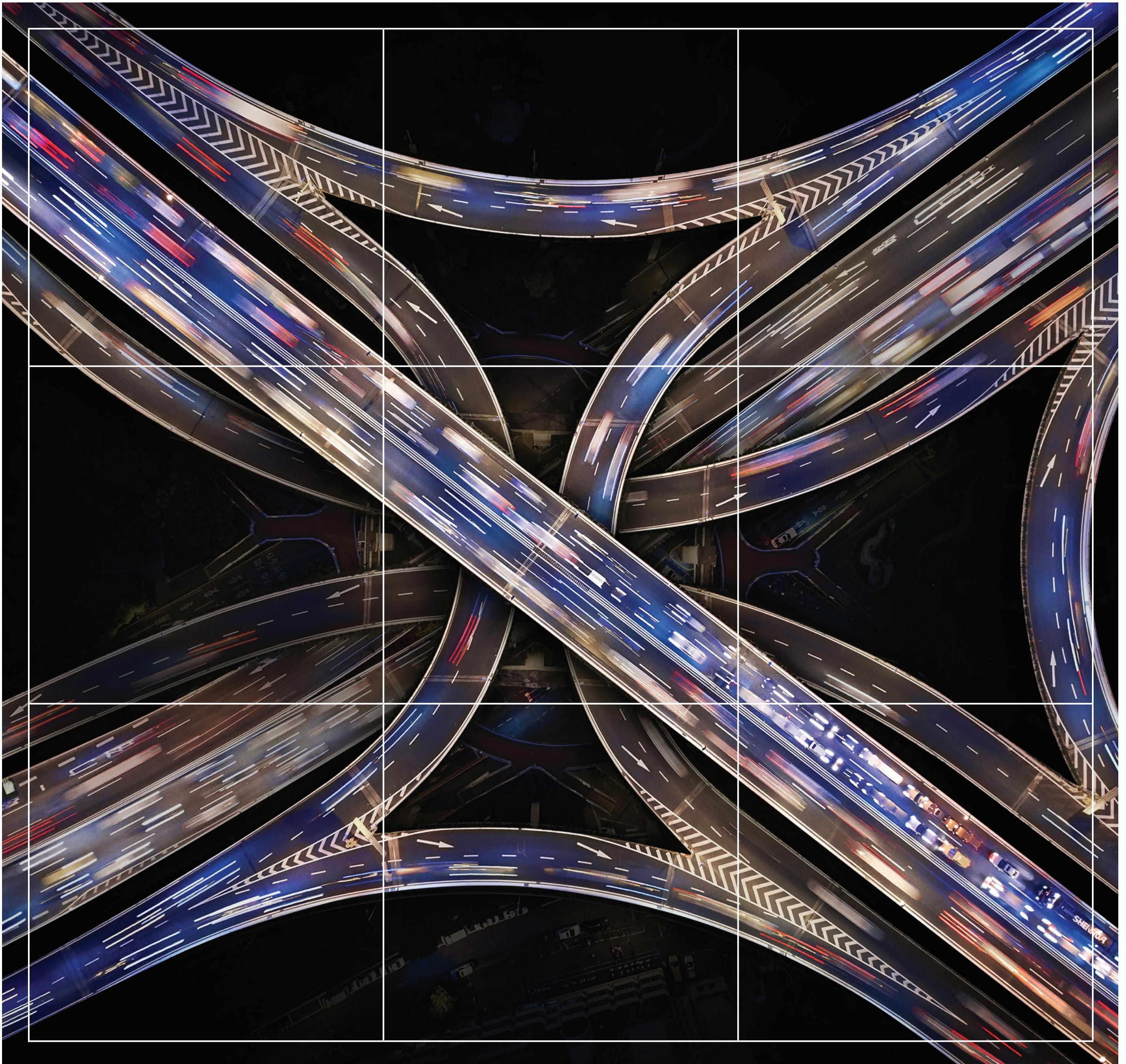
SEPTEMBER 2019

THE ROAD AHEAD
DRIVING SUCCESS IN 2020



ROPES & GRAY

TABLE OF CONTENTS

ARTICLES

Business Conflicts Inherent in Managing Affiliated Credit and Private Equity Funds 4

Key Person Terms Among Credit Managers 7

Hot Topics in BDC Regulation 10

Foreign Credit Support for U.S. Credit Facilities 13

Ten Things Fund Managers Should Know About Value-Based Care 16

HIGHLIGHTS

Advising Across the Business Life Cycle............................6

Ropes & Gray as a Thought Leader 9

Contributors...18

About Ropes & Gray's Credit Funds Practice...................18

AS THE MARKET GROWS, SO DOES ROPES & GRAY

The private credit industry grew by leaps and bounds over the past decade: AUM jumped to $769 billion as of June 2018[1], from $275 billion in 2009. To keep pace with this stunning growth, Ropes & Gray's private credit team also expanded in numbers and vision.

In this thought report, we've collected five articles from members of our credit funds team that highlight the forward-thinking advice that Ropes & Gray offers clients on the formation and operation of credit funds. These articles touch on the conflicts inherent in managing both credit and PE funds, the prevalence of key person terms, the intricacies of BDC regulation and value-based payment arrangements in the health care industry, and the potential changing landscape of foreign credit support.

As the private credit industry expands, new challenges and opportunities will continue to emerge. While these articles cover topics that may seem disparate, they are all focused on the opportunities and challenges that credit fund managers are likely to face in the coming year.

As we enter 2020, Ropes & Gray is committed to remaining on the cutting edge of developments and trends as we work with credit fund managers to implement strategies that capitalize on emerging opportunities. We hope you'll enjoy this report.

[1]2019 Preqin Global Private Debt Report.

Business Conflicts Inherent in Managing Affiliated Credit and Private Equity Funds

Many multiplatform private fund sponsors manage credit funds alongside their private equity funds. Some sponsors that historically focused on equity might launch credit funds as a way of diversifying their portfolio, but maintain a clear separation between their existing private equity business and the new credit business. Other private equity sponsors launch credit funds with the intent to make loans to, or otherwise participate in the debt of, the portfolio companies of their private equity funds. While this strategy has the potential to create appealing synergies between the two platforms, it introduces conflicts of interest that the sponsor must carefully navigate to avoid the risk of regulatory exposure to the entire business. Such conflicts are numerous and varied in nature, and each one calls for careful consideration.

TYPES OF CONFLICTS

One important consideration for sponsors managing a private equity fund alongside a credit fund is the interplay between fiduciary duties owed to each fund that arise under the Investment Advisers Act and under contract law. These duties are more likely to conflict when the private equity and credit fund make investments in the same portfolio company, as decisions made with respect to investments held by one fund could adversely affect the investments of the other. For instance, if a credit fund invests in a portfolio company of an affiliated private equity fund that holds interests more senior or junior to the credit fund, the sponsor may face a conflict when determining which actions are in the best interests of each fund.

The potential for conflicting duties also arises in circumstances where a sponsor's funds have overlapping mandates. For example, a credit fund may be permitted to make certain equity investments as a part of its overall strategy, while a private equity fund may have flexibility to make investments in debt instruments. If either fund is entitled to priority allocation rights with respect to investments within its mandate, the sponsor will face conflicts of interest in attempting to meet the allocation needs of, and obligations to, each fund.

One important consideration for sponsors managing a private equity fund alongside a credit fund is the interplay between fiduciary duties owed to each fund.

These are but a few examples of the many pronounced conflicts a sponsor may face when managing both credit and private equity funds. Conflicts will also often arise in the day-to-day management decisions with respect to a particular investment. In order to satisfy its fiduciary duties to each fund, a sponsor must take steps to mitigate conflicts of interest.

MITIGATION OF CONFLICTS

Sponsors take varying approaches to managing conflicts of interest and complying with their duties under the Investment Advisers Act. However, the most effective approach combines internal policies and procedures with well-drafted conflict mitigation provisions in the fund partnership agreement and robust disclosures in the private placement memorandum and Form ADV.

When a conflict is particularly pronounced and infrequent, a sponsor might simply turn to the advisory committee of

each fund to address the conflict. The advisory committee is a useful approach to manage conflicts arising as a result of transactions that a sponsor does not anticipate will be part of the ongoing investment strategy, but rather a unique opportunity beneficial for both funds. However, sponsors who expect to repeatedly engage in particular conflicted transactions, such as cross trades, are likely to view advisory committee consent procedures as operationally burdensome, and such repeated advisory committee requests may strain the sponsor's relationship with its strategic investors and unnecessarily cloud the overall investment objectives initially presented in a fund's offering documents.

Instead, sponsors might find it more prudent to include a specific framework for how to handle certain conflict transactions in the fund partnership agreement, together with robust disclosure in the private placement memorandum. By expressly including certain conflict transactions, not only are investors fully informed and providing consent at the time of subscription, but sponsors are well positioned to execute transactions in a timely manner. This approach, however, may be insufficient to cure other types of conflict transactions that require investors to consent at the time of the transaction under the Investment Advisers Act, such as principal transactions and agency cross transactions.

Sponsors also rely on allocation and/or conflict committees comprised of employees who are investment, legal and compliance professionals. The committees are responsible for analyzing and determining how to best resolve conflicts, particularly those involving affiliated funds buying and selling from one another. Committees approving allocation decisions typically consider a variety of factors, including the amount of capital each fund has available for new investments, the nature and size of the opportunity, the life cycle of each fund, portfolio construction matters, and any investment restrictions and/or investment opportunity allocation provisions in the governing documents of each fund. Committees can also be called upon to make determinations with respect to certain conflicted transactions, such as cross and affiliate transactions. Although these committees are not independent of the sponsor, they can operate in a consistent manner to alleviate investor concerns by, for example, seeking independent advice when necessary to demonstrate objectivity in the evaluation of a conflict transaction and to ensure consistent consideration of key factors in the decision-making process.

> Regardless of the specific policies and procedures adopted to handle conflicts of interest, sponsors should provide comprehensive disclosures in each fund's offering documents.

Regardless of the specific policies and procedures adopted to handle conflicts of interest, sponsors should provide comprehensive disclosures in each fund's offering documents in order to put prospective investors on notice of potential conflicts at the time of subscription. Effective disclosures detail the types of conflict transactions likely to arise, the implications for investors and the mechanisms in place to address the conflicts. Sponsors take varying approaches to disclosure, but what is most important is that prospective investors are made aware of anticipated conflicts and how they may ultimately impact a fund.

CONCLUSION

Sponsors managing private equity funds alongside credit funds will face conflicts of interest when making decisions that impact both types of funds, particularly where the interests of one fund are better served by actions that would adversely affect the other. Mitigating such conflicts requires sponsors to establish effective and well-designed internal policies and procedures. These policies and procedures, together with robust disclosures in fund offering documents and the sponsor's Form ADV, will significantly help in managing the exposure of the business to regulatory risk resulting from conflicts of interests inherent in private equity and credit fund strategies.

Amanda N. Persaud, Partner; Casey Burns White, Associate

ADVISING ACROSS THE BUSINESS LIFE CYCLE

DRAWING UPON OUR LEADING PRACTICES IN KEY AREAS, Ropes & Gray understands the unique, interconnected business and legal needs of credit-focused asset managers. Our multidisciplinary, global team offers seamless advice and innovative, tailored solutions to credit fund managers across all parts of their business life cycle.

UPSTREAM **CAPITAL RAISING**

FUND FORMATION & MANAGEMENT COMPANY MATTERS

- Private and registered/retail fund formation
- Management company formation, corporate transactions
- Seed investment transactions

FUND OPERATIONS & REGULATORY COMPLIANCE

- Ongoing fund operations, regulatory and compliance counseling
- Derivatives documentation and regulatory compliance

BORROWER FINANCING TRANSACTIONS

- Credit facilities for private and registered funds
- Co-investment and subscription/ capital call leverage facilities
- Structured finance transactions, including CLOs

DOWNSTREAM **CAPITAL DEPLOYMENT**

FUND INVESTMENTS

- Liquid investments trading
- Derivatives and commodities trading
- Investments in private equity and private debt

DISTRESSED, SPECIAL SITUATIONS & RESTRUCTURING

- Special situations investments/ distressed situations
- Restructurings, in-court (bankruptcy) and out-of-court proceedings

LITIGATION & ENFORCEMENT

- Commercial and securities litigation, tax controversy
- Regulatory examinations, enforcement investigations

Key Person Terms Among Credit Managers

MANY PRIVATE CLOSED-END CREDIT FUNDS have "key person" provisions designed to assure investors whose capital commitments are locked up for significant periods of time that the crucial investment team members will continue to manage fund assets throughout the investment period of the fund. These provisions can take a variety of approaches and are often heavily negotiated by investors. This article analyzes an in-depth Ropes & Gray survey of 100 credit managers to determine trends in such "key person" terms in credit funds.

KEY PERSONS

While including a "key person" provision may depend on facts specific to each fund strategy and manager, the vast majority (95%) of the funds surveyed included a "key person" term, indicating that most investors expect to see some level of key person protection in closed-end credit funds. While 8% of the "key person" terms applied throughout the term of the fund, offering protection during the wind-down of the portfolio, 92% of the "key person" terms applied only during the investment period.

KEY PERSON TRIGGER

Questions regarding the time and devotion standard, to which fund the key person standard applies, or if the standard applies more broadly to a strategy or to the manager's activities arise when managers apply a key person standard in credit funds. For credit fund managers, structures with multiple funds or accounts with overlapping strategies are common. As a result, a devotion of time standard tying all or a substantial majority of a key person's time to a single fund is unusual. For example, our survey found that a majority of the funds with key persons (55%) had time and devotion standards tied to the manager and its business as a whole, and not to an individual fund.

SINGLE PERSON KEY PERSON

An important issue for many managers whose strategies are closely tied to one portfolio manager is the business concerns caused by the potential departure or illness of a single individual triggering a "key person" event—namely, a breach of a time or devotion requirement that gives investors certain protective rights, which could include limiting the fund's ability

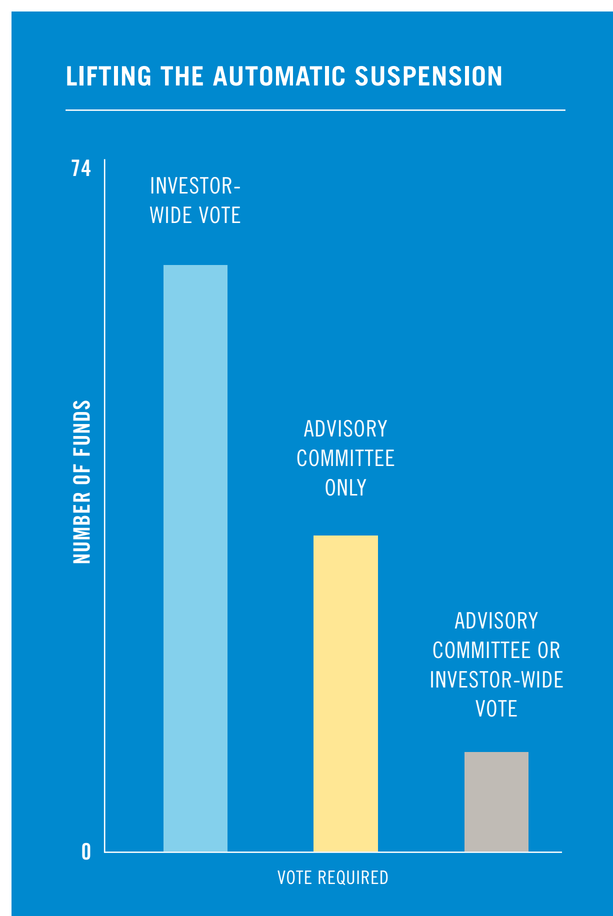
95% of the funds surveyed included a "key person" term, indicating that most investors expect to see some level of key person protection.

to make new investments, requiring wind-up or giving investors other protective rights. Triggering a key person event is particularly concerning to larger managers who view their products as more institutional and less tied to specific business team members if such an event would cause the departure of a single employee to adversely affect the manager's ability to continue to manage a fund. In addition to wanting to reserve flexibility in staffing, managers are also hesitant to give individual team members the negotiating power they would have if a fund were subject to a single key person. Perhaps not surprisingly, only 14% of the funds had a key person provision that was exclu-

sively tied to a single founder or principal (i.e., a "1 out of 1" person trigger), while 28% of the funds had a key person provision tied to any one individual out of a particular group (i.e., a "1 out of 2" person trigger). In our experience, this also varies within managers, depending on the particular strategy and investment team dynamic.

LIFTING A KEY PERSON TRIGGER

Once triggered, the key person provisions most commonly resulted in automatic suspension of the investment period (74% of the surveyed funds). While many investors prefer automatic suspension, as it can be difficult to coalesce around an investor vote, managers often prefer the opposite—that investors need to act—particularly if they believe they can continue to manage the strategy successfully.

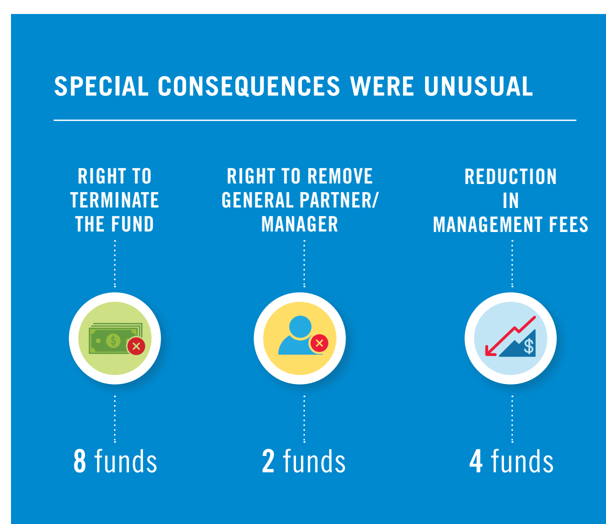


SPECIAL CONSEQUENCES WERE UNUSUAL

During a suspension period due to a key person event, a majority of credit managers were permitted to draw down to the same extent as would otherwise be permitted under the fund's governing documents after the expiration of the investment period for certain follow-on and protective investments (63%). This reflects the view that, regardless of whether a key person event has been triggered, managers and investors are aligned in wanting the continued ability to protect the portfolio.

However, in a few funds, additional restrictions were imposed on activities during a suspension period to provide investors with stronger protections in decision-making if key persons are no longer making decisions for the portfolio. For example, 13 funds prohibited follow-on investments following a key person event, while 2 funds required advisory committee approval of any follow-on investments during the suspension period. It is not surprising that such restrictions were less common, where they tie a manager's hands in continuing to run the fund and could have a negative impact on the fund, particularly in credit where it may be necessary to make investment decisions on a shorter time frame from other strategies.

The occurrence of a key person event triggering other special consequences was more unusual, but included (i) the right to terminate the fund (8 funds), (ii) the right to re



weremove the fund general partner/manager (2 funds), and (iii) a reduction in management fees (4 funds).

Other unusual consequences following a key person event included (i) a reduction in the incentive allocation (1 fund); (ii) termination of the general partner's right to consent, on behalf of the fund, to an Investment Advisers Act "assignment" under the investment management agreement (1 fund); (iii) lowering the voting threshold to terminate the fund from a supermajority to a majority of investors (1 fund); and (iv) suspension of the general partner's ability to launch a fund with a substantially similar strategy for six months (1 fund).

CONCLUSION

While key person provisions and their negotiation can be bespoke to a particular strategy, adviser, investment team and investor dynamic, our survey did find certain trends. Notably, key person terms in closed-end private credit funds as well as automatic investment period suspensions were prevalent. In addition, we found that the key person provision commonly applies only during the investment period and that most credit funds maintained some ability to make protective and follow-on investments even after a key person event. We also found that devotion of time standards limiting portfolio managers' abilities to manage more than one fund were very unusual, and a majority of key person standards were tied to employment with the manager, not management of the fund. We also found that consequences such as reduction in fees or carry, removal of the manager, or termination of the fund, were unusual in the marketplace.

Jessica O'Mary, Partner; Lacy Villanueva, Counsel; Lisa Goodman, Deandré Harris, Arielle Mack, Kyung Paik, Shudan Shen, Associates

ROPES & GRAY has a dedicated credit funds team drawn from multiple practices and industry groups.

As part of our credit funds service offerings, we provide a number of knowledge management tools to address fund managers' questions and concerns regarding topics such as fund structuring, formation, transactions, and regulatory and compliance issues. We have developed and continue to develop proprietary databases of fund terms that give us unparalleled access to market and industry insights at a granular level.

OUR PODCAST SERIES has addressed topics on recent issues relating to credit funds, such as Treaty Structures, 1940 Act Interval Funds, Withholding Tax of European Investments, LIBOR Transition and more. To access our credit funds podcasts, please visit ropesgray.com/credit-funds-podcasts.

IN 2018, we published an in-depth survey of 100 senior-level credit fund managers on their concerns and outlook for the credit sector. We conducted the survey in partnership with the financial publication *Debtwire*.

WE BOAST a database of more than 3,500 private funds.

WE HOST a biannual credit funds forum.

WE OFFER a CLE training program focused on credit fund issues.

Hot Topics in BDC Regulation

This article summarizes a few important regulatory developments and current issues affecting business development companies (BDCs).

BDC OFFERING REFORM

On March 20, 2019, the Securities and Exchange Commission (SEC) proposed rule revisions and form amendments (Offering Proposals) intended to streamline the registration, communications and offering practices of BDCs and registered closed-end investment companies. These Offering Proposals were made as a result of legislation enacted in March 2018.[1] If adopted as proposed, the Offering Proposals would permit BDCs to use the securities offering and proxy rules that are already available to operating companies. Relying on the legislation, which was self-effectuating as of March 2019, many BDCs have already started to take advantage of reforms included as part of the Offering Proposals even though the SEC rules have not yet been formally adopted. In particular, the Offering Proposals would:

- Streamline the registration process for eligible BDCs by, among other things, introducing a short-form shelf registration statement on Form N-2 to effect securities sales "off the shelf" more quickly.[2]
- Allow BDCs to rely on communications rules previously available only to operating companies, including rules regarding the publication of factual information about the issuer or the offering, the dissemination of regularly released factual and forward-looking information, the use of a "free writing prospectus," and more flexibility with respect to broker-dealer research reports.[3]
- Authorize BDCs to qualify as "well-known seasoned issuers" (WKSIs) under Rule 405 of the Securities Act of 1933 (Securities Act), which would provide applicable BDCs additional flexibility in communications and registration.[4]
- Permit BDCs to satisfy their prospectus delivery requirements in the same manner as operating companies, including by filing with the SEC under Securities Act Rules 172 and 173.[5]

FUND-OF-FUNDS RULE PROPOSAL

On December 19, 2018, the SEC proposed new Rule 12d1-4 (the FoF Rule) and related amendments under the Investment Company Act of 1940 (1940 Act) to enhance and streamline the regulation of funds that invest in other funds. In general, Section 12(d)(1)(A) of the 1940 Act limits investments in registered investment companies by other funds through the so-called 3-5-10% limits.[6] While certain types of fund of funds arrangements that exceed these limits have been permitted under statute, by rule and by SEC exemptive orders, the FoF Rule would create a consistent framework for all registered funds and BDCs.[7]

Under the current regime, investments in BDCs by other investment companies are generally subject to the limits in Section 12(d)(1), although many open-end investment companies and exchange traded funds (ETFs) are permitted to invest in listed BDCs in excess of the Section 12(d)(1) limits, pursuant to SEC exemptive orders. The FoF Rule would allow any investment company or BDC to acquire securities of any BDC in excess of the limits in Section 12(d)(1), subject to certain conditions.[8] As a result, the FoF Rule would for the first time permit unit investment trusts (UITs) and closed-end funds to invest in BDCs in excess of the Section 12(d)(1) limits, and would for the first time permit open-end funds and ETFs to invest in unlisted BDCs in excess of the Section 12(d)(1) limits. Further, BDCs would be permitted to invest in excess of these limits in open-end funds, closed-end funds and other BDCs.

The FoF Rule proposal has attracted significant comment from the industry. In particular, many commenters have focused on the condition that acquiring funds holding

more than 3% of the outstanding voting securities of an acquired open-end fund limit their redemptions of the acquired fund shares to 3% during any 30-day period. Other commenters have focused on the voting restrictions that apply to holdings greater than 3% of acquired funds, highlighting that this proposal effectively serves to create two classes of the same security, i.e., one with voting rights and one without. Others contend that the voting restrictions will limit the influence of activist investors, which can also be viewed as limiting typical governance actions available to stockholders. These redemption and voting restrictions may serve to discourage acquiring funds from taking advantage of the new relaxed ownership provisions. SEC Chairman Clayton's current short-term rulemaking agenda includes the FoF Rule,[9] but a final rule is not expected until after the SEC has finalized its ETF rulemaking (which appears to be imminently forthcoming).

DISCLOSURE OF ACQUIRED FUND FEES AND EXPENSES

The BDC industry has long been recommending that the SEC modify the disclosure requirements for registered investment companies relating to "acquired fund fees and expenses" (AFFE). Under the current disclosure regime, registered investment companies must disclose as a separate line item in their prospectus fee table any fees and expenses incurred indirectly through investments in shares of "acquired funds," including BDCs.[10] This also has the effect of increasing the acquiring fund's disclosed total expense ratio, a key data point for gatekeepers and investors generally. Many practitioners argue that including BDCs within "acquired funds" subject to the AFFE disclosure requirements overstates a mutual fund's expenses because the fees and expenses of a BDC are more closely analogous to the expenses of an operating company (which are not required to be included in AFFE) than they are to the expenses of a registered investment company or private fund. This, many practitioners argue, creates a misleading picture that distorts the cost of a BDC investment from the shareholder's perspective.

> Many industry participants remain optimistic that the SEC will make appropriate revisions to the AFFE provisions.

Many mutual funds facing increasing pressures to disclose lower fees are reluctant to invest in BDCs because of the

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[1] See Small Business Credit Availability Act, Pub. L. No. 115–141, 132 Stat. 348 (2018).

[2] This short-form registration statement could satisfy Form N-2's disclosure requirements by incorporating by reference information from the BDC's reports that have been or will be subsequently filed under the Securities Exchange Act of 1934. In particular, this will alleviate the need for BDCs to file a post-effective amendment or a new registration statement when financial statements in the Form N-2 would have previously gone stale. As a result, BDCs with an effective shelf registration statement should avoid the delay and uncertainty associated with a potential SEC review.

[3] This would involve amendments to Rules 134, 168 and 169, 164 and 433, and 138 under the Securities Act, respectively. Previous amendments had been made to Rule 139 under the Securities Act, which also offered enhanced flexibility to rely on safe harbors for research reports for BDCs, bringing the treatment of BDCs more closely in line with that of operating companies.

[4] In general, a WKSI's shelf registration statement is automatically effective upon filing, which eliminates the SEC review and comment process and reduces the time to market, thereby enhancing the WKSI's ability to take advantage of market windows. WKSIs also enjoy more flexibility in their ability to make offers. Generally, WKSIs are companies that have a worldwide non-affiliate public float of $700 million or more or have issued, in the last three years, at least $1 billion aggregate principal amount of non-convertible securities other than common equity in primary offerings for cash, are eligible to register a primary offering of their securities relying on General Instruction I.B.1 of Form S-3 or Form F-3, and meet certain other conditions.

[5] The proposed amendments to Rules 172 and 173 under the Securities Act would permit BDCs to rely on the "access equals delivery" means of satisfying the final prospectus delivery requirements, currently available only to operating companies.

distortive impact such investments would have on the AFFE and total expense ratio required to be disclosed by the mutual fund. In 2014, S&P and Russell removed BDCs from their respective indices because of concerns cited by the mutual fund industry regarding the impact BDCs would have on the expense ratios of mutual funds tracking such indices.[11] The exclusion of BDCs from S&P and Russell indices has limited institutional investment into BDCs, arguably diluting the effectiveness of active corporate governance in the space and limiting the protections it provides to investors.[12]

Many practitioners believe the area is ripe for SEC action. In 2017, the House Committee on Appropriations recommended that the SEC revisit the rule, as "the AFFE rule unnecessarily harms the [BDC] industry."[13] A group of BDCs filed an application for SEC exemptive relief in September 2018 that would exclude BDC fees and expenses from the calculation of AFFE.[14] Most recently, in proposing the FoF Rule in December 2018, the SEC sought comment on whether BDCs should continue to be treated as acquired funds for purposes of the AFFE disclosure rules.

The BDC industry's support on Capitol Hill remains steady, as evidenced by the House Appropriations Committee's bill earlier this year, reiterating its recommendation that the SEC "make necessary regulatory . . . changes to limit the adverse effect of [the AFFE regime]" on BDCs. While the redemption limits and voting restrictions in the FoF Rule proposal have attracted significant comment, those issues have no direct connection to the AFFE disclosures (although lower institutional ownership of BDCs is a likely consequence of both the redemption limits and voting restrictions in the FoF Rule proposal and the AFFE rule), and many industry participants remain optimistic that the SEC will make appropriate revisions to the AFFE[14] provisions when the final FoF Rule is adopted.

Brian McCabe, Michael Doherty, Paul Tropp, Partners; Teo Larsson-Sax, Associate

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[6] Section 12(d)(1)(A) generally prohibits an investment company (the acquiring company) from acquiring any security issued by any other investment company (the acquired company) if the acquiring company immediately after such acquisition owns in the aggregate (i) more than 3% of the total outstanding voting stock of the acquired company, (ii) securities issued by the acquired company having an aggregate value in excess of 5% of the value of the total assets of the acquiring company or (iii) securities issued by the acquired company and all other investment companies having an aggregate value in excess of 10% of the value of the total assets of the acquiring company. Section 12(d)(1)(B) addresses the sell-side of such investments, and Section 12(d)(1)(C) contains limitations on fund investments in registered closed-end funds. Section 60 generally makes Section 12 applicable to ABDC as if it were a registered closed-end fund.

[7] See Fund of Funds Arrangements, SEC Release No. IC-33329, at 15-16 (Dec. 19, 2018).

[8] Private funds relying on section 3(c)(1) or 3(c)(7) of the 1940 Act are not included as acquiring funds within the scope of the proposed rule. As a result, if the rule is adopted as proposed, private funds would remain subject to the 3% limitation on investments in registered investment companies described in section 12(d)(1)(A)(i).

[9] See Agency Rule List – Spring 2019, Securities and Exchange Commission, available at https://reginfo.gov/public/do/eAgendaMain?operation=OPERATION_GET_AGENCY_RULE_LIST¤tPub=true&agencyCode=&showStage=active&agencyCd=3235.

[10] See, e.g., Item 3 of Form N-1A and the instructions thereto. Forms N-2, N-3, N-4, and N-6 contain similar requirements.

[11] See Removal of BDCs from Indices May Reduce Equity Access, Fitch Ratings (Mar. 13, 2014).

[12] Id.

[13] H.R. Report No. 115-234, at 69 (2017).

[14] See The Coalition for Business Development. et al. (File No. 812-14946) (Sept. 4, 2018).

[15] See Fund of Funds Arrangements, SEC Release No. IC-33329, at 74 (Dec. 19, 2018).

[16] H.R. Report No. 115-792, at 67 (2019).

Foreign Credit Support for U.S. Credit Facilities

BECAUSE OF THE "DEEMED DIVIDEND" ISSUE created by Section 956 of the U.S. Internal Revenue Code (the Code) and the regulatory guidance relating thereto, there has been a longstanding custom and practice in middle-market and larger financings to U.S. companies for lenders to forgo guarantees and collateral from foreign subsidiaries and to limit pledges of voting stock of foreign subsidiaries to no more than two-thirds of the voting stock. Recent changes to the Code have largely eliminated the "deemed dividend" issue; however, empirical evidence suggests that the market practice has not reflected this in that lenders are not generally requiring full liens and guarantees from foreign subsidiaries.

In this article, we examine why this might be so and how market practice can be expected to develop.

THE DEEMED DIVIDEND ISSUE

In 1962, in order to discourage U.S. companies from shifting income to their foreign subsidiaries, and thereby to reduce their U.S. income tax burden, Congress required certain U.S. owners of a "controlled foreign corporation" (CFC) to include in income their pro rata share of certain income of the CFC (this income is referred to as "subpart F income" and generally consists of passive and portable income). While this prevented deferral of a CFC's subpart F income, no U.S. income tax applied to the CFC's non-subpart F income unless and until the CFC actually distributed such earnings to the U.S. parent as a dividend.

This left a perceived loophole in that a CFC could still defer income for U.S. tax purposes that had not technically been distributed as a dividend to its U.S. parent, but had been used to support the liquidity needs of the U.S. parent. To prevent this, Congress enacted Section 956 of the Code. Section 956 imposed a U.S. income tax on a CFC's undistributed earnings if the CFC provided credit support to the U.S. parent—a "deemed dividend."

These limits on foreign credit support have historically resulted in a significant portion of the value of foreign operations not being pledged to support the U.S. parent credit facilities. As such, not only were lenders to the U.S. parent structurally junior to any creditors at the foreign subsidiaries due to the lack of guarantees and collateral, the fact that only a two-thirds stock pledge could be given left one-third of the value of the foreign operations fully available for unsecured creditors in bankruptcy restructurings and work-outs.

DEEMED DIVIDEND TREATMENT REPEALED

In 2017, as part of the tax law changes, Congress enacted Section 245A of the Code. Section 245A and related regulations eliminate the tax impact to U.S. corporations from receipt of non-subpart F income dividends by generally providing U.S. corporations a deduction for dividends received from CFCs, including deemed dividends.

The net result of these changes is to eliminate the adverse tax consequences under Section 956 from U.S. loan facilities' receipt of foreign guarantees and collateral and full stock pledges of foreign subsidiary stock, effective as of January 1, 2018.

THE CURRENT LANDSCAPE

Based on our survey of public and private bond and loan documentation, we have not seen a broad-based market response requiring full collateral and guarantees from foreign subsidiaries, or full pledges of their equity.

This seems surprising given the clear benefit to lenders of obtaining foreign credit support. For one thing, a pledge of 100% of the equity of foreign subsidiaries

would avoid a valuation fight with unsecured creditors of the U.S. parent in the event of a bankruptcy. In addition, direct guarantees from foreign subsidiaries could, subject to local law limitations, make the lenders' claims pari passu with other creditors of the foreign guarantor and, where collateral is also provided, even priority over such other creditors. Thus, each of these incremental steps adds potential value to the lenders' claims.

> We expect that full stock pledges will become more common as the market adapts to the changes in tax law.

Given these clear benefits, why has the market been slow to require full foreign credit support? We see several reasons for this.

1. The tax law changes are relatively recent—they only took effect starting in 2018, and related regulations were not finalized until May 2019. There may simply not have been sufficient time for the impact of these changes to be fully reflected in market terms.

2. The relief provided by current regulations only applies to corporate U.S. shareholders; non-corporate U.S. shareholders remain potentially subject to adverse tax consequences for deemed distributions under Section 956. As a result, the determination of whether to provide foreign guarantees and full stock pledges may be more complex than it appears.

3. In a generally borrower-friendly market with a plethora of financing sources chasing deals, lenders may simply not feel they are in a position to press for the alteration of what have become market-standard exceptions to collateral and guaranty requirements. Bolstering this rationale, we have seen significant movement on these exemptions in contexts other than large- to mid-market sponsor-driven deals.

4. Perhaps most importantly, Section 956 has never been the sole impediment to lenders obtaining collateral and guarantees from foreign subsidiaries. In many foreign jurisdictions, upstream guarantees present substantial legal restrictions and impediments, including risk to individual directors, and may be of limited usefulness to lenders to a parent entity because of limitations on their enforcement. In addition, taking collateral in many foreign jurisdictions is complex and costly.

COST AND COMPLEXITY: FOREIGN CREDIT SUPPORT

Obtaining guarantees and collateral outside of the United States is relatively complex and costly, and can vary widely from country to country. For example, even within Europe, there are myriad regimes establishing different rules and restrictions on the provision of upstream guarantees and pledges of collateral. This significantly affects the practicalities and benefits of obtaining foreign credit support.

Guarantees provided for the benefit of a parent entity raise issues of director duties and guarantor corporate benefit. In England and Wales, the Law Society published guidance in June 2018 noting that as long as a guarantee by a subsidiary was given in relation to a "normal financing transaction" and was "in good faith," this would not constitute a distribution. The penalties for getting it wrong can be severe. In France, failure to provide adequate corporate benefit can lead to civil or criminal sanctions for relevant directors. In Germany, in order to mitigate risks to directors, market practice is to limit upstream guarantees through language that protects the guarantor's registered capital and thus shields directors from liability. Such limiting language, however, can render guarantees of uncertain utility to lenders when time to enforce.

The differentiation and complexity across European jurisdictions is particularly acute when we come to examine taking and documenting security. Whereas the Unit-

ed States provides a relatively simple and cost-effective lien creation and perfection process, this is not the case across Europe. England is one of the more favorable jurisdictions in this regard—the English law security package is often documented as an all-asset debenture and can include a floating charge covering the entirety of the business, including future and fungible assets. In contrast, the concept of an all-asset debenture or a floating charge is not recognized in France, Germany or Spain, and in such jurisdictions, the security package must be documented on an asset-by-asset basis.

In Asia, similar corporate benefit and director liability issues arise, as well as onerous approval and registration requirements. In some Asian jurisdictions, approval from the central bank is required for the grant of guarantees and security. For example, an Indian company cannot grant guarantees or security to support an offshore loan without the approval of the Reserve Bank of India, which approval is highly uncertain.

In other jurisdictions in Asia, perfecting a guarantee or grant of security requires registration with a local authority, and successfully registering such guarantee or security may be difficult. For example, guarantees granted by Chinese companies for offshore loans must be registered with the local State Administration of Foreign Exchange (SAFE) in order to repatriate any proceeds of enforcement of such guarantee out of China. However, since late 2018, market participants have been reporting an increasing number of cases where SAFE has either declined or significantly delayed such registration.

As in certain European countries, various jurisdictions in Asia impose potential criminal liability on the directors of a target company if the target grants financial assistance for the acquisition of its shares. For example, in South Korea, the directors of a target company face risk of criminal liability if the target company provides financial assistance for its parent's acquisition loan used to acquire the target's shares unless the directors of the target are able to identify a benefit flowing directly to the target that is commensurate with the harm suffered by the target in forfeiting its assets if the parent borrower defaults.

All of these risks, costs, complexities and enforcement limits discourage parties from pursuing full foreign credit support for U.S. borrowings, even without adverse federal income tax consequences of taking foreign guarantees and collateral.

A PATH FORWARD

In situations where substantial value resides in foreign operations, lenders now have options to adopt approaches based on the practicalities of obtaining effective collateral in relevant foreign jurisdictions rather than taking blanket approaches, as was the case prior to the changes to Section 956 of the Code.

First and foremost, the impediments that exist to providing foreign guarantees and collateral should generally not hinder lenders from requiring unlimited stock pledges. Making this simple change in pledge documentation to require 100% stock pledges rather than the market-standard two-thirds will plug a hole in the collateral representing one-third of the value of the foreign subsidiaries, thereby providing domestic lenders with priority over the entire equity value of foreign subsidiaries. For this reason, we expect that full stock pledges of foreign subsidiaries owned by domestic loan parties will become more common as the market adapts to the changes in tax law.

As lenders and borrowers become accustomed to the current, more limited scope of the Section 956 regime, we anticipate that they will develop nuanced approaches to foreign guarantee and collateral requirements, and that new conventions will develop around which foreign jurisdictions and assets are typically carved out of such requirements, as well as which foreign jurisdictions and assets become routine sources of foreign credit support.

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Ten Things Fund Managers Should Know About Value-Based Care

1. VALUE-BASED PAYMENTS ARE HERE TO STAY

The health care industry has embraced value-based payment (VBP) arrangements, which seek to link payments to the cost and quality of care for a particular patient population. Given the importance of health care cost containment, and the widely held view that transitioning to VBPs is key to controlling those costs, industry participants have pursued and will continue to pursue these arrangements aggressively. It is critical for fund managers investing in and lending to the health care industry to understand the key business and legal issues related to VBP arrangements, as they can have a substantive impact on the revenue streams and market position of borrowers, as well as on the due diligence process.

2. INDUSTRY-WIDE TRANSITION

VBP arrangements now span the entire health care industry. Commercial health plans are partnering with providers, medical device and pharmaceutical manufacturers, and health technology vendors to share the financial risk of caring for an insured population. Pharmaceutical companies are tying drug pricing to achievement of clinical results; medical device companies are offering consulting services and data analytics to facilitate better outcomes for patients; and health technology companies are offering a variety of services to better engage patients and to monitor and promote achievement of quality, cost and outcome metrics.

3. VBPs ARE A GROWING SEGMENT OF INDUSTRY REVENUES

Industry leaders aim to have the majority of health care payments tied to outcomes via VBP arrangements within the next few years. Already, Aetna, Cigna and United each report paying a majority of provider reimbursements through VBP models. Similarly, the Health Care Transformation Task Force, a group of more than 40 major health systems, payors, purchasers and patient organizations announced that its provider and payor members did just under half of their business through VBP arrangements in 2017—progress toward the stated goal of converting 75% of business to VBP arrangements by 2020.

4. MANY PARTICIPANTS ARE ASSUMING FINANCIAL RISK

Providers, pharmaceutical companies and medical device companies, health technology firms, and others are assuming downside risk in the form of bundled payments, guarantees, shared savings and losses, and other arrangements that stake service fees and product prices upon the achievement of agreed-upon quality and cost metrics. VBP arrangements can be complex, and creditors should consider broadening diligence to better understand a company's financial responsibilities for the services it provides, as well as its potential financial exposure related to VBP arrangements.

5. CARE REDESIGN CAN BE ESSENTIAL TO SUCCESS

Succeeding under VBP arrangements may require redesigning the way care is delivered, as well as how providers and partners are incentivized. For example, participants in bundled payments for surgical episodes redesign care to improve coordination among pre-operative, surgical and post-operative service providers, as well as to incentivize those providers to minimize complications during the full episode of care. Investors and lenders should review the company's products and services in light of its VBP arrangements and assess the company's ability to implement any needed care redesign.

6. OBTAINING TIMELY AND ACTIONABLE INFORMATION IS CRUCIAL

Access to data, data analytics and enhanced information systems is critical to success under VBP models. Companies are investing heavily in systems that can better mea-

sure and guide performance, and can ensure appropriate collection and use of patient data. In conducting business diligence, lenders and investors should review the company's information systems capabilities and explore the company's readiness to succeed under VBP arrangements while complying with applicable information privacy laws.

7. CONTINUED CONSOLIDATION AND GROWTH OF STRATEGIC PARTNERSHIPS

The industry is investing in capacity and integration across the continuum of care, building networks of providers aligned around value-based metrics or management of population health, and implementing systems to identify and proactively engage high-risk patients. Some organizations have pursued vertical integration to control care delivery "end-to-end," while others have established horizontal, strategic partnerships. In diligence, investors and lenders should seek to understand how a company's strategy aligns incentives across the relevant continuum of care, how it seeks to preserve or enhance its market position as a desirable partner in VBP arrangements, and the role acquisitions or partnerships play in that strategy.

8. IMPORTANCE OF PATIENT ENGAGEMENT

Lenders and investors should consider whether a company has the human capital and technological support for patient engagement—e.g., care coordinators, patient coaches, mobile/digital applications to better engage with patients, call centers and other avenues for patient-focused communications. Sophisticated VBP participants implement multifaceted strategies to improve patient engagement—e.g., using data analytics to identify high-risk patients for outreach and care management.

9. ASSESSING MANAGEMENT CAPABILITY

Many provider organizations have established a senior executive position focused on delivery system transformation or clinical integration. Some provider organizations also retain a dedicated management team comprising both clinical and non-clinical personnel to manage against agreed-upon quality benchmarks. Lenders and investors should consider whether a company has a seasoned management team that is knowledgeable about VBP arrangements and is focused on pursuit of a well-articulated strategy for participating in VBP models.

> It is critical for fund managers investing in and lending to the health care industry to understand the key business and legal issues related to VBP arrangements.

10. LEGAL CHALLENGES REMAIN

The current regulatory framework presents challenges for companies implementing VBP arrangements. While federal VBP models administered by the Center for Medicare and Medicaid Innovation are eligible for waivers of federal antitrust and fraud and abuse laws, commercial arrangements must grapple with a fraud and abuse regulatory framework that is not inherently well suited to VBPs. The Office of Inspector General and the Centers for Medicare & Medicaid Services, through Requests for Information issued in 2018, indicated some willingness to modify the regulations or expand existing waivers to facilitate such commercial arrangements. However, neither agency has yet taken any such actions. Investors and lenders should consider the legal implications of risk assumption, including the potential applicability of state insurance and risk-bearing organization laws and regulations, which, if applicable, may require licensure, solvency review or capital reserves, and other forms of approval to assume financial risk in the context of VBP arrangements. Finally, arrangements must be reviewed for compliance with federal and state data privacy laws, including the Health Insurance Portability and Accountability Act of 1996, as amended.

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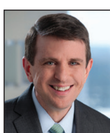

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