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Fund Finance Friday

Whose Cash Is It Anyway?

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In many subscription credit facilities, lenders establish a multi-faceted timeframe for the borrowers to, among other things, make mandatory prepayments, pay certain tax reimbursements and post cash collateral in the event of a defaulting lender. This time frame is usually comprised of a two-prong test pursuant to a definition such as the following:

> "Required Payment Time" means, with respect to any event or circumstance giving rise to a requirement of a Borrower to make any payment: (a) within two (2) Business Days of the occurrence of such event or circumstance, to the extent funds are available in the Collateral Accounts or any other account maintained by a Borrower; and (b) otherwise, to the extent that it is necessary for the Credit Parties to issue a Capital Call to fund any required payment, within ten (10) Business Days of the occurrence of such event or circumstance (but, in any event, the Credit Parties shall issue such Capital Call and shall make such payment promptly after the related Capital Contributions are received).

Clause (b) of the above sample definition often involves some minor negotiation of the time period in which the applicable credit party must make a capital call, but, in most cases, this concept does not result in intense consternation. To the contrary, clause (a) of the above sample definition (the "Account Clause") frequently contains a myriad of contested points.

The first area of negotiation is often whether the funds intended to be captured by the Account Clause should extend to funds held in accounts other than the collateral accounts. Borrowers often argue that the lenders' reach should be limited to only those accounts that constitute collateral. Lenders counter with the argument that the circumstances in which the "Required Payment Time" definition applies are limited in scope and only in dire circumstances. Accordingly, a lender should be able to look to any available funds to rectify the existing circumstance and satisfy the applicable repayment obligations of the borrower.

The second concern raised by the Account Clause is how to treat funds in the applicable accounts that are allocated, or earmarked, by the borrowers for a particular purpose. Generally, private equity funds do not hold cash in the collateral accounts for extended periods of time or without a specific purpose.

Against this backdrop, borrowers often argue that granting a lender the right to remove funds from the borrowers' accounts pursuant to the Account Clause can interfere with the borrowers' time frame for completing an investment. In other words, if a lender is allowed to withdraw funds from the accounts during a two-day period, the borrowers must call capital again to replenish the accounts for the withdrawn funds. This, pursuant to the most common borrower arguments, could result in delays and cause the borrowers to fail to satisfy their obligations to effectuate an investment within a contractually-agreed timeline. Hence, the competing interests of the lenders and the borrowers diverge and the arguments are made over which party should have rights over the amounts in the borrowers' accounts and whether the lenders must wait for the borrowers to call capital to make the necessary repayment.

We have seen this argument resolved in a number of different ways, but the solution often reached is to preclude the lenders from withdrawing funds from the collateral account (or other accounts) only to the extent such funds are earmarked for a contractually binding investment that will be effectuated in a time frame that would not allow the borrowers to call capital a second time to meet its contractual obligations. For example, if the investment is not slated to occur for twenty days from the date on which the lenders are authorized to remove funds from the borrowers' accounts, the lenders should not be constrained from withdrawing those funds. The borrowers can call capital again and use the proceeds of that capital call to fund the anticipated investment. On the other hand, if the investment is to be effectuated in under ten business days from the date on which the lenders are authorized to withdraw funds from the accounts, the lenders agree to rely on the credit parties to call capital (clause (b) of the above sample definition) to effectuate the necessary repayment. In the latter case, the lenders would likely expect confirmation that the contemplated investment did in fact occur as planned.

There is certainly no one-size-fits-all solution. However, the question of "whose cash is it anyway?" has an answer that focuses on time. The resolution must protect the lenders' interest in obtaining a timely repayment but not at the expense of the borrowers' ability to deploy capital within a desirable timeframe.