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The ABCs of KYC (accounts)

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Subtly pivoting from the topic of collateral accounts, introduced in the August 25, 2023 *Fund Finance Friday* ("FFF") article by Chad Stackhouse and Katie Clardy titled "Control or Control Agreement", we will explore a few of the issues which we have encountered with respect to anti-money laundering ("AML") accounts operated by third-party fund administrators.

This article aims to provide a high-level overview of some complications which have arisen in the course of our transactional work with respect to AML accounts and does not address the substance of any applicable AML regulations. Each agreement between a fund and a fund administrator is unique, and it remains essential that legal advice is sought on each transaction to ensure that lender(s) benefit from comprehensive security packages tailored to the structure of each fund.

The Recap

So what are collateral accounts, again? As previewed in the preceding FFF article, the answer in the context of subscription facilities is most commonly the accounts into which investors pay their capital contributions. Please refer to the previous FFF article for the details on how to attach and perfect account pledges in the US.

Okay ... So what's the issue?

Funds may have the in-house capability to perform their own AML checks but often engage third-party fund administrators to outsource these functions.

In such instances, administration agreements are typically put in place empowering a fund administrator to operate an AML account on behalf of a fund, which may result in that fund having limited or no control over the monies in these accounts until such time as all requisite AML checks have been completed.

Therefore, an AML account may in fact be the account into which capital contributions are initially paid and a "collateral account" may be where capital contributions end-up.

This poses a potential issue for lenders given that a third-party may have the power, or be under an obligation, to remit funds away from a secured account, potentially resulting in cash leakage.

So if there is a third-party administrator, how could a lender get comfortable with these arrangements?

The belt-and-suspenders approach would be to take security over both the AML and the collateral accounts, though this is ultimately a commercial point and not always achievable.

If it isn’t possible to take security over the AML account, a lender could require that the administrator enter into an ‘"administrator side letter". Such a side letter could provide, for example, that the AML account will be subject to a standing instruction requiring all funds to be swept into a secured collateral account within one business day of the completion all applicable AML checks, and that such instruction could not be altered without the consent of the lender. It could also include an acknowledgment by the administrator that it has no interest in the funds on deposit in the AML account and that the borrower has no ability to exercise any discretion with respect to the transfer of such funds.

The handful of provisions above are examples of some of the potential solutions available to lenders. As previously noted, each situation is unique and requires careful analysis. Negotiating side letters with third-party fund administrators can also be difficult, given that they typically wish to avoid entering into any loan documents or being required to comply with the instructions of anyone other than the fund sponsor.

Are there any other consequences for the loan documents?

Unsurprisingly, yes. It is common to see the inclusion of covenants in credit agreements which oblige credit parties to: maintain collateral accounts, ensure that the proceeds of all capital calls are paid into such accounts and limit withdrawals from such accounts following the occurrence of a cash control event. However, if the proceeds of investor capital calls are actually paid into AML accounts (which are not the subject of security), prior to the funds being remitted to the so-called "collateral accounts", these covenants must be tailored to ensure that adequate carve-outs are included to avoid triggering any day-1 defaults.

Lenders could also seek to include covenants restricting the ability of credit parties to exercise any discretion they may have with respect to the transfer of funds from an AML, without obtaining the consent of the lender(s).

In any case, lenders must be satisfied that in an enforcement scenario the risk of cash leakage is minimized and an administrator side letter may provide comfort on this point but is not a substitute to a perfected account pledge.

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