Cash Collateralizing Letters of Credit

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Fund finance facilities often provide for the issuance of letters of credit in addition to loans. Such letters of credit are customarily secured by the same collateral *pari passu* with loans. In syndicated facilities, each lender may agree to participate in the letter of credit liability *pro rata* to their commitments.

Loans in revolving facilities must generally be repaid at the maturity of the facility and any time that the outstanding principal amount (plus the letter of credit liability) exceeds the borrowing base. Reducing letter of credit liability is not as straightforward given that letters of credit support obligations of borrowers to third parties. The termination of a letter of credit is therefore likely to be more disruptive to a creditworthy borrower than repayment of a revolving line of credit. On the other hand, allowing a letter of credit to remain outstanding after collateral is released would leave the issuer of the letter of credit unsecured.

Many credit agreements address such conflicting interests by allowing the borrower to secure letters of credit by depositing cash in a collateral account controlled by the letter of credit issuer. Cash collateralization can be used to eliminate letter of credit liability in excess of the borrowing base (or a letter of credit sub-limit), but is more commonly used to secure letters of credit that remain outstanding after maturity date of the facility. The required amount of cash collateral is generally at least equal to the maximum amount that could be drawn on the letter of credit. (Additional cash may be required to cover any expenses or foreign exchange exposure.) While the letter of credit issuer remains liable for any draws on the letter of credit, the letter of credit issuer can offset such draws with the cash collateral, and any participating lenders will not have any exposure to letter of credit liability.

Credit agreements may also require letters of credit to be cash collateralized with the proceeds of capital calls in order to make it clear that funds in the cash collateral accounts are the proceeds of the lender’s collateral. This requirement reduces the risk that the payment may be deemed to constitute a “preference” under Section 547 of the U.S. Bankruptcy Code. Section 547 provides that if a debtor transfers funds for the benefit of a creditor with respect to an existing liability within 90 days of a bankruptcy filing and the amount transferred is greater than the amount the creditor would have received in a liquidation of the debtor in a bankruptcy proceeding, the creditor may be forced to return funds for distribution among the creditors of the insolvent debtor that would have been entitled to such funds. A secured lender has priority over other creditors with respect to such lender’s collateral (including capital contributions). Therefore, a lender that only receives the proceeds of such collateral should be able to demonstrate that the lender has not received more than it would have received in a liquidation in bankruptcy.

To effect cash collateralization of letters of credit, subscription facilities often contemplate separate letter of credit cash collateral accounts rather than directing the borrower to deposit additional cash in the collateral accounts into which capital is called from limited partners. Separate accounts allow borrowers, in the absence of default, to withdraw capital contributions from collateral accounts and allow lenders to retain letter of credit cash collateral as long as the related liability is outstanding.

If a separate cash collateral account is established, the borrower and the letter of credit issuer will enter into a cash collateral security agreement that provides for control of the account by the letter of credit issuer, the minimum amount of collateral and the release of excess collateral. The parties generally do not establish a separate account at the closing of the facility, given that such an account may never be needed. The parties should therefore be prepared to negotiate the terms of a security agreement, taking into account the matters discussed above, prior to establishing such an account.