FUND FINANCE FRIDAY

# Cascading Security

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With the increasing complexity of fund structures and the growing prevalence of US Pension Funds in the European market, we have seen an uptick in the number of queries particularly from European banks and funds around how to structure their security packages in circumstances where direct security is not possible from one or more feeder funds.

As touched on in our previous discussion of available credit support options for Lenders[1], where there are Feeder Funds within the structure for a subscription line facility, Lenders' preference will usually be to seek a direct guarantee and security from each Feeder Fund (as well as from the Master Fund) in order to ensure that the Lenders have direct recourse to the uncalled capital of each of the investors. However, in circumstances where a direct guarantee and security isn't possible, it may be possible to replicate the Lenders' recourse under direct security through a cascading pledge or assignment and we have sought to set out below a brief primer on cascading structures, what are they and when are they used, as well as a brief checklist of key points to consider.

**What drives the use of cascading security?**

A Feeder Fund may be prohibited from granting direct security to a Lender under the terms of its limited partnership agreement or as a result of regulatory restrictions or the tax structuring requirements of investors. Prohibitions are most commonly seen in the context of Feeder Funds whose investors include US pension funds subject to the Employee Retirement Income Security Act ("ERISA").

ERISA investors have historically served as one of the largest sources of institutional capital for funds. However, as previously discussed[2], the ERISA regime imposes material restrictions on

transactions that may be entered into by “plan asset vehicles,” (including Feeder Funds where more than 25% of the value of the Feeder Fund’s equity is held by private sector employee benefit plans, (“Benefit Plans”)) with other “parties in interest”. These restricted transactions include any loan between a plan asset vehicle and a party in interest. This is intended to limit the risk of the Benefit Plan’s assets being appropriated through self-dealing by pension managers and other fiduciaries, but banks will typically assume that they will be deemed to be a party in interest for the purpose of ERISA. To the extent it is not possible to rely on one of the Prohibited Transaction Exemptions, any prohibited transaction entered into by a party in interest with a plan asset vehicle may be unenforceable against the Benefit Plan and any fiduciary causing a Benefit Plan to enter into a prohibited transaction may be required to unwind the transaction and compensate the Benefit Plan if it has incurred any losses.

Given the potentially draconian consequences, it is in the interest of both the fund and the Lenders to avoid having any plan asset vehicle enter into a prohibited transaction. In order to avoid this, a Lender may elect not to take security and to treat the Feeder Fund (and any investors participating through the Feeder Fund) as an excluded investor and carve them (and any investors coming in through that Feeder Fund) out of the borrowing base entirely. Subject to reviewing the terms of the fund documents, this will typically not prevent the Lender from being able to take security and enforce against any investors in the Master Fund or any other Feeder Fund. Alternatively, a “cascading pledge” may be used to navigate the restrictive security regimes of ERISA investors, through the use of a series of cascading pledges or assignments in order to indirectly assign the fund’s ultimate rights to the benefit of the uncalled commitments of the Feeder Fund to the Lenders.

Although ERISA is the most common regulatory driver for the use of cascading security that we come across, the regulatory regimes in other jurisdictions may similarly restrict the ability of certain funds to grant direct security. As previously highlighted by Arthur Cox in these pages[3], where an Irish Collective Asset-Management Vehicle (“ICAV”), as a regulated fund, sits within the wider structure of a financing, the AIF Rulebook prohibits the ICAV from acting as a guarantor on behalf of a third party and this will often prevent the ICAV or an Irish Investment Limited Partnerships (the “ILP”) which is a Feeder Fund to a third party Master Fund from granting direct security.

**How is cascading security structured?**

While the complexity of the cascading security can be significantly increased where there are multiple feeders/leveraged funds within the structure, at its most basic level cascading security will typically be structured as:

- a pledge or assignment (the “Upper Level Cascading Pledge”) granted by the Feeder Fund and the Feeder Fund GP over (i) their respective rights in respect of the LP Commitments from the investors in the Feeder Fund and (ii) any bank account into which such LP Commitments are to be paid (together the “Pledged Rights”) in favour of the Master Fund. The secured obligations under the Upper Level Cascading Pledge are typically defined by reference to the Feeder Fund’s subscription obligations to the Master Fund under the LPA for the Master Fund; and
- an on-assignment or pledge by the Master Fund of its rights under the Upper Level Cascading Pledge (the “Lower Level Cascading Pledge” and, together with the Upper Level

Cascading Pledge, the "Cascading Pledges") in favour of the Security Agent, with the Secured Obligations defined by reference to the Master Fund's obligations as Borrower under the Facility Agreement, but with the two Cascading Pledges otherwise on substantially similar terms.

Through the combination of the two Cascading Pledges, the Lenders will effectively have the benefit of indirect security over the Pledged Rights and should be entitled under the powers of attorney included in both Cascading Pledges to step into the shoes of (a) the Master Fund and (b) the Feeder Fund GP and call capital from the ultimate investors in the Feeder Fund.

**Key structuring considerations for cascading security**

While Cascading Pledges are capable of providing the Lenders with effective recourse to the Feeder Fund LP Commitments, there are a number of key additional structuring considerations that will need to be taken into account, including the following:

1. the constitutional documents of both the Feeder Fund and the Master Fund will need to be carefully reviewed to ensure that they contain the necessary authority to grant the Cascading Pledges and we would also typically expect either the Feeder Fund LPA or the Upper Level Cascading Pledge to include an acknowledgement of the Lower Level Cascading Pledge and an undertaking to comply with any drawdown request issued on enforcement;
2. in addition to ensuring compliance with the restrictions in the constitutional documents, confirmation should be sought from the relevant ERISA / tax / local counsel that the cascading structure will not fall foul of the relevant restrictions which prevented the grant of direct security;
3. where there are any blocking vehicles within the structure, as set out more fully in our previous article,[4] thought will need to be given to whether the intermediate blockers will need to be party to the Cascading Pledges;
4. where the Feeder Fund and the Master Fund are located in separate jurisdictions, care will need to be taken in relation to any potential conflict of law issues and, in particular, additional complexities in certain civil law jurisdictions in Europe in relation to the recognition of common law security concepts and the enforceability of security over assets that are situated outside the jurisdiction; and
5. the enforcement triggers in the Cascading Pledges should be aligned so that the security will be enforceable at both levels on the acceleration of the underlying facility. To the extent the enforcement trigger in the Upper Level Cascading Pledge is instead tied to a default of the Feeder Fund in its payment obligations under the Master Fund LPA, this will effectively create a staggered enforcement process whereby the Security Agent will only be able to issue drawdown notices to the investors in the Feeder Fund on the expiry of the relevant drawdown period under the Master Fund LPA.

**Conclusion**

Properly structured cascading security will enable lenders to include the Feeder Fund commitments within their security net and therefore allow these commitments to count towards the borrowing base calculation. Where the need for cascading security arises, it is important to front load discussions of the security structure and to engage with any relevant tax and ERISA specialists at an early stage in order to ensure that the structure will comply with all necessary

requirements. The viability of cascading security will also need to be confirmed with local counsel, but while there is limited case law around its enforceability it is increasingly widely adopted in key jurisdictions such as Ireland, Luxembourg and the Cayman Islands.

**[1] https://www.cadwalader.com/fund-finance-friday/index.php?eid=1860&nid=253#_ftn2**

**[2] https://www.cadwalader.com/fund-finance-friday/index.php?eid=126&nid=16&search=ERISA**

**[3] https://www.cadwalader.com/fund-finance-friday/index.php?eid=1905&nid=263**

**[4] https://www.cadwalader.com/fund-finance-friday/index.php?eid=1095&nid=144**