

Fund Finance Friday



Control or Control Agreement

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As most of our readers know, the majority of subscription facilities are secured by the right to call capital and receive capital contributions from the fund's investors and the bank deposit account into which those capital contribution proceeds are deposited by such investors. Focusing on the deposit account, frequently called the collateral account, there are two methods provided by Article 9 of the UCC for perfecting a lender's security interest in such account: (1) the collateral account is maintained with the lender or (2) the lender and the fund enter into a control agreement with the bank that maintains the collateral account.

If the collateral account is maintained with the lender, the lender has control of such account and its security interest is perfected pursuant to Article 9-104(a)(1) of the UCC. The related credit agreement will include covenants that require that the fund maintain the collateral account with the lender, direct all capital contribution proceeds to such collateral account, and may also include covenants describing when the lender may prohibit the withdrawal of proceeds from the collateral account. It is worth noting that the collateral account should be a segregated account exclusively used to maintain and to identify the capital contribution proceeds, the lender's primary collateral and source of repayment in a subscription facility, and shall not permit such proceeds to be comingled with other cash deposits by the fund.

If the collateral account is maintained with a financial institution other than the lender (such financial institution, the "Account Bank"), a control agreement between the fund, the Account Bank, and the lender will establish control of the collateral account for perfection of the lender's security interest under Article 9-104(a)(2) of the UCC. In most control agreements for subscription facilities, the Account Bank will follow instructions of the fund with respect to the flow of funds in and out of the collateral account and, upon receipt of a shifting control notice from the lender, the Account Bank will then only follow instructions of the lender. The control agreement should explicitly provide that the Account Bank will have two days or less after receipt of the shifting control notice to implement and effect the shift of control from the fund to the lender. However, the control agreement will not specify when the lender may send a shifting control notice; instead, the related credit agreement should include terms detailing when the lender may take exclusive control of the collateral account (typically, this occurs upon a cash control event or an event of default).

A control agreement for subscription facilities should include the following provisions:

Subordination. The Account Bank's interest in the collateral account (other than its interest in the account associated with bank fees) is subordinated to the lender's security interest in the collateral account securing the obligations of the fund to the lender under the credit facility.

Indemnity. The fund will indemnify the Account Bank with respect to any loss, liability or expense incurred in connection with the control agreement, the collateral account or as a result of following the fund's instructions with respect to the collateral account. To the extent the Account Bank is not indemnified by the fund, the lender may agree to indemnify the Account Bank but only for items incurred after the lender has delivered a shifting control notice and such indemnity shall exclude items incurred by the Account Bank's fraud, gross negligence or willful misconduct.

Termination. The Account Bank may terminate the control agreement upon at least ten business days advance written notice.

Governing Law. The governing law of the control agreement and the Account Bank's jurisdiction for purposes of the UCC are most frequently New York. Most subscription facilities will require an opinion covering perfection of the collateral account and will require the governing law and jurisdiction of the Account Bank to align with the jurisdiction of the law firm providing the opinion.

If a control agreement is required for perfection of the collateral account, there are a few additional important terms to address in the related credit agreement. Many credit agreements will provide that the collateral accounts shall be maintained with the Account Bank or an eligible institution that enters into a control agreement, and if the Account Bank ceases to be the Account Bank or an eligible institution, the fund will have thirty days to move its collateral account to a replacement Account Bank that is either the lender or an eligible institution and deliver to the lender a control agreement over such new collateral account. Similarly, if any Account Bank terminates a control agreement, the credit agreement will require the fund to open a new collateral account subject to a new control agreement with a replacement Account Bank within thirty days of the earlier of such termination or notice of the intent to terminate. Additionally, the lender may require receipt of account statements detailing the assets held in or credited to the collateral account on a monthly basis and/or the fund to ensure that the lender has electronic monitoring access to each collateral account at all times.

It is very common for bilateral facilities to have the collateral account maintained with the lender. However, a syndicated facility that has the collateral account maintained with the administrative agent may still require a control agreement for perfection of its security interest. The administrative agent in a syndicated facility acts on behalf of the lenders (or secured parties). The lenders may prefer a control agreement to document that the administrative agent's security interest in, control of and perfection of the collateral account is on behalf of the lenders (or secured parties).