

Spotlight on GP-Led Secondary Transactions

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As assets mature in aging funds, both GPs and investors alike are seeking ways to unlock this liquidity. GP-led secondary transactions have become an increasingly popular way of achieving this, accounting for over a quarter of all secondary transactions in 2018, and fund financiers are following suit to provide debt finance for these types of transactions.

Types of GP-led transactions

The main attraction of GP-led secondary transactions is that investors are offered an exit option, while managers are able to maximize the value of their mature investments. The four most popular types of GP-led transactions are fund restructurings (also referred to as fund recapitalizations), direct secondaries, stapled secondaries and tender offers. The common theme among all of them is that a secondary buyer purchases the existing investments and a new vehicle is established to hold those assets. The participation of the existing manager in the ongoing management of the assets and the participation of the existing limited partners are the key differences between the various types of transactions.

The primary characteristic of **fund restructurings** is that all existing investors are offered an opportunity to either sell their existing position in the fund or an option to roll their positions into the newly formed vehicle. The GP typically remains in place to manage the underlying assets, with the added benefit of a longer investment period and added capital to assist them in maximizing value. This option provides incentives to both the limited partners and the GP while allowing them to pursue their independent investment strategies. This can give rise to potential conflict-of-interest issues for the GP, who is on both sides of the table and continues to owe a fiduciary duty to the existing limited partners.

Direct secondaries involve the sale of all of the assets in a portfolio to a buyer along with the responsibility to manage the portfolio, thereby excluding the GP from future management of those assets. This is of interest to GPs who are looking to focus their attention on other matters or investments.

Stapled secondaries are a hybrid of a fund restructuring and offer investors the opportunity to participate in the GP's new fund, thereby combining a secondaries and primary offering.

Tender offers are the least complex of the GP-led secondary transaction types. These involve a buyer (who could be an existing investor or an affiliate of the GP) tendering for all or a portion of the existing limited-partner interests.

Pros and cons

The incentives to structure GP-led secondary transactions primarily are:

- creating liquidity for limited partners;
- providing options for limited partners (i.e., to continue with their exposure or not);
- allowing limited partners to restructure their portfolio;
- providing additional time and capital for the relevant assets which, in turn, can lead to better returns on those assets, resulting in potential additional value; and
- reincentivizing the GP and allowing it to raise fresh capital for follow-ons.

The downsides and potential pitfalls of these transactions include:

- unsettling limited partners who may feel they do not have sufficient time and/or resources to properly evaluate the transaction;
- in respect of the GP, a material conflict-of-interest risk which has already caught the attention of various regulators, including the SEC. As there is no standardized approach to these types of transactions, ILPA has helpfully announced that it will be issuing guidance on GP-led secondary transactions, including the conflict of interest risk. We understand that ILPA will be considering how limited partners can push for better market testing on pricing, including an intermediary in the transaction, "full and frank" disclosure from the GP and whether a fairness opinion on valuation and the prospective deal should be required. The common theme here is transparency on the part of the GP with respect to the limited partners, particularly in respect of the information that the GP has on the value of the existing portfolio to which no third party has access.

We fully expect the volume of these types of transactions to continue to grow, as well as the use of debt finance to support them. However, it will be fundamental that the issues we raise above be addressed while the market is still relatively niche.



By **James Frazier**

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We are frequently getting ERISA questions from our Fund Finance banking clients, often in Europe where U.S. retirement plans have increased their investment allocations in recent years. Here, we provide a high-level overview of ERISA and its implications in Fund Finance. In later editions, we will detail out the specifics around the relevant issues, including the exemptions that can help to keep banks in the clear.

What is ERISA

The Employee Retirement Income Security Act of 1974 (“ERISA”) is a United States federal law that was adopted to protect the interests of employee participants and beneficiaries in private sector employee benefit plans (“Benefit Plans”). The ERISA regime intends to, among other things, ensure that assets in Benefit Plans do not get squandered by self-dealing or actions by the pension managers and other fiduciaries, and other parties with certain relationships with Benefit Plans. ERISA only covers Benefit Plans and does not apply to governmental plans (such as CalPERS and CalSTRS), church plans, or non-U.S. benefit plans.

To protect Benefit Plans and their participants and beneficiaries, ERISA rules include a list of “prohibited transactions.” These type of transactions are, um, prohibited. They apply to transactions between a Benefit Plan or a “plan asset vehicle” (e.g., an investment fund that is subject to ERISA) and a “party in interest,” a term of art under ERISA. A “party in interest” includes an investment manager or other fiduciary to a Benefit Plan, a service provider (e.g., a custodian or broker) to a Benefit Plan and certain entities related to the foregoing by ownership attribution. Unless an exemption applies, a loan between a Benefit Plan and a party in interest will be prohibited. A fiduciary causing a Benefit Plan to enter into a prohibited transaction faces liability under ERISA and must unwind the transaction (to the extent possible) and compensate the Benefit Plan for any losses (including reimbursement of fees). In addition, any party in interest engaging in a non-exempt prohibited transaction may be subject to liabilities and penalties under ERISA and to excise taxes and penalty taxes under the U.S. Internal Revenue Code (the “Code”).

ERISA also includes rules relating to the funding of Benefit Plans that are defined benefit pension plans (generally, traditional plans paying benefits based on a pre-established formula that are required to be funded). These plans may cover either one or a group of related employers (frequently called “single-employer” plans) or may be union-sponsored plans that cover employees of multiple employers (frequently called “multiemployer” plans). These plans are subject to funding rules that create special problems by, among other things, imposing joint and several liability for underfunded plan liability not only on the relevant employer but on all the employer’s “ERISA Affiliates” (generally, the employer and all of its 80% or more commonly owned affiliates). Importantly, there is case law that indicates that in some circumstances a private equity fund could potentially be an ERISA Affiliate. Typically, lenders are most concerned about two types of ERISA funding liabilities: (i) termination liability for an underfunded “single-employer” pension plan, and (ii) withdrawal liability to a “multiemployer” pension plan (generally triggered by either a cessation or a significant reduction in an employer’s contributions). In the U.S., many pension plans are significantly underfunded, and this often results in multimillion dollar termination or withdrawal liabilities.

ERISA and Fund Finance

So, what the heck does all this have to do with Fund Finance? Banks are not typically lending to Benefit Plans in these transactions. Well, lawyers were involved in drafting ERISA, so there are of course a host of technicalities.

One must first determine whether ERISA applies to the Fund borrower^[1]. Benefit Plans invest in private equity fund borrowers (“Funds”), and under ERISA there is a “look-through rule.” As a general matter, unless an exception applies, a Fund can be deemed a plan asset entity (and thus be subject to ERISA) if its equity holders include Benefit Plans. Under a commonly relied-upon exception in the private fund space, a Fund will not be deemed a “plan asset vehicle” under ERISA if less than 25% of the value of each class of the Fund’s equity is held by Benefit Plans, certain other plans covered by the Code, and “plan asset” entities (together “Benefit Plan Investors”). That means if the Fund or any feeder fund or parallel fund in its structure has Benefit Plan Investors that aggregate to more than 25% of the value of any class of equity in such entity, the Fund is a plan asset vehicle unless another exception applies.

Given how broadly the term “party in interest” is defined and the ramifications of violating these rules, Banks generally assume they are, or during the term of a transaction will become, a party in interest to any Benefit Plan invested in a Fund borrower that is a plan asset vehicle. If a Bank lends to a Fund which is a plan asset vehicle and the Bank is a “party in interest,” the prohibited transaction rules apply. Fortunately, in our experience, the majority of Funds stay below the 25% threshold and this is a non-issue with respect to the loan itself (i.e., the prohibited transaction rules are not relevant regarding the loan). The Fund can give the lender comfort with a representation, covenant and related deliverable(s) to the effect that it does not and will never exceed the 25% threshold.

But what if a class of equity in the Fund is over 25%? Or what if the Fund is still fundraising and does not know for sure what its ultimate investor pool will look like? Well, there are other exceptions to plan asset status available to protect the parties. As a general matter, assets in funds registered under the Investment Company Act of 1940 are not “plan assets” subject to ERISA. Also, the Fund can be a “venture capital operating company” (a “VCOC”) or a “real estate operating company” (a “REOC”) to avoid constituting a plan asset vehicle. The VCOC and REOC classifications are highly detailed under ERISA regulations, but at a high level, the Fund operates less like a passive investment vehicle and is more actively involved in management of its portfolio company or real estate investments. The conditions for either status are specific, and a legal opinion is typically required to give comfort on qualification.

But what if any class of equity in the Fund is over 25% and there is no exception to “look through” treatment? In such instance, the Fund would be a plan asset vehicle and ERISA and the prohibited transaction rules would apply with respect to the loan transaction. To avoid engaging in a prohibited transaction, the Bank will want to make sure an exemption applies. In Fund Finance, the most commonly relied-upon exemption for loan transactions with plan asset Funds is the so-called “QPAM Exemption” (Prohibited Transaction Exemption 84-14), which provides relief where the Fund is managed by an independent “qualified professional asset manager” (or “QPAM”). Section 408(b)(17) of ERISA, the so-called “Service Provider Exemption,” where the Bank is merely a party in interest to investing Benefit Plans by virtue of being a service provider to the Benefit Plans or related to such a service provider, might also be available depending upon the facts and the Bank’s comfort with the exemption. The Fund and manager typically give the Bank representations and covenants speaking to the application of the relevant exemption and other potentially relevant ERISA considerations (e.g., that the Bank is not a fiduciary to the Fund).

The prohibited transaction rules are also a consideration in connection with the capital calls relating to Benefit Plan Investors. The relevant issues can be addressed structurally or through application of an exemption. In the latter case, some Banks have the benefit of their own lending exemption (although rarely used in fund finance transactions) applicable to these issues. These “Bank side” exemptions do not affect whether a loan transaction is “prohibited” (that is the function of the QPAM Exemption or Service Provider Exemption, referenced above), but they can provide additional comfort and protection around certain Benefit Plan related issues, e.g., security enforcement. We will provide specifics on these issues and related exemptions and how they may apply to address the relevant concerns in a subsequent edition.

Finally, Banks are generally concerned with how a borrower’s ERISA obligations to any Benefit Plans may impact the borrower’s ability to satisfy its obligations under a loan. As described above, it is not only a borrower’s direct obligations to a Benefit Plan that can impose liability on a borrower or guarantor. Instead, the borrower is jointly and severally liable for the ERISA obligations of all of its “ERISA Affiliates” (including possibly a Fund). Failure to satisfy these obligations may result in liens, and the Pension Benefit Guaranty Corporation – a U.S. agency responsible for overseeing U.S. pension plans – takes the position that it may even pursue non-U.S. “ERISA Affiliates” for these liabilities (even though it may encounter jurisdictional barriers to enforcing a judgment against non-U.S. affiliates). Because the scope of these liabilities can be large, loan documentation generally includes representations and covenants from borrowers that there are no (and will not be) ERISA pension obligations applicable to a borrower or any of its “ERISA Affiliates” that could materially affect the borrower’s ability to satisfy its loan obligations.

Conclusion

ERISA is highly technical and requires experienced lawyers to ensure you get it right. And the consequences of getting it wrong can be severe. But the issues are generally manageable in Fund Finance and can be resolved to the satisfaction of both Funds and lenders.

[1] The considerations discussed here are also generally relevant with respect to any guarantor.

FFA Next Generation — Inaugural Event

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The Next Generation in Fund Finance sub-group of the FFA formally launched in Europe with a panel session at Cadwalader's offices in London earlier this week. Following a welcome from Cadwalader partner Jeremy Cross, the breakfast panel session, titled "What can a career in fund finance look like for you?," was introduced by Jeff Johnston as Chairman of the FFA Board and attended by nearly 100 participants from the fund financing sector. The program marked an impressive start for the Next Generation initiative in Europe.

The panellists (moderated by Billal Malik of Citi) had experience from across the industry and comprised George Cherry (Citi), Thomas Rapp (Wells Fargo), Bethany Walker (Pemberton Capital Advisers) and Samantha Hutchinson (Cadwalader).

The panel provided an informative and enjoyable session, with discussions ranging from their personal career history and development to views on the market and industry trends. Panelists agreed that one of the key points of distinction for the fund finance market is the fact that it requires a diverse skill base with professionals needing to maintain and develop client relationships and to look for and create business opportunities and products while at the same time understanding the technical detail of the fund and lending documents and the industries in which fund clients operate.

There were also extensive discussions regarding: general advice for junior members of the industry; where the next generation should be focusing given market movements; what industry employers look for in candidates; and how the industry is working to bridge perceived and actual generation gaps.

Billal explained that this was the first of many events to be arranged as part of the Next Generation initiative, with future events including networking and educational sessions.

If you are interested in becoming involved with the Next Generation in Funds Finance group details are available [here](#). Billal Malik and Rob McClean would be happy to hear ideas for future events or to hear from volunteers who would like to share some of your time to assist with the initiative.

FFA Next Generation Announces New York Event

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This week the Fund Finance Association's Next Generation initiative announced its inaugural event in New York. The networking reception is open to junior bankers and lawyers and will take place the evening of Thursday, February 21 at 7:00 pm at First Republic Bank's office at 1230 Avenue of the Americas. For information about the event or to register, click [here](#).

Join Us at the 9th Annual Global Fund Finance Symposium

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Cadwalader invites you to join us for cocktails and hors d'oeuvres at Scarpetta at the Fontainebleau Miami Beach from 8 - 11 pm on Sunday, March 24 to kick off the 9th Annual Global Fund Finance Symposium.

Commonwealth Bank of Australia Fund Finance Job Posting

- Commonwealth Bank of Australia is looking for a Risk Executive to join its Risk Management, Institutional & Business Banking division in its New York office to work on private equity transactions. The job posting is available [here](#).

SMBC Subscription Secured Finance Job Posting

- SMBC is looking for an Associate to join its Subscription Secured Finance Department in its New York office. The job posting is available [here](#). SMBC's Subscription Secured Finance team provides fund finance to global private sponsors, manages lines of credit from origination to closing and provides ongoing monitoring.

Santander Bank Subscription Finance Job Posting

- Santander Bank has a posting on LinkedIn for a Credit Risk Specialist in Subscription Finance in its New York office. The job posting is available [here](#). Santander Bank has its corporate offices in Boston and operates in eight U.S. states. The bank has approximately \$79 billion in assets. It is a wholly owned subsidiary of Madrid-based Banco Santander, S.A., which trades on the NYSE as SAN.

Cadwalader Seeks Fund Finance Associate

- Cadwalader's Charlotte and New York offices seek an associate for the fund finance practice. Qualified candidates will have 3-7 years of experience in syndicated lending, commercial lending, leverage finance, fund formation, CLOs or other relevant experience. Candidates must possess excellent academic credentials and solid law firm or in-house legal experience as well. Anyone interested please email Wes Misson directly at Wesley.Misson@cwt.com.

Also in This Issue

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2019: A Year for the Borrower?

Debevoise & Plimpton LLP this week released an article spotlighting borrower-friendly trends that have emerged in the expanding fund finance market.

As the menu of lenders and financial products available to borrowers in the current fund finance market has grown (and continues to grow), the competitive landscape has similarly re-shaped and reactively shifted slightly in favor of borrowers. This is evident in Debevoise's article, which highlights lenders' increased leniency in financial covenants, an increased use of borrower default cure periods, and a general willingness of lenders to accommodate issues in side-letters, to name but a few of these borrower-friendly trends.

Debevoise predicts that the trend towards borrower-friendly provisions will continue in 2019 but cautions that the recent political and financial volatility coupled with the Abraaj aftermath, have yet to fully play out. The link to this article is [here](#).

Private Equity International Article on Fund Finance

On January 29, *Private Equity International* published an article, titled "Fund finance is here to stay." The premise of the article is that the fund finance markets continue to be busy and that rising interest rates have not created headwinds for facility demand. The article also includes some speculation as to what might cause the markets to slow. The article is available [here](#).

