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Cash Control Event: Lender and Borrower Considerations

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Our readers have been blessed with wonderful *Fund Finance Friday* articles dealing with the maintenance of collateral accounts in '**When Deposits Don't Travel with Loans**', control over collateral accounts in '**Control or Control Agreement**' and lastly, events of default in '**Common Events of Default in Subscription Credit Facilities: How Parties End Up Here, and Recommendations for Avoiding Preventable EODs**'. In this article we explore the circumstances under which lender may take action with respect to collateral accounts, often called Cash Control Events.

Background

As explained by Chad Stackhouse and Katie Clardy **here**, subscription credit facilities are generally secured by (1) the right to call capital and receive capital contributions from the fund's limited partners and (2) the collateral account into which those capital contribution proceeds are deposited by such limited partners. The security interest over such collateral account is perfected by control, either by the account being maintained with the lender or by entry into a control agreement with the account bank that maintains the collateral account.

Although the lender may have "control" over a collateral account for perfection purposes, provided no Cash Control Event has occurred, the borrower is permitted to withdraw funds from its collateral account. If an event that triggers a Cash Control Event does occur, the borrower's ability to withdraw funds from the collateral account is suspended and the lender would be able to take effective control over the collateral account and access the funds on deposit in such collateral account. Thus, understanding when a Cash Control Event could occur and its consequences is of paramount importance to borrowers, limited partners, fund managers, and lenders alike.

What is a Cash Control Event?

Generally, a Cash Control Event is triggered if (1) an Event of Default has occurred and is continuing, (2) a potential default has occurred and is continuing, or (3) a mandatory prepayment is required. Events of Default are covered by Brian Kettmer in great detail **here**.

A potential default usually includes any condition, act or event which, with the giving of notice or lapse of time or both, would become an Event of Default. A mandatory prepayment is typically triggered when the outstanding principal amount of the loans exceeds the amount that the borrower can borrow under the subscription credit facility.

While the above is a typical construct, the scope of what may be covered under the potential default prong can depend on the borrower-lender relationship, the composition and robustness of the borrowing base (and credit support), the reputation of the fund sponsor and the track record of the fund. The borrower may seek to limit potential defaults to more serious or uncurable events such as payment and insolvency Events of Default. At the same time a lender may wish to have a wider list of potential defaults to ensure that it would be able to prevent the withdrawal of funds from the collateral account promptly if any Event of Default is likely to arise.

Thus, a Cash Control Event is the first layer of protection available to the lender. On the one hand, a lender wants to be able to access funds in the collateral account as soon as possible upon any indication that an Event of Default would or could occur and on the other hand, the borrower wants to maintain access to liquidity and is very focused on not triggering a Cash Control Event. The Cash Control Event construct is beneficial to both lender and borrower in that it provides certainty to the borrower regarding the scope of events that could trigger a Cash Control Event while the lender has some comfort that it has the ability to prevent withdrawals of cash from the collateral account and can gain access to the funds in the collateral account.

Cash Control Event consequences vs enforcement under an Event of Default

One of the main takeaways here is timing. A Cash Control Event can be triggered before an Event of Default actually occurs. There is an important distinction between the consequences of a Cash Control Event and enforcement of security interests pursuant to an Event of Default. Triggering a Cash Control Event does not necessarily mean that the lender would immediately be able to make a capital call pursuant to an Event of Default. The immediate consequences of a Cash Control Event is that (1) the lender would have the authority to take control of the borrower's collateral account and (2) withdrawal of funds by the borrower from the collateral account is prohibited. Depending on the business agreement between the parties, the consequences of a Cash Control Event could also include that (1) the borrower would not be able to borrow, (2) credit party payments or advances on any debts and liabilities to any other credit party, the limited partners and the investment manager would be prohibited (the rights to payments or advances of such other credit parties, limited partners and the investment manager (together with any liens thereon) would be subordinated to the obligations due to the lender), and (3) payments of distributions to limited partners would be prohibited. Thus, the consequences of a Cash Control Event are serious and immediate and can arise well before a potential default ripens into an Event of Default.

Documentation and Taking Control

When crafting the credit agreement and other loan documents it is important to distinguish between situations that trigger a Cash Control Event and situations that trigger an Event of Default. The collateral account pledge trigger is typically a Cash Control Event, to allow a lender control over the collateral account i.e. access to the funds in the collateral account. However, the trigger under the security agreement is generally an Event of Default. This is because a lender would require access to funds in the collateral account at an early stage, while a lender is generally only be able to step in to make a capital call pursuant to the security agreements once an Event of Default has occurred.

Generally, if a Cash Control Event occurs and the lender decides to act thereon pursuant to the control agreement, it will send a notice to the account bank (or the division of the lender administering the account) and notify such that a Cash Control Event (sometimes called an event of default in the control agreement) has occurred under the subscription credit facility. Upon receipt of the notice, the account bank would be required to cease taking instruction from the borrower with respect to the collateral account and will hence forth only act upon the lender's instruction. This is a crucial consideration for the lender, because such action memorializes the event that triggered the Cash Control Event and subjects the borrower and the fund to much higher levels of scrutiny than what would be the case if the issue that triggered the Cash Control Event was anticipated, communicated and discussed by the parties (and possibly resolved) prior to such escalating to the level where the lender has to send a notice to the account bank.

Conclusion

A lender can, but is not required to, send a notice to the account bank to take control of the collateral account. This is again why the business relationship between the parties is so important. Ideally, it would be most beneficial to all parties if any Cash Control Event can be addressed before the lender takes formal action to take control of the collateral account. To borrow from Brian Kettmer and reiterating the importance of the business relationship, "*[o]ne of the best ways to avoid EODs is the borrower maintaining open and regular communication with its internal finance and operations teams, external counsel, and the admin agent under a facility to help maintain the mutually beneficial and positive business relationship among the parties.*" By understanding the consequences of a Cash Control Event, a borrower and investment manager can proactively manage liquidity and ensure effective communication with limited partners and the lender, to navigate through periods of uncertainty with resilience and agility. As always, a strong relationship and collaboration among all parties involved is essential to maintaining healthy subscription credit facilities.