

CADWALDER

## How to Address Your Control Issues

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One of the important components of the collateral package for a subscription finance facility is the lender's perfected security interest in the fund's bank deposit account into which the actual cash constituting the proceeds of the capital calls are deposited (frequently called the "collateral account"). As many of our readers and market participants are well aware, there are two avenues to perfecting a lender's security interest in a collateral account in the U.S.: (1) entering a tri-party control agreement with the fund and the third-party account holder (establishing control pursuant to Section 9-104(a)(1) of the UCC); or (2) maintaining the collateral account in house at the lender's institution (establishing control pursuant to Section 9-104(a)(2) of the UCC). However, what do you do if the fund cannot give a lender "control" using either of these methods because it has already ceded control to another bank?

Enter, the anti-money laundering (AML) account.

As a service to funds, we are increasingly seeing a handful of U.S. lending institutions acting as an anti-money laundering agent (an AML Agent). Essentially, rather than running an AML process internally at the fund – a process intended to monitor for suspicious activity that could potentially involve money laundering – the fund has contracted with an AML Agent to provide this service. As part of this process, capital call proceeds are placed (typically for a one-business day period) into a special AML account at AML Agent's bank; during this brief layover, the AML Agent performs the requisite AML checks. Then, once the check is passed, the AML Agent will move the cash to a standard account of the fund over which the lender is able to establish control pursuant to one of the available methods established by Article 9 of the UCC.

It is important to note that the AML Agent is unable to provide a standard control agreement over the AML account because doing so would obligate them to follow the instructions of the lender in certain circumstances and therefore render them unable to perform the AML Agent function (namely, return the cash to the investor if the AML check were negative). As a result, lenders have had to get comfortable that they are protected against the default and/or bankruptcy of the fund in another manner.

As a side note, we frequently see this setup in a cascading structure in which investors are committed via a feeder vehicle. In such cases, the cleared funds may even be swept directly into the collateral account of the borrowing entity below the feeder in the structure. In such a case, it is worth noting that the lender receives a derivative rehypothecation of the security interest of the borrower (i.e., the borrower has a security interest in the capital call rights and then on-pledges that security interest to the lender), but that does not impact the analysis set forth here.

As a primary mitigant, it should be noted that it is very unlikely that a fund will default or file for bankruptcy – this has happened extremely rarely and only under unusual situations (e.g., fraud). For further protection (and we see this frequently), the lender may restrict the applicable entity in a manner such that it has very limited capacity for indebtedness outside of the subscription finance facility; as such, there would not be any material creditors to either cause the fund to file for bankruptcy or to be incentivized to attempt to obtain a right in the capital call proceeds or other assets of the fund.

There is one more critical element to this setup for the benefit of the lender, which was alluded to above. The AML Agent would typically be required to (and, in our experience, all have agreed to) enter into a standing order instruction (the Standing Order Instruction), which provides that the business day after capital call proceeds clear the AML process (the only requirement), such amounts are then wired directly into a controlled collateral account (either held at the lender's institution or via a standard control agreement). The Standing Order Instruction is documented in a side letter addressed to the lender. Critically, the fund has no control over the cash that goes into the AML account and no ability to transfer or withdraw such amounts. In addition, the fund is not permitted to amend the Standing Order Instruction as long as the subscription finance facility is in place. While not technically "control" for UCC perfection purposes, this contractual arrangement provides the key benefits of practical contractual control of the flow of funds for

the benefit of the lender. Therefore, prior to a bankruptcy of the fund, there should be little risk that the proceeds find themselves outside of the lender's security interest, because if they do, the lender would have a claim against the AML Agent for contractual breach.

In the remote chance that the fund filed for bankruptcy, the lender should be protected, as well – even if the bankruptcy process stopped the normal functioning of the Standing Order Instruction. Under both U.S. bankruptcy law and non-bankruptcy law (i.e., the Uniform Commercial Code), a security interest extends to proceeds of the original collateral (i.e., the capital call rights) over which a perfected security interest exists to the extent that those proceeds are “identifiable.” Given the tightly constructed setup of the accounts and accompanying documentation, including limitation on other co-mingled funds, the lender can have a very high level of confidence that the deposited capital call proceeds would be regarded as the identifiable proceeds of the preexisting capital call rights over which the lender has a perfected security interest. Therefore the lender would have a perfected security interest over the capital call proceeds in the AML account even without a control agreement in place.

We often see Cayman entities when we encounter these AML accounts located in a U.S. jurisdiction. The security documents for the U.S.-based AML accounts would be governed by New York law. Based on discussions with Cayman counsel, it seems highly probable that a Cayman court (in a Cayman bankruptcy) would defer to the U.S. analysis. While there is always a chance that someone could apply to the Cayman court to challenge this or the U.S. choice of forum, it is extremely unlikely any such application would be successful given the Cayman courts traditionally seek to give effect to contractual agreements between parties (absent fraud or illegality). Further, given the lack of creditors at the fund (as detailed above), the class of parties that would be incentivized to even attempt such a challenge should be very limited or non-existent.

Given the unique facts of an AML account, the setup described above addresses the inability of the fund to provide a standard control agreement accomplishing control perfection, while also protecting the lender's security interest and ultimate benefit in the collateral in a commercially reasonable and practical manner.

## FFA Global Symposium - Looking Forward

March 29, 2024



The Fund Finance Association wants to say thank you again to all those who attended the 13th Annual Global Fund Finance Symposium!

They are excited to share an online version of available slides from the [Preqin presentation](#), as well as a copy of [Global Legal Insights 2024 Edition](#).

Photos from the symposium can be viewed [here](#)!

Save the dates for the upcoming global symposiums:



### 14th Annual Global Fund Finance Symposium

**When:** February 24th - 27th, 2025

**Where:** Fontainebleau Miami Beach, 4441 Collins Ave., Miami Beach, FL 33140



### 15th Annual Global Fund Finance Symposium

**When:** February 2nd - 4th, 2026

**Where:** Fontainebleau Miami Beach, 4441 Collins Ave., Miami Beach, FL 33140

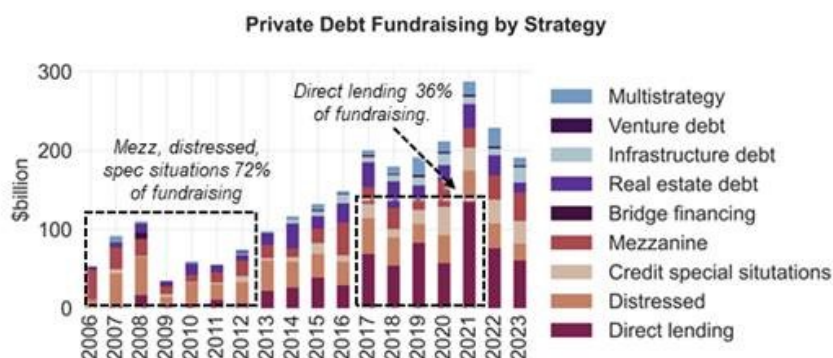
## What We're Reading

March 29, 2024

The Bank of England this week **flagged concerns** about the financial stability risks posed by private equity in light of higher interest rates and the resulting pressure on valuations. While the announcement has been widely covered in the financial media, no concrete actions were announced. The BoE's Financial Policy Committee plans to report back on its analysis at a June meeting.

Global M&A deal value jumped 30% to \$690 billion in Q1 according to London Stock Exchange Group data **cited in** the Financial Times. We have previously suggested that the recent easing in financial conditions could support improvement in investment, exit, and distribution trends in private markets. Dealmaking activity during the quarter, however, skewed to larger transactions, and the recovery in Europe outpaced the improvement in the U.S.

The direct lending share of global private debt fundraising declined again 2023 after reaching an all-time record of 47% in 2021, according to **data from Pitchbook**. Until the 2012, distressed, special situations, and mezz strategy funds dominated private debt fundraising, accounting for as much as 90% of dollars raised in 2006, and reflecting interest and returns in difficult-to-access, non-commoditized fixed income. That interest appears to be making a return.



Source: Pitchbook and Cadwalader, Wickersham & Taft LLP.

Meanwhile, **Bloomberg reports** that private credit funds are giving up fees to attract capital as competition between closed-end funds, BDCs, and banks intensify. Illustrating the point, **Apollo recently waived** the first year of fees on its Middle Market Apollo Institutional Private Lending BDC for its anchor investor Mubadala Investment Co.

## Fund Finance Hiring

March 29, 2024

Fund Finance Hiring

Here is who's hiring in Fund Finance:

Hark Capital is looking for an Analyst to join their investment team in New York. Founded in 2013, Hark was one of the early pioneers in NAV lending and has raised four dedicated funds. The Analyst qualifications include: 1-2 years of relevant work experience at a commercial bank, investment bank or similar institution, strong work ethic and the desire to be part of an entrepreneurial team. If you are interested, the full job description can be found [here](#).

M&T Bank is looking for a Senior Underwriter/Portfolio Manager, Fund Banking to join their team in New York. The position is responsible for evaluating and determining, monitoring and assessing the credit risks of larger, more complex commercial clients through detailed financial statement analysis, industry assessment, collateral valuation, cash flow analysis and the ability to repay annual debt service. If you're interested in learning more, the full job description can be found [here](#).

Please apply online: [www.mtb.com/careers](http://www.mtb.com/careers) Requisition ID: R61520

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