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Table of Contents:

- 'Fund Finance Friday: Industry Conversations' — Flexibility in Unique Circumstances (30 Minutes)
- Cash Collateralizing Letters of Credit
- Secondaries Investor Report on H1 Preferred Equity Deal Volume
- Privcap Podcast Examines the Fund Finance Market Amid COVID-19
- The Drawdown Unveils Shortlist for 2020 Private Equity Service Provider Awards
- Recommended Reading

'Fund Finance Friday: Industry Conversations' — Flexibility in Unique Circumstances (30 Minutes)

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Industry Conversations

In today's *Fund Finance Friday: Industry Conversations*, Cadwalader's Samantha Hutchinson hosts Stephen Quinn of 17Capital to discuss liquidity solutions during the COVID-19 era.

Subscribe on **Apple Podcasts**, **Google Podcasts** or **Spotify** to never miss an episode.

Cash Collateralizing Letters of Credit

August 14, 2020 | Issue No. 90

By Trent Lindsay
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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.

Secondaries Investor Report on H1 Preferred Equity Deal Volume

August 14, 2020 | Issue No. 90

Secondaries Investor reported on the significant uptick in volume of preferred equity transactions in H1, demonstrating that preferred equity solutions continue to be an increasingly important part of the fund finance market. You can read the article **here**.

Privcap Podcast Examines the Fund Finance Market Amid COVID-19

August 14, 2020 | Issue No. 90

Haynes and Boone partner Albert Tan moderated a Privcap Podcast earlier this week and, along with guests Jeff Johnston, Head of Asset Management at Wells Fargo Bank and Chair of the Fund Finance Association, and Jonathan Peiper, a Managing Director and Head of Subscription Financing at Mizuho Americas, discussed the fund finance market and provided some market observations amid the COVID-19 pandemic. Click **here** to read an excerpt by Haynes and Boone and **here** to listen to the full episode (17 minutes).

The Drawdown Unveils Shortlist for 2020 Private Equity Service Provider Awards

August 14, 2020 | Issue No. 90

The Drawdown has announced its shortlist for the 2020 Private Equity Service Provider Awards, which recognize private equity service providers across multiple categories. Cadwalader is honored to be named a finalist in the “Advisory/Consultancy: Fund Finance” category.

The winners will be announced at an awards ceremony on October 5 in London.

To read more about the awards and to view the finalists across all categories, please visit **here**.

Recommended Reading

August 14, 2020 | Issue No. 90

- More recommended viewing than reading, but DoubleLine Capital launched a YouTube program titled "Channel 11." This week's inaugural episode features an interview with the firm's Deputy CIO, Jeffrey Sherman. Founded in 2009, DoubleLine today manages assets of over $135 billion. Watch the first episode **here**.
- Fitch Ratings affirmed its AAA rating of United States Foreign Currency and Local-Currency Issuer Default Ratings for the U.S. on July 31, 2020, while downgrading the outlook on both to negative. That report, citing ongoing deterioration in the country's public finances and absence of a "credible fiscal consolidation plan", can be accessed **here**.
- Treasury's auction of a record amount of $26 billion of 30-year bonds yesterday met with a lukewarm market response. Primary dealer inventories absorbed more than $7 billion of the bonds. The funding need in coming months remains significant. A recap of the auction can be found **here** and upcoming Treasury auction sizes **here**.