

**CADWALADER**

# Cascading Security

March 8, 2024



**By Tom Spinks**  
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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<sup>[1]</sup>, 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<sup>[2]</sup>, 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<sup>[3]</sup>, 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,<sup>[4]</sup> 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](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>

## Miami Momentum

March 8, 2024



Cadwalader had a great time attending the Fund Finance Association's 13th Annual Global Fund Finance Symposium in Miami Beach.

Keep reading for some in-depth analysis from the symposium in this week's issue. In case you missed it, we covered [13 Takeaways from Miami](#) last week.

## In Our CRT Era: Cadwalader CRT Reception at FFA

March 8, 2024



**By Jed Miller**  
Partner | Financial Services



**By Leah Edelboim**  
Partner | Fund Finance

The hottest acronym at this year's Fund Finance Association Global Symposium was "CRT" (capital relief trade). The Cadwalader CRT practice has been very busy as of late as U.S. banks have sought their assistance to use CRTs to manage regulatory capital constraints. The fund finance team has been working closely with our CRT colleagues as fund finance clients explore the use of CRTs. Subscription line financings are a fund finance product that is particularly well-suited for these trades.

On the first day of the conference, Cadwalader hosted an event for our regional bank clients to learn more about CRTs. Between the beautiful setting in the garden of the W Hotel in Miami on an absolutely perfect evening, where we brought together the brightest minds in the space to talk about the most cutting edge elements of these deals, and the great representation of our clients and friends, it truly had all the elements that make the FFA conference all that it is. This event, just like the conference, was a spectacular opportunity for members of the fund finance community to come together, to learn about the smartest execution of solutions to the most pressing issues, and to spend time together and connect with one another while we do it.

Cadwalader partner Jed Miller, who leads the firm's CRT practice, led a discussion on the CRT market and its trends alongside some of the foremost industry leaders in the space. Jed himself is an expert on U.S. bank regulatory capital rules (Regulation Q), especially as they relate to capital relief strategies that involve synthetic securitizations, credit default swaps and other risk transfer products.

Jed was joined by Derek Li, Missy Dolsky and Richard Sehayek. Derek, a Managing Director at Goldman Sachs, is widely recognized as one of the foremost CRT experts and advisors in North America. Both Missy, Global Head of Capital Markets at Varde, and Richard, a Managing Director at Ares, are leading investors in CRTs; each of them provided an invaluable investor's perspective on these trades.

The consensus among the speakers and the attendees was that 2024 will be a breakout year for CRTs, including for fund finance products.

You can learn more about CRTs [here](#). This article, previously published in *Fund Finance Friday*, gives a good introduction to CRTs and contains links to a [four-part webinar](#) on the subject.

Thanks to all of our client and industry colleagues who joined us for this wonderful gathering. If you have any questions or would like more information on CRTs, please reach out to us.



## Former FDIC Counsel Rejoins Cadwalader in New York

March 8, 2024



Cadwalader partner and bank regulation head [Andrew Karp](#) spoke with *Law360* about his [joining the firm](#) from the FDIC and the current environment facing the banking industry.

"Bank regulatory work is fascinating because it involves matters where policy, business imperatives, and law intersect," Andrew said. "And now, a recent wave of regulatory and supervisory developments, such as bank capital proposals and enhanced supervisory scrutiny, suggests that those matters will become even more interesting and important to banks, their investors, and their counterparties. I'd like to be part of a team that can help such clients successfully address those matters."

[Read it here.](#)

# Celebrating International Women's Day 2024

March 8, 2024



In celebration of International Women's Day, join Women in Fund Finance to raise money for Heifer International's Women Entrepreneurs 2 project, in Mexico, which will assist 1,000 families in the Yucatán Peninsula to close the living income gap by developing and/or strengthening women-led cage-free egg businesses that link to the market and strengthen the communities' social capital. Click [here](#) to learn more information.

Even if you choose not to participate in the race around the world, we encourage you and your company to [make a donation](#) to this incredible organization!

#InspireInclusion

# Announcing the 2024 Annual FFA Industry Recipients!

March 8, 2024



## INDUSTRY AWARDS

Congratulations to all of the incredible recipients of the 2024 Fund Finance Association Industry Awards. With such an outstanding pool of accomplished, dedicated, and hardworking nominees, it was certainly a difficult decision for the FFA selection committee.

See the below 2024 Award recipients:

### **Julian Black Lifetime Contribution to the Industry Award**

F. William Reindel, Fried, Frank, Harris, Shriver & Jacobson LLP

### **Dee Dee Sklar Women in Fund Finance Award**

Jocelyn Hirsch, Kirkland & Ellis LLP

### **Diversity in Fund Finance Award**

Saaima Khaliq, New Mountain Capital

### **NextGen Member of the Year Award**

Annabella Kwei, Stifel Bank

### **Annual Contribution to the Industry Award**

Gavin Rees, HSBC

Jessica Lai, Blackstone

Mark Dempsey, Mayer Brown

## Meet the Instructors of FFA U: Europe

March 8, 2024



The Fund Finance Association is thrilled to announce the confirmed instructors for the upcoming FFA U: Europe!

Join the FFA for an intensive virtual training session for newcomers and seasoned Fund Finance professionals. The program will provide a comprehensive understanding of Fund Finance with sessions taught by many of the industry's leading senior practitioners.

Attendees will have the chance to conclude the program at an in-person Networking Receptions in London, held by the FFA NextGen committee at the Mayer Brown office.

Don't miss the Head of Cadwalader's UK Fund Finance Team, Samantha Hutchinson, teaching a session on Creative Fund Financing.

Visit [here](#) for a detailed agenda and speaker profiles.

# Registration Now Open for 2024 FFA: Japan

March 8, 2024



The Fund Finance Association is pleased to announce that registration is now OPEN for the inaugural FFA: Japan event, set to take place at the MUTB Tokyo Office on Thursday, 25th April.

As we prepare for this insightful and engaging event, we encourage you to secure your spot early and take advantage of this opportunity to connect with industry leaders, gain valuable insights, and foster meaningful connections within the fund finance community in Japan.

[Register now!](#)

Event Details:

Date: Thursday, 25th April, 2024

Time: 3:00 - 7:00 pm JST

Location: MUTB Tokyo Office

1 Chome-4-5 Marunouchi, Chiyoda City, Tokyo, 100-0005

## Fund Finance Tidbits – On the Move

March 8, 2024

### CADWALADER FUND FINANCE 'ON THE MOVE'

The following individual(s) are on the move in the fund finance industry.



**Kaylin Szigety**  
Huntington National Bank

Congratulations to **Kaylin Szigety** who has been promoted to Director, Fund Finance at Huntington National Bank. She was previously a Vice President, Fund Finance at Huntington National Bank. Prior to that she was a Vice President at Signature Bank in the Fund Banking division.



**Frederic Bambuck**  
North America at Credit Agricole CIB

Congratulations to **Frederic Bambuck** who has been promoted to Managing Director, Head of Fund Solutions Group for North America at Credit Agricole CIB, effective April 1st.