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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.

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