Ten Things Every Fund Finance Banker Should Know About the UCC

April 2, 2021 | Issue No. 120

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The initiative to draft a code that would unify commercial transactions across U.S. states came about in 1942. The drafters went to work in a remarkable setting that, aside from a global war, was marked by clashes of ideologies growing out of the Great Depression and the New Deal era. The group spent most of the next decade completing a comprehensive published version of the Uniform Commercial Code (the "UCC") for presentation to the states and then the initial process of enactment by the states continued through 1968. Given this backdrop, the origin and development of the UCC has spawned a seemingly endless supply of legal research material. We set all of that to the side here and boil things down to what we see as the must-know points on the UCC for fund finance bankers.

1. Getting it right matters. Following the steps to a obtain a valid security is foundational to correctly pricing risk – secured loan margins look best on secured loans. Related to this point, the essential value of the perfected security interest is the benefit it gives a secured creditor in the event of a bankruptcy. In bankruptcy, subject to a few narrow exceptions, a perfected secured interest will have priority with respect to the collateral over other potential claimants, including over judgment lien creditors and the bankruptcy trustee. The secured creditor's position in bankruptcy is, of course, also a helpful negotiating leverage point outside the courtroom context. A mistake as to the validity and enforceability of a security interest can be expensive.

2. The UCC is not entirely uniform. Most of the time when "the UCC" is discussed, it refers to a model code. States have followed their own processes for enacting the model code into law and, in the lawmaking process, have often made some variations from the model. Florida and Tennessee, for example, add tax compliance and disclosure requirements to financing statements. While the security documents and process part of the deal process may have a rinse-and-repeat feel to it, in practice, the state variations mean that the security aspect of each deal requires close legal attention.

3. Fund finance is mostly concerned with Article 9 of the UCC. Because the UCC sets out a unified framework for commercial transactions across states, it covers a wide swath of territory, including the sales of goods, leases, investment securities and so on. Fund finance transactions are primarily concerned with Article 9 of the UCC, which deals with secured transactions.

More specifically, Article 9 addresses any interest in personal property (as opposed to real property) which secures payment or performance of an obligation. This type of interest is referred to as a security interest and the property that is subject to the security interest is called the collateral. A few other key terms: The person who holds a property interest in the collateral is referred to as the debtor; the person who owes the secured obligation is the obligor; and the person in whose favor the security interest is granted is the secured party.

4. Attachment happens when the contract rights between the debtor and the secured party become enforceable. A security interest attaches to collateral when it becomes enforceable against the debtor with respect to the collateral. (The parties can agree to have the time of attachment occur at a later point in the future.)

In any event, enforceability is the key concept underpinning attachment. Focusing on the points that matter in the fund finance context, a security interest is enforceable when the following criteria have been met: (1) Value has been given (a binding commitment to lend money is one way to give value); (2) The debtor has rights in the collateral or the power to transfer rights in the collateral to a secured party; and (3) The debtor has authenticated a security agreement that provides a description of the collateral or, alternatively, the collateral is a deposit account and the secured party has control.

5. The security agreement must reasonably identify the collateral. The drafters of the UCC set out to get rid of some old legal formalities and to prioritize function over form in business transactions. The security agreement is an example of how this goal has been accomplished.

The security agreement is simply the agreement that creates or provides for the security interest. The security agreement does not need to be a standalone document, and under what's known as the Composite Document Rule, multiple documents executed between the parties can be read to make up the security agreement.

To be effective, the security agreement must reasonably identify the collateral and must be authenticated. The "reasonably identify" requirement for the collateral description evidences that the debtor and the secured party agreed on what constitutes the collateral. To this end, super-generic descriptions, such as "all of the debtor's assets," are not considered a reasonable means for identifying the collateral.

The requirement that the security agreement be "authenticated" is a relatively new development in the UCC that is intended to move beyond signed paper to accommodate electronic communications, although the UCC does not spell out exactly what constitutes authentication.

6. Perfection describes the secured party's position relative to other potential claimants. Perfection is a step that follows attachment and that serves to lock in the secured party's interest in the collateral relative to other potential claims.

The process required for perfection depends on the type of collateral. In the subscription facility context, the perfection of a security interest in capital commitments (and the related bundle of sticks, including capital call rights and the proceeds of capital calls) is accomplished by filing a financing statement (UCC-1). A security interest in a deposit account may be perfected by control.

7. Listing the debtor's correct name on the financing statement is important. Actually, there's more than one important point to get right in a financing statement, but the debtor's name ranks among the top of the list. The purpose of filing financing statements is to provide a searchable database of existing filings indexed by the names of debtors. Because the system depends on finding records by debtor, the UCC places emphasis on getting the name right by linking the effectiveness of the financing statement to the debtor's name. The correct debtor's name for a financing statement is the name noted on the debtor's "public organic record," referring to the debtor's formation documents on record with the state. A mistake in the debtor's name can render the financing statement to be ineffective if the filing cannot be found under a search for the correct name of the debtor using the filing office's standard search logic.

8. Financing statements expire. Financing statements expire after five years and require a filing to renew within six months prior to the expiration date, a point that Isabella Shaw previously wrote about in more detail in *Fund Finance Friday* **here**. (Probably not a must-know fact, but it's 10 years in Wyoming.) To preserve the priority of a security interest, a lender will need to timely file a UCC-3 continuation statement.

9. Security interests in deposit accounts are perfected by control. Rather than following the financing statement filing process, a secured interest in a deposit account is perfected from the time the secured party obtains control of the account and it continues while the secured party remains in control. Control can mean one of two things: (1) The secured party is (or becomes) the bank with which the account is held, or (2) The secured party holds the power to direct the disposition of the funds under an agreement with the debtor.

10. Prompt filing or perfection protects priority. A perfected security interest will prevail over, or can be said to have priority over, claims of the debtor's unsecured creditors with respect to the collateral. Issues of priority become more sensitive, however, when two secured creditors hold competing claims to the same collateral. In such a dispute, the secured party that was first to file (and later perfect) or to perfect will have priority and will retain priority as long as its perfection has not lapsed. Because the timing of filing and perfection drives priority, lenders and their counsel move to file financing statements right after closing.

The Drawdown Interviews Fund Finance Partner Samantha Hutchinson

April 2, 2021 | Issue No. 120

Following the Cadwalader Fund Finance Team's **recognition** at *The Drawdown*'s Private Equity Service Provider Awards earlier this year, the publication's editors sat down to talk with partner Sam Hutchinson about the group's London team. Sam discusses the value of being part of a diverse team, the importance of early-career business development experience and how her early foray into the nascent fund finance market instilled an ongoing commitment to innovation and creativity in her practice. You can read the entire feature **here**.

Private Funds CFO: The Emergence of ESG-Linked Subscription Facilities

April 2, 2021 | Issue No. 120

Graham Bippart, the Editor at *Private Funds CFO*, this week published a cover story for the April/May edition that provides in-depth coverage and analysis of the emergence of ESG-linked subscription facilities. As he often does, Graham really dug in and has produced a thoughtful and well-researched piece. We recommend its reading to anyone interested in the market. The subscription-required article is accessible **here**.

Women in Fund Finance: Trends in Venture Capital

April 2, 2021 | Issue No. 120

Join Women in Fund Finance on April 8 from 11 a.m. to 12 p.m. EDT for a discussion among four industry leaders who will take a look at the current trends of venture capital and how the venture market is completely transforming private equity. Registration is available **here**.

Women in Fund Finance: Fireside Chat with Alice C. Early

April 2, 2021 | Issue No. 120

Women in Fund Finance will host a virtual fireside chat with author Alice C. Early on April 13 at 11 a.m. EDT. For more information or to register, click **here**.

PEI Article Discussion on Fund Finance Developments

April 2, 2021 | Issue No. 120

Private Equity International this week published an article discussing how COVID has changed the landscape of key negotiation points between GPs and LPs. One of the key themes in the article is how the need for portfolio company liquidity at the height of the crisis drove consideration of NAV and Pref Equity options, and how that experience is now leading to discussion of upfront parameters on leverage for new funds. The subscription-required article is available **here**.

On the Move – Fund Finance Tidbits

April 2, 2021 | Issue No. 120

On the Move

Josh Binder has joined Mizuho Americas as an Associate on its fund finance team. He will support the bank's initiative to grow its fund finance business by originating, structuring and executing subscription finance facilities for best-in-class fund managers. Josh most recently served as a Credit Risk Associate at Commonwealth Bank of Australia.