Subscription-Secured Financings: Enforcement vs. Perfection

A Lexis Practice Advisor® Practice Note by
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This practice note discusses the mechanisms available to a lender to protect its rights in collateral under a subscription-secured finance facility. In any finance transaction, a primary focus for the lender will be ensuring that it has sufficient rights in collateral pledged to secure the obligations of a borrower. Sufficient rights in the collateral generally means that the lender has a perfected security interest; however, many lenders will also take additional steps to eliminate barriers to enforcement of rights against the collateral. Perfection of a security interest will preserve the lender's position against the collateral relative to competing creditors of the borrower, while enforcement protections seek to enable the lender to enforce its rights against the collateral in the most expedient way possible.

This practice note explains the legal and contractual protections employed by lenders in subscription-secured financing facilities, including the distinction between the lender's rights arising from perfection of its security interest in the collateral (see Perfection) and its contractual rights of enforcement against the collateral (see Enforcement).

INTRODUCTION

In order to fully understand the various protections available to lenders, it is important to recognize the difference between perfection of a security interest and enforcement mechanics that are aimed at facilitating recovery of the collateral. The distinction between perfection and enforcement protections can be evidenced in subscription-secured finance facilities, where the lender will often perform significant diligence to simplify its path to recovery against the collateral. In a subscription-secured finance facility, the primary collateral will be the obligations of the investors in a fund to make contributions of capital (referred to as capital contributions) to the fund. In order to protect the lender's rights to the collateral, it is necessary to perfect the lender's security interest in the capital contributions under the Uniform Commercial Code (UCC), the statutory regime governing secured transactions in the United States of America (UCC section references used herein shall refer to the UCC as in effect in the State of New York as of the date hereof).

However, often subscription-secured finance transactions are also structured to provide easier enforcement mechanisms to the lender in the event that the lender has to pursue remedies under a credit agreement, security agreement, or other loan documents following the occurrence of an event of default. In such an event, the lender will be relying on the investors to fund their capital contributions for the purpose of paying down obligations under the loan documents. Therefore, it is to the benefit of the lender to have means to directly compel the investors to pay any requested capital contributions without reliance on judicial or bankruptcy proceedings. These direct enforcement means will provide important rights in a pre-bankruptcy default situation, but will not improve the lender's position in a bankruptcy proceeding.

PERFECTION

As with all secured finance deals, it is imperative that a lender's security interest in the collateral be perfected under the terms of the UCC. Having a first priority, perfected security interest will help ensure maximum recovery for the lender in the event that a borrower's assets become subject to bankruptcy proceedings because a perfected security interest will take priority over an unsecured loan, a secured loan with an unperfected security interest, or a perfected security interest created later in time. For this reason, it is common for a lender to perform UCC and other lien searches (such as tax lien or judgment searches) to verify that no prior liens exist that would take priority over the liens to be created under the loan documents. Furthermore, a perfected security interest will also enable the lender to exercise rights afforded to secured creditors under the UCC.

UCC-1 Financing Statement

Under the UCC, capital contributions would be classified as "payment intangibles," defined in U.C.C. § 9-102(61) as "general intangible[s] under which the account debtor's principal obligation is a monetary obligation." Pursuant to U.C.C. § 9-310, a security interest in a general intangible is perfected upon the filing of a UCC-1 Financing Statement in accordance with the UCC. Therefore, in all subscription-secured finance deals, the lender should file a UCC-1 financing statement in respect of the capital contributions (and any rights or interests related thereto, or other collateral for which perfection can be achieved by way of filing a financing statement). In addition to providing important bankruptcy protection and rights under the UCC by ensuring the priority of the lender's security interest, the financing statement will also put third-party creditors on notice of the lender's security interest in the capital contributions and will prevent conflicts among third-party lenders.

Control Agreement

Note that while a security interest in many forms of collateral can be perfected by the filing of a financing statement, under Article 9 of the UCC, certain types of collateral will require additional steps for perfection. For example, in a subscription-secured finance facility, the lender will often take a security interest in the deposit account into which capital contributions will be paid. Under U.C.C. § 9-104, a security interest in a deposit account must be perfected by "control," as opposed to the filing of a financing statement.

Control under the UCC can be achieved in several ways. Most commonly, the lender will enter into a deposit account control agreement among the borrower, the lender, and the bank at which the deposit account is maintained, pursuant to which the bank agrees that it will comply with the instructions of the lender concerning the disposition of funds in the deposit account without the further consent of the borrower. In addition to fulfilling the requirements for perfection by control under the UCC, the deposit account control agreement will also protect the borrower's accounts from unauthorized access and provide the lender additional assurance through the agreements made by the bank. Therefore, lenders should remain mindful that a financing statement may not be the only action required for perfection, and should discuss the necessity of additional perfection measures with counsel.

ENFORCEMENT

Due Diligence

In addition to the perfection of a security interest, many subscription-secured finance transactions also include enforcement mechanics that will enable a lender to directly compel the investors to pay capital contributions in a default situation. While structuring the transaction and performing initial diligence, the lender may look at several factors relating to the relative rights and obligations of the borrower and its investors, including the creditworthiness of the various investors and the relevant agreements and covenants made by the investors in the borrower's limited partnership agreement, subscription agreements, or other governing documents. Investors may also enter into side letters or other agreements with the borrower to alter the terms of the governing documents as they pertain to such investor. The lender should carefully review any side letters to ensure that they do not contain any provisions that would limit the lender's rights against an investor.

In performing diligence on the investors, the lender will typically review the borrower's governing documents to determine whether they clearly set forth the obligation of the investor to fund its capital contribution. Having a clear expression of the investors' obligations provides comfort that such obligations will be valid and enforceable against the investors, and will form the basis of a reliance claim by the lender under the Delaware Revised Uniform Limited Partnership Act, or other applicable law, that the lender reasonably relied on the rights to call for capital contributions in extending credit to the borrower.

Direct Agreements and Covenants

Additionally, in the subscription-secured finance market, lenders prefer that the governing documents of the borrowers include specific language regarding the credit facility. This language typically includes a specific consent by the investors to the borrower entering into the credit facility and pledging a security interest in the borrower's rights to call for and receive capital contributions. Preferably the language would include further agreements of the investors, including an agreement to fund capital contributions called directly by the lender, agreements to fund capital contributions into a deposit account in which the lender has control (as discussed above), and confirmation of the investor's obligations to fund all capital calls without defense setoff or counterclaim. In the event that this preferred language is not included in the governing documents, the lender may require that the investors execute additional documentation confirming such agreements for the benefit of the lender.

The purpose of these express agreements made in the governing documents for the benefit of the lender is to create a framework for the lender to realize on the rights assigned to it pursuant to the loan documents, including the right to issue a call for capital contributions following the occurrence of an event of default. These agreements, along with the loan documents, will also create contractual obligations on the part of the borrower and the investors, which contractual requirements will be in addition to any remedies available to lender under the UCC or other applicable law. If the lender does not have these express agreements or other assurances as to the enforceability of the underlying rights in the collateral and the lender's rights thereto, in a default situation, absent the initiation of formal legal proceedings, the lender could be relying on the cooperation of the borrower and the investors to enforce rights against the collateral.

By way of example, in a default situation, a lender may request that the borrower call for capital contributions for the purpose of paying down obligations outstanding under the loan documents. However, following an event of default, a borrower may be unwilling or unable to cooperate with a lender, depending on the nature or the severity of the default or any deterioration of the relationship with the lender. Therefore, it is common for the loan documents to permit the lender to issue a call for capital contributions directly on the investors following an event of default. Moreover, the UCC affords certain rights to secured creditors under Article 9, including the right to notify an account debtor to make payment for the benefit of the secured creditor, if so agreed, and in any event following an event of default.

In connection with the rights of the lender under the UCC and the loan documents, there is tremendous benefit for the lender if it can enforce its rights by calling directly on the investors, without the necessity of the borrower's cooperation. Additionally, because the investors have already acknowledged the existence of the credit facility and agreed to fund calls for capital contributions made by the lender, they are prevented from failing to make payment on the basis that the lender is not authorized to call for capital, or that such a call for capital is not done in accordance with the governing documents. These mechanics seek to allow the lender to quickly pursue enforcement without the need to obtain further agreements by the borrower or any investor, or seeking judicial enforcement of the provisions of the loan documents.

Ultimately, the lender can pursue enforcement of its rights against the investors absent these direct agreements and covenants, by asserting a claim against the investors on the basis of breach of contract, reliance, unjust enrichment, or promissory estoppel, or by compelling enforcement of the borrower's rights against the investors through judicial proceedings. However, while a lender may be likely to prevail on these theories of recovery, enforcement may only be accomplished through prolonged and costly legal proceedings, which may span several jurisdictions depending on the location of the investors. Given the potential for instability following a default, it is advantageous for the lender to be able to enforce its rights as quickly and efficiently as possible. This will also benefit the borrower by limiting the incurrence of legal fees and permitting it to move forward with its business as in an expeditious manner.

It is important to note that if bankruptcy proceedings have been initiated against the borrower, an automatic stay will be placed over the borrower's assets preventing the lender from making a call for capital contributions or otherwise enforcing rights under the loan documents or governing documents. The purpose of the automatic stay is to prevent the lender (as well as all other creditors of the borrower) from exercising rights against the collateral or any other assets of the borrower, until such time as the bankruptcy court has determined or approved a fair and equitable plan for distribution of the borrower's assets (taking into account the priority of each creditor's claim, as discussed above). Therefore, while the enforcement protections discussed herein will not ensure recovery in a bankruptcy, they provide important protections in a situation where the borrower is in default but has not yet become the subject of bankruptcy proceedings.

CONCLUSION

In any subscription-secured finance facility, it is essential for a lender to ensure both that it has a perfected security interest under the UCC, and for it to understand its enforcement options in a default situation. While the former will ensure the priority of the lender's security interest for purposes of the UCC and bankruptcy proceedings, the latter will provide quick and efficient means for enforcement of a lender's security interest prior to bankruptcy. In structuring subscription-secured finance transactions, lenders should remain mindful of the value of both perfection and enforcement mechanisms, and should discuss their options and expectations with counsel.

RELATED CONTENT

- Subscription Facilities
- Subscription Facility Exclusion Events
- Exclusion Event Definition in Subscription Facilities
- Subscription Facilities: Security Interests and Enforcement Checklist

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Tim Powers is Haynes and Boone's managing partner. In his role as chief executive, Tim chairs the firm's executive committee and board of directors, and is responsible for developing and implementing the firm's strategy for achieving its goals and growth plans. He also has the responsibility for maintaining the firm's culture, and for attorney, staff and client satisfaction. Tim has been a longtime Haynes and Boone leader, holding numerous firm-wide roles, including department chair, practice management chair, marketing partner, lateral hiring partner and member of the compensation and appointments committees. He also has led the development of the firm's international practice, as well as its global geographic growth.

In his practice Tim is widely credited with having led the legal development of the subscription secured credit facility market, and he has helped build Haynes and Boone into a global leader in the representation of U.S. and foreign commercial and investment banks in subscription financings for private equity funds. To date he has advised lead agents and arrangers on more than 500 such facilities with an aggregate notional value in excess of $60 billion. In connection with his subscription finance practice, Chambers USA has written that Tim is recognized by clients as "the originator and the expert in the industry, and an incredibly strong attorney, with a strong power base, excellent business sense, pragmatic, and with the ability to get things done effectively and in a no-nonsense manner."

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Ellen McGinnis is a partner at Haynes and Boone, LLP, Washington, DC, and Co-Chair of the firm's Fund Finance practice group, for which Haynes and Boone is trusted counsel for U.S. and foreign commercial and investment banks as lenders to private equity funds. Ellen provides critical thinking and practical advice to a wide-range of clients in financing transactions, focused in particular on subscription-secured credit facilities, having worked on the product since its initial development in the late 1980's. Ellen has recently represented a number of clients in hybrid collateral facilities, leads many of the practice's international and multi-currency transactions, and represents lenders making loans to private equity firm partners.

Ellen is the chair of the firm's Admission to Partnership Committee and is a member of the firm's Board of Directors, and participates on the Opinion Committee and Technology Committee.

Ellen received her J.D. from New York University School of Law, where she was a member of the Journal of International Law and Politics. She was graduated cum laude from Yale University.