)]. It should be noted that there are persons who are both service providers and fiduciaries, such as investment advisers, and there are service providers who are not fiduciaries, such as record-keepers, and other service providers who assist the plan in operating but whose duties are ministerial in nature and not discretionary.

In 2016, the U.S. Department of Labor issued regulations that greatly expanded the categories of advisers to a plan who could be considered fiduciaries. In general, the new regulations would not affect the subscription credit facilities discussed in this article. In addition, as of the date of this article, such regulations are at risk of being invalidated by Congress and the new administration.

ERISA's prohibited transaction rules prohibit a party in interest to a Plan from engaging directly or indirectly in the following transactions with such Plan [ERISA Section 406(a)]:

- the sale, exchange, or leasing of any property between the Plan and the party in interest, such as the sale of property by a Plan to a Plan's investment advisor;
- the lending of money or extending of credit by the Plan to the party in interest, such as a loan made by a Plan to a service provider;
- the furnishing of goods, services, or facilities by the Plan to the party in interest or by the party in interest to the Plan;
- any transfer to, or use by or for the benefit of, the party in interest, of any assets of the Plan, such as a payment to a service provider unrelated to its servicing of the Plan; and
- causing the Plan to acquire and to retain employer securities or employer real property that do not meet certain requirements or exceed 10% of the Plan assets.

These transactions are often referred to as "*per se*" prohibited transactions.

The prohibited transactions rules also prohibit a fiduciary from engaging in transactions where there is a risk that the fiduciary's judgment may be affected by its own interests or potentially adverse to the interests of the Plan or its beneficiaries. A party in interest that is a fiduciary to a Plan is prohibited from engaging in the following transactions [ERISA Section 406(b)]:

- dealing with Plan assets in its own interest;
- acting in a transaction involving the Plan on behalf of a person whose interests are adverse to the interests of the Plan; and
- receiving any consideration for the fiduciary's own personal account from any party dealing with the Plan in connection with a transaction involving the Plan's assets.

These transactions are often referred to as "self-dealing" prohibited transactions.

A fiduciary causing a Plan to enter into a prohibited transaction becomes liable under ERISA §409(a) to "undo" the transaction to the extent possible and make good any losses to the Plan resulting from such prohibited transaction (including reimbursement of any fee paid by the Plan). In addition, any party in interest (including a fiduciary) engaging in a prohibited transaction is subject to an initial excise tax under section 4975 of the Internal Revenue Code of 15% of the amount involved for each year (or part of a year) in the period beginning when the prohibited transaction occurs and ending when it is corrected, by either undoing the transaction to the extent possible or restoring the Plan's financial position. There is an additional excise tax of 100% of the amount involved if the transaction is not corrected within 90 days after the IRS mails a notice of deficiency to the taxpayer. The "amount involved" is defined as the "greater of the amount of money and the fair market value of the other property given or the amount of money and the fair market value of the other property received…"

In some circumstances, exemptive relief from the prohibited transaction rules is available. ERISA contains a number of statutory exemptions and authorises the U.S. Department of Labor ("DOL") (which enforces ERISA) to issue administrative exemptions on both a class and individual basis. Where a particular transaction satisfies the requirements for exemptive relief, the parties in interest are permitted to engage in the transaction without triggering penalties under ERISA or excise taxes under the Internal Revenue Code.

Is the borrower considered an ERISA plan or deemed to hold ERISA Plan assets?

As discussed above, the ERISA prohibited transactions rules apply to transactions between a Plan and a party in interest to that Plan. If a lender is a party in interest to a Plan at any time during the term of the loan, the lending of money by that lender to the Plan will constitute a prohibited transaction unless there is an available exemption.

Although subscription line credit facilities rarely are directly between a lender and a Plan, the borrower (typically a private equity fund) can itself be considered to be a "plan asset vehicle" and, in such a case, the prohibited transaction rules would apply. This is known as the "look-through rule". While the DOL plan asset rules provide for exceptions to the look-through rule, in general if 25% or more of any class of the borrower's securities are held by Plans, the borrower will be considered a plan asset vehicle. If the borrower is a plan asset vehicle, a loan to the borrower by the lender is considered, for the purposes of ERISA's prohibited transaction rules, to be an extension of credit directly from the lender to the Plan investors of the borrower. Assuming that a lender in the deal is a party in interest to one of the Plan investors in the borrower, unless there is an applicable exemption, the loan would be a prohibited transaction that would subject the lender to the excise taxes described above, as well as a duty to "undo" the transaction to the extent possible.

As a result of this concern, most subscription credit facilities will be drafted so that the borrower makes representations and covenants that the borrower is not a plan asset vehicle. There are various ways for a borrower having ERISA investors to enable itself to make these representations and covenants. The first is to limit the amount of ERISA investors in the borrower to less than 25% of all investors. Under ERISA's plan asset rules, the 25% threshold is applied separately to each class of equity securities issued by the borrower, and is calculated by disregarding the equity interests held by any managers of the funds or their affiliates (other than Plan investors).

In some cases, adhering to the 25% threshold is not a practical alternative for a borrower, either because monitoring the threshold will be difficult or impossible (for example, if interests in the borrower are freely transferrable), or because for business reasons the borrower does not want to restrict the amount of ERISA money that can be invested in the borrower. If that is the case, the borrower may try to fashion itself as a "venture capital operating company" (a "VCOC") or a "real estate operating company" (a "REOC"). An entity that qualifies as a VCOC or a REOC is not considered a plan asset vehicle even if its ERISA investors exceed the 25% threshold; provided that 100% of the interests in the borrower are not held by one Plan or a group of Plans sponsored by the same employer or controlled group members of the employer.

To qualify as a VCOC:

(i) on the first day in which the borrower makes any long-term investment (i.e. an investment that is not a short-term investment pending long-term commitment), at least 50% of its assets (other than short-term investments) must be invested in operating companies with respect to which the partnership has or obtains right to influence the management of the borrower (the "VCOC 50% Test"); and

(ii) at some time during that year the partnership must actually exercise these management rights (the "VCOC Management Rights Test").

In each subsequent year, at some time during the partnership's "annual valuation period" (which is a period of up to 90 days that is set during the borrower's first year) the VCOC 50% Test must be met, and at some time during that year it must meet the VCOC Management Rights Test.

The requirements for a REOC are similar to those of a VCOC, except that a VCOC's investments are in operating companies, whereas a REOC's are in real estate under management or development.

To qualify as a REOC:

(i) on the first day on which the borrower makes any long-term investment (i.e. an investment that is not a short-term investment pending long-term commitment), at least 50% of its assets must be invested in real estate that is managed or developed and with respect to which the partnership has the right to substantially participate directly in the management or development activities (the "REOC 50% Test"); and

(ii) at some time during that year it must actually be engaged directly in management or development activities of the real estate (the "REOC Management Rights Test").

In each subsequent year, at some time during the partnership's "annual valuation period" (which is the period of up to 90 days set during the borrower's first year) the REOC 50% test must be met, and at some time during that year it must meet the REOC Management Rights Test.

Another method of ensuring that the lender will not be engaging in a prohibited transaction is to qualify for an exemption from the prohibited transaction provisions. For the reasons discussed below, most subscription line facilities do not rely on these prohibited transaction exemptions. Typical exemptions for this purpose are the "QPAM exemption" and the "Service Provider exemption" of ERISA Section 408(b)(17).

The QPAM exemption generally requires the borrower to enter into the loan under the discretionary authority of a qualified professional asset manager (a "QPAM"), which must be a bank, savings and loan institution, insurance company or registered investment adviser with at least $85 million under management, and shareholders' or partners' equity of at least $1 million. In addition, none of the lenders can have the power to appoint or remove the QPAM or to negotiate the terms of the QPAM's management agreement with the borrower. Furthermore, the lenders cannot be related to the QPAM. Very generally, a lender is considered related to the QPAM if (i) the QPAM or a person controlling or controlled by the QPAM owns a 10% or more interest in such lender, or (ii) such lender or a person controlling or controlled by the lender owns a 10% or more interest in the QPAM. Because of the highly factual analysis that must be taken to ensure that the QPAM exemption applies, it is not generally useful in subscription facilities where there are often numerous lenders and Plans.

The Service Provider exemption applies only if the lenders are parties in interest to the investing Plans because they are service providers who are not fiduciaries who have authority over the decision of the Plans to invest in the borrower or over anything relating to the loan. There is also a requirement under this exemption that the Plans not receive any less than "adequate consideration" in the transaction as a whole. There currently are no regulations describing the meaning of "adequate consideration" or how it would apply to a loan between a Plan and a party in interest. Again, because of the highly factual determination this exemption would require, it is rarely relied upon in subscription lines.

Are capital calls by the lender prohibited transactions?

A typical feature of subscription credit facilities is the ability, in the event of the borrower's default, for the lender to directly call capital from the investors in the borrower in accordance with the terms of the relevant loan and security documents and the borrower's limited partnership agreement or equivalent agreement. One issue is whether a lender's capital call on an ERISA investor might be considered a "transaction" between the lender and the Plan that could trigger the prohibited transaction provisions of ERISA. Most practitioners have got comfortable concluding that a capital call made by a lender to an ERISA investor is not actually a transaction between the lender and the ERISA investor. They have reached this conclusion because the lender's right to call capital from investors is established in the borrower's agreement with the ERISA investor (typically the limited partnership agreement or equivalent agreement of the fund). The theory is that the lender is only stepping into the shoes of the borrower and exercising the borrower's right to call capital. When capital is called, the investor typically pays its capital to an account of the borrower over which the lender has a security interest (and not to a lender account). In order to ensure that the borrower and its counsel agree that calling capital does not cause a prohibited transaction, the borrower is routinely required to make a representation to that effect, and its counsel may be asked to render a written legal opinion to the lender to the same effect.

Note that the theory that there is no transaction between a lender and an ERISA investor when calling capital does not apply to any transaction that is a self-dealing prohibited transaction. A self-dealing prohibited transaction could occur if the lender or its affiliate is the fiduciary for the ERISA investor who has investment authority over the assets invested in the borrower. In such a case, the lender would be considered to be on "both sides" of the interaction between the lender and the ERISA investor and, as a result, a decision by the fiduciary to invest plan assets in the borrower, or to respond to a capital call that could benefit itself or its affiliate acting as the lender, could violate ERISA's prohibited transaction rules. This concern does not apply where neither the lender nor any of its affiliates has any involvement with the plan as a fiduciary or service provider, or where its involvement with the plan does not include authority over the assets of the ERISA investor invested in the borrower.

A possible alternative to obtaining the borrower's representation and its counsel's opinion is for the lender to obtain an exemption from the DOL that the ability of a lender to call capital on employee benefit plans is exempt and not a prohibited transaction. This exemption was first granted to Bank of America, as exemption PTCE 2004-2 (the "Exemption"). Because there were a number of banks who wanted similar exemptions, the DOL permitted banks to apply for the Exemption on an expedited basis, called the "ex-pro" application process. The process for obtaining this exemption on an ex-pro basis expired in 2014, and it is not clear whether the DOL would currently entertain granting a similar exemption, or how long it would take to obtain the exemption if the DOL were receptive to granting it.

Very generally, this exemption permits:

(i) a borrower to assign the capital commitments of investors, including ERISA investors as collateral for a loan;

(ii) the lender to call capital from investors, including ERISA investors following an event of default under the loan agreement; and

(iii) ERISA investors to acknowledge the right of the borrower to assign the borrower's right to capital contributions to the lender, and the right of the lender to call capital without the right of the borrower to claim any counterclaim, setoff, or defence.

The conditions for the exemption to apply are:

(i) the transaction is on terms no less favourable to the Plan than what the Plan would get in an arm's length transaction;

(ii) the decision-maker for the Plan is not the lender or an affiliate of the lender, and no such lender or affiliate has any investment authority for the Plan with respect to such investment;

(iii) the Plan (or group of related Plans) has assets of at least $100 million; and

(iv) not more than 5% of the Plan's (or group of related Plans) assets are invested in the fund.

As mentioned above, the ability to obtain the Exemption expired in 2014. Lenders who did not obtain the exemption before then do not have this exemption available to them. As a result, lenders without the Exemption generally rely on the borrower's representations and the written legal opinion of borrower's counsel.

Relevant credit agreement provisions

Credit agreements for subscription lines can cover ERISA issues in the following sections:

(i) Representations and warranties –

- Representation by the borrower that the assets of the borrower are not Plan assets.
  - While the borrower typically makes certain representations about its ERISA status, it is advisable for lenders to do their own diligence. Lender diligence for subscription credit facilities could include reviewing information about the investors in the borrower (not just the "included investors" that are analysed for credit purposes of the borrowing base).
- Representation by the borrower that, subject to certain assumptions about the lender, the transactions will not constitute a non-exempt prohibited transaction under ERISA that would subject the lender to any tax or penalties imposed under ERISA or Section 4975 of the Internal Revenue Code.

(ii) Affirmative covenants –

- Covenant by the borrower to notify the lender if the borrower has reason to believe that the borrower's assets constitute Plan assets of an ERISA investor.
- Compliance with law covenant should include a reference to ERISA.
- Covenant by the borrower that it will require all investors to make capital contributions to a particular account over which the lender will have a security interest.
  - A review of the borrower's limited partnership agreement or equivalent agreement is often part of lender diligence. One item to look for is a requirement in the limited partnership agreement that investors make their

capital contributions to a particular fund account specified in the drawdown notice. In the alternative, this could be addressed by a covenant by the borrower in the credit agreement (although this is less desirable).

(iii) Negative covenants – Subject to certain assumptions about the lender, the borrower will not take any action or omit to take any action in connection with the transaction that would give rise to a non-exempt prohibited transaction under ERISA or Section 4975 of the Internal Revenue Code that would subject any lender to any tax or penalty on prohibited transactions imposed under ERISA or Section 4975 of the Internal Revenue Code.

(iv) Events of default – Other than due to inaccuracy of the assumptions about the lender referred to above, an event of default if the transaction constitutes a non-exempt prohibited transaction under ERISA or Section 4975 of the Internal Revenue Code.

(v) Legal opinions – A lender sometimes requires that borrowers provide a legal opinion regarding the ERISA status of the borrower as a condition to making the loan. If the limited partnership agreement or equivalent agreement of the borrower requires the borrower to provide its investors with an ERISA opinion or certificate regarding ERISA status, the credit agreement may require the borrower to provide a copy of this opinion or certificate to the lender and allow the lender to rely on such opinion or certificate.

Borrower limited partnership agreements – ERISA items

As noted above, lender diligence for subscription credit facilities should include a review of the borrower's limited partnership agreement. Below are some ERISA-related provisions to look for:

(i) Collateral account – Requirement that investors make capital contributions to the account specified in the drawdown notice.

(ii) ERISA opinion or certificate – The partnership agreements of subscription line borrowers may have a requirement that the borrower provide its investors with an annual legal opinion or a certificate regarding the ERISA status of the borrower. ERISA investors often insist on this requirement in order to protect their Plan asset exceptions. Subscription line credit agreements may require the borrower to provide a copy of this opinion or certificate to the lender and allow the lender to rely on such opinion or certificate.

(iii) ERISA related authority of General Partner – Provision stating that the general partner of the fund will operate the fund such that its assets will not be deemed to be ERISA plan assets, and that the general partner has the power to take action to prevent its assets from being deemed plan assets.

(iv) ERISA related transfer restrictions – Restriction on transfer of interests by an investor if, in the judgment of the general partner, the transfer would cause the fund's assets to be Plan assets.

Conclusion

ERISA issues may not be at the top of the list of lenders' concerns when entering into a subscription credit facility. It is important, however, for lenders to understand how ERISA impacts on these financings, including to avoid the risk of severe penalties. Given the difficulty for many banks and other institutional lenders in determining whether or not they are a "party in interest" to a Plan investing in a borrower, lenders need to diligence whether the borrower is a plan asset vehicle, and that the financing is not a prohibited transaction. Lenders can additionally protect themselves through inclusion of representations, covenants and defaults in the credit agreement and through diligence of the borrower's partnership agreement.

Paul Borden
Tel: +1 415 268 6747 / Email: pborden@mofo.com
Paul Borden is a Partner in Morrison & Foerster's San Francisco office. Mr. Borden focuses his practice on a broad spectrum of matters relating to employee benefits, including defined benefit and defined contribution plans, and fiduciary and prohibited transaction issues. Mr. Borden is recommended by *Chambers USA 2016*, *Legal 500 US 2016*, *Best Lawyers In America 2015*, and *Super Lawyers 2012*. Mr. Borden earned his A.B. and J.D. from University of California, Berkeley.

Geoffrey R. Peck
Tel: +1 212 336 4183 / Email: gpeck@mofo.com
Geoffrey Peck is a Partner in Morrison & Foerster's New York office. Mr. Peck specialises in financial transactions and restructurings, representing banks, funds, issuers and borrowers in a broad spectrum of financings, including syndicated and asset-based loans, acquisition, subscription-backed, debtor-in possession, mezzanine, structured commodity and project financings, and secondary market trading. His practice is both domestic and cross-border. Mr. Peck received his B.A. and B.S. from Boston University and his J.D. from the University of Pennsylvania.

Steven J. Bleiberg
Tel: +1 212 3364228 / Email: sbleiberg@mofo.com
Steven Bleiberg is an Associate in Morrison & Foerster's New York office. He represents financial institutions, public and private borrowers, and other corporate entities in a variety of finance transactions, with a particular focus on credit and securities transactions, and mergers and acquisitions. Mr. Bleiberg earned his J.D./M.B.A. from Columbia University, where he was a Harlan Fiske Stone Scholar and a Milbank Law & Economics Fellow, and served on the Columbia Business Law Review. He received his B.A. in quantitative economics from Tufts University.

Morrison & Foerster LLP

250 West 55th Street | New York, NY 10019-9601, USA
Tel: +1 212 468 8000 / Fax: +1 212 468 7900 / URL: www.mofo.com