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Control or Control Agreement

August 25, 2023

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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).

Loans Are Not Securities

August 25, 2023

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We have a final answer to the question of whether a term loan is a security. Yesterday, the Second Circuit Court of Appeals affirmed the District Court's decision in the Kirschner Case that a term loan is not a security. We have been closely following this case, which has been working its way through New York federal courts for years, and you can find our updates **here**.

This case has been described as "a potential gamer changer" and even "an existential threat" to the syndicated loan market given the potential consequences it would have to the syndicated loan market if state and federal securities laws were to be applicable to that market. The case has received a lot of attention over the last few months as the participants in the $1.4 trillion loan market have sat up and taken notice on the developments as the Second Circuit heard oral argument and has made certain requests for additional briefing.

Significantly, following a hearing, the Second Circuit entered an order asking the U.S. Securities and Exchange Commission ("SEC") to submit "any views it wishes to share" on whether the loans in the Kirschner case are securities. Much was made of what the SEC might say and what that statement would mean for the Court's decision. In the end, following multiple motions for extensions of time from the SEC, the SEC ultimately declined to submit a legal brief on the subject.

The Loan Syndications Trading Association ("LSTA") has also been quite vocal in this case. As it said in a statement yesterday when the opinion was issued, "Maintaining the characterization of Term Loan Bs as non-securities has been a central focus of the LSTA for years. We are gratified that the SEC declined to submit a brief and that the Court adopted the long-standing view that loans." The LSTA also submitted a very thorough and thoughtful amicus brief with the Second Circuit Court of Appeals during the briefing period of the appeal which set forth its view that term loans are not securities and explaining the consequences that a determination otherwise would have for the entire syndicated loan market – borrowers, agents, lenders and others alike.

The Kirschner case in question involved a broadly syndicated $1.775 billion term loan. The credit agreement also facilitated the creation of a secondary market for the notes. Following certain legal struggles, Millennium filed for bankruptcy seeking relief under Chapter 11 of the Bankruptcy Code in the United States Bankruptcy Court for the District of Delaware. The litigation we have been following began in the course of the Chapter 11 proceedings. As part of the proceedings, the plaintiff in the case was appointed trustee of the Millennium Lender Claim Trust ("Trust"). The ultimate beneficiaries of the Trust are lenders who purchased notes and have claims in the bankruptcy proceedings.

Litigation ensued in New York federal court, culminating in a decision by the District Court in May of 2020 granting defendants' motion to dismiss, which thereby dismissed the plaintiff's state-law securities claims because it concluded that plaintiff failed to plead facts plausibly suggesting that the Notes are "securities" under the standard set forth in the Supreme Court decision *Reves v. Ernst & Young*, 494 U.S. 56 (1990). The plaintiffs timely appealed bringing the case before the Second Circuit Court of Appeals, which for our non-lawyer readers is a Court that is second only to the Supreme Court.

The decision issued yesterday turned principally on whether the Court found that the plaintiff in the case "plausibly suggested that the notes are "securities" under *Reves"* and the Court held that he did not. The relevant test that the Supreme Court set forth in *Reves* is a 4-factor test that is meant to distinguish between notes that are issued for investment purposes, for which securities laws would apply, and those that are for a commercial or consumer context, for which they would not. The Court applied the 4-factor test and analyzed each factor against the facts in the case. Ultimately, the Court determined that the District Court had ruled properly and affirmed its decision in yesterday's published opinion.

SEC Adopts Extensive New Rules for Investment Advisers

August 25, 2023

On August 23, 2023, the Securities and Exchange Commission voted to implement a number of new requirements for private funds, including requiring private funds to issue quarterly fee and performance reports and to perform annual audits. The new rules also impact adviser-led secondary transactions and restrict certain practices that the SEC characterizes as having continued "despite our enforcement actions and that disclosure alone will not adequately address." The preferential treatment rule, in particular, will be relevant in the context of fund finance transactions as it requires private fund managers to disclose certain fee arrangements made with investors and restricts certain types of preferential investment terms. Bespoke fee or liquidity arrangements are typically memorialized in side letters, which are an important component of most fund finance deals. They are reviewed by lenders in connection with due diligence reviews (i) for subscription line facilities to determine the rights and obligations of investors in respect of capital commitment collateral and (ii) for NAV facilities to determine the liquidity and information rights attached to equity interest collateral. This will also impact institutional investors who often use side letters for statutory, regulatory or governance compliance, other investors (*e.g.*, many pension plans) who need the flexibility to divest for internal portfolio risk limits and seed or anchor investors. For an in-depth analysis of the new rules, please read our Clients & Friends Memo **here**.

Summer Reading

August 25, 2023

From key trends shaping fund finance to NAV finance on the rise – here's what we're reading this week.

Private Equity International published an article summarizing trends currently shaping a rapidly evolving fund finance market. As with much industry commentary recently, the emphasis was on the opportunity in NAV. Read the article **here** (subscription required).

News that Apollo has allocated around $4 billion to financing loans tied to the net asset value in private equity portfolios (as first reported by *Bloomberg*) has been much discussed the past two weeks. *Private Debt Investor* highlighted this development as yet another signifier of NAV lending's rise. Read the article **here** (subscription required).

Register Now for Cadwalader's Annual Finance Forum

August 25, 2023

It's time to register for Cadwalader's annual Finance Forum on October 19 at The Ritz Carlton in Charlotte, North Carolina.

Nearly 450 industry leaders have already signed up. Attendees generally come from the financial services, investment management, private equity and legal communities, and this year's program will once again focus on fund finance, along with panels on commercial real estate, leveraged finance, middle market lending, private credit, securitization and structured finance.

More details with a schedule featuring this year's panel lineup and speakers will be announced shortly.

You can register for the Finance Forum **here**.