Pratt's Journal of Bankruptcy Law

LEXISNEXIS® A.S. PRATT® APRIL/MAY 2021

LexisNexis

Pratt's Journal of Bankruptcy Law

VOLUME 17 **NUMBER 3** **April/May 2021**

LexisNexis®

(2021–Pub.4789)

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Library of Congress Card Number: 80-68780

ISBN: 978-0-7698-7846-1 (print)
ISBN: 978-0-7698-7988-8 (eBook)
ISSN: 1931-6992

Cite this publication as:

[author name], [*article title*], [vol. no.] PRATT'S JOURNAL OF BANKRUPTCY LAW [page number] ([year])

Example: Patrick E. Mears, *The Winds of Change Intensify over Europe: Recent European Union Actions Firmly Embrace the "Rescue and Recovery" Culture for Business Recovery*, 10 PRATT'S JOURNAL OF BANKRUPTCY LAW 349 (2014)

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POSTMASTER: Send address changes to *Pratt's Journal of Bankruptcy Law*, LexisNexis Matthew Bender, 230 Park Ave. 7th Floor, New York NY 10169.

U.S. Collateral Account Best Practices

By Mark C. Dempsey, Sean T. Scott, Massimo Capretta, and Vincent R. Zuffante*

This article explores potential areas of concern for lenders associated with collateral account documentation and offers drafting and best practices to mitigate, and ideally avoid, potential issues associated with collateral accounts.

A key component of the collateral package for subscription-backed credit facilities (each, a "Facility") is the security interest an investment fund (each, a "Fund") grants to the lender(s) under a Facility in the deposit or securities account established to hold the capital contributions received from the Fund's investors (the "Collateral Account"). Although the Collateral Account in many Facilities may be a securities account, this article is limited to a discussion of deposit accounts as that term is defined in the applicable Uniform Commercial Code (the "UCC").

This article explores potential areas of concern for lenders associated with Collateral Account documentation and follows with considerations for drafting and best practices used to mitigate, and ideally avoid, potential issues associated with Collateral Accounts.

NEW YORK UCC RULES

Under the UCC in effect in the State of New York (the "NY UCC"), in order to perfect a security interest in a Collateral Account which is a deposit account, the lender (as the secured party) must establish and maintain control of the account.[1] The NY UCC provides the following methods a lender may use to establish the control required for perfecting a security interest in a deposit account:

1) The lender is the bank maintaining the deposit account (the "Account Bank");

2) The lender, the Fund and the Account Bank enter into a written

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[1] Under NY UCC § 9-314, security interests in deposit accounts are perfected when the secured party establishes control of the collateral and remain perfected only as long as the lender continues to have control.

agreement pursuant to which the Account Bank agrees to follow the lender's instructions regarding the funds in the account without further consent from the Fund;

3) The lender is the customer of the Account Bank with respect to the deposit account;

4) The name on the account is the name of the lender or indicates that the lender has a security interest in the account; or

5) Another person has control of the account on behalf of the lender or, if the person is already in control of the account, acknowledges that it has control on behalf of the lender.[2]

In most Facilities, the lender establishes control of the Collateral Account by serving as the Account Bank or entering into a triparty control agreement with the Fund and the Account Bank, as described in NY UCC Section 9-104(a)(2) above (each, a "Control Agreement"). The Control Agreement establishes the lender's control over the Collateral Account for perfection purposes and specifies when the Account Bank will accept instructions relating to the funds in the account from the lender, the Fund or both. Although the Control Agreement provides the lender with the continuous control required for perfection, in practice, the lender may encounter issues maintaining and exercising its contractual rights in the Facility's Collateral Account which cannot practically be addressed in the Facility documents or Control Agreement.

RISKS FOR THE LENDER WHEN THE COLLATERAL ACCOUNT IS HELD AT A SEPARATE ACCOUNT BANK

When the lender does not maintain the Collateral Account, potential risks for the lender include that the Account Bank will not act on the lender's instructions regarding the Collateral Account in a timely manner, the Account Bank's failure to comply with the lender's instructions entirely and the early or unexpected closure of the Collateral Account by the Account Bank.

Timing Delays

Most Control Agreements provide the manner in which the lender may deliver instructions and notices to the Account Bank regarding the Collateral Account. Often, notices of exclusive control will be subject to the Account Bank's specific procedures for delivery, including obtaining signatures from designated representatives of the lender and delivery of such notices to the Account Bank via overnight courier or facsimile.

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[2] NY UCC § 9-104(a)(1)–(5).

Due to internal administrative procedures at the Account Bank, delays of two or three business days may occur between the time an Account Bank receives instructions from the lender and the time the instructions are acted upon. Such delays could be problematic for the lender in situations where a default has occurred under the Facility documents and the lender has elected to exercise exclusive control of the Collateral Account to protect its collateral from unauthorized removal by a defaulting Fund.

The timing delays discussed above may be reduced or eliminated if the lender is the Account Bank, because this avoids the delays associated with the internal procedures of a separate institution. To protect the Facility's collateral from unauthorized removal by the Fund, the Facility documents will typically include provisions restricting the Fund's ability to withdrawal funds from the Collateral Account once a default has occurred.

If the lender is not the Account Bank, the Control Agreement should expressly limit the amount of time the Account Bank has to comply with a notice of exclusive control. Finally, any procedures for the delivery of instructions and notices of exclusive control should be expressly set forth in the Control Agreement and followed exactly by the lender to avoid potential delays.

Noncompliance Risk

In addition to the timing issues discussed above, there may be circumstances in which the Account Bank chooses not to comply with the lender's instructions regarding the Collateral Account in order to avoid violating applicable law or regulations, or incurring liability to the Fund or third parties. For example, the Account Bank may be hesitant to comply with the lender's instructions if it suspects the instructions are premature or improper, or where the Account Bank has concerns that acting on the instructions may violate applicable insolvency or bankruptcy laws.

To address these concerns, the Control Agreement should include a waiver of liability of the Account Bank for actions taken pursuant to instructions given by the lender as well as language making it clear the Account Bank has no obligation to investigate the circumstances prompting the lender's delivery of a notice of exclusive control, and can rely on any such notice that it receives. Including such provisions is helpful, as it may encourage the Account Bank's compliance with the lender's instructions by removing its concern of incurring liability to the Fund when acting on such instructions. However, most Account Banks will require a similar waiver of liability from the lender, which could reduce the likelihood that the Account Bank will comply with the lender's instructions pursuant to the Control Agreement where there are disputes around the default or other contentious circumstances.

Unexpected Collateral Account Closure

The Account Bank's ability to close the Collateral Account or terminate the Control Agreement could also present risk to the lender. Generally, the Account Bank will reserve the right to close the Collateral Account without cause upon providing the required advance notice to all parties to a Control Agreement. The Account Bank may also be permitted to immediately close the Collateral Account if the Fund defaults in its obligations to the Account Bank, including the nonpayment of bank fees described in the Control Agreement (and possibly if the Fund is in default on a separate obligation to the Account Bank). Regardless of the cause, an unexpected account closure may result in the lender losing control of the account collateral and, therefore, perfection of its security interest in the Collateral Account under the NY UCC.

To avoid unexpected account closures, the applicable Control Agreement should expressly identify the circumstances under which the Account Bank will be able to close the Collateral Account and should require advance notice to all parties of any impending closure. The Fund and the lender should also agree in the Facility documents that in the event of a Collateral Account closure, the Fund will open a new Collateral Account within a specified time frame and execute a new control agreement granting the lender similar or identical rights in the new Collateral Account.

In the event the Collateral Account is unexpectedly closed, the lender could itself open a replacement Collateral Account; however, the lender should be aware that the Fund's governing documents or separate agreements between the Fund and its investors may excuse investors from contributing capital to an account not held by the Fund. For this reason, in the event of a default under the Facility documentation, the lender should ensure that the appropriate power-of-attorney is included in the Facility documents, allowing it to open accounts on behalf of the Fund.

Subordination and Indemnification

An additional risk for lenders relating to Collateral Accounts is that many Control Agreements include provisions allowing the Account Bank to recover obligations the Fund owes to the Account Bank by withdrawing such amounts from the Collateral Account, often without having to recognize any subordination to the lender's security interest. Such obligations may include the Account Bank's right to charge the Collateral Account for fees or charges due with respect to the Account, including any returned deposits originating from the account.

Even if a Control Agreement does not expressly contain such provisions, an Account Bank may have a common law right to offset such owed amounts due

it against funds on deposit with the Account Bank. As such, to the extent practicable, the Control Agreement should provide that the Account Bank subordinates any such rights to collect or offset amounts owing it to the lender's security interest in the Collateral Account (and amounts on deposit therein).

The lender should also consider negotiating the Control Agreement to expressly limit its own indemnification liability to losses resulting from actions taken by the Account Bank in compliance with the lender's instructions or losses occurring after a notice of exclusive control is given effect, and should be further limited to amounts the lender actually received from the account.

ELIGIBLE INSTITUTIONS AND INSOLVENCY RISK

Another potential risk for the lender is that the Account Bank maintaining the Collateral Account may itself become insolvent and be placed into a receivership or conservatorship. In the United States, most banks' deposits are insured by the Federal Deposit Insurance Corporation (the "FDIC"). In the event of bank failure and resulting receivership or conservatorship, the FDIC, as receiver or conservator, will reimburse the depositors of the failed bank for the value of their insured deposits (up to $250,000 for a single account) and will coordinate a sale of the failed bank's assets to repay the bank's remaining uninsured deposit obligations.

To the extent a depositor has deposits in excess of the federally insured amount, the depositor has a claim against the failed institution's receivership estate for the uninsured amount, which will be repaid with the proceeds recovered from the liquidation of the failed institution's assets. As a result, repayment of uninsured deposits could be delayed considerably depending on the timing of the liquidation proceeding with respect to the bank's assets. In addition, while uninsured depositors are paid before other unsecured creditors, full recovery for uninsured depositors is not guaranteed.

To minimize the risk of insolvency by the Account Bank, the Fund and the lender may specify in the Facility documents that the Collateral Account be held only at an institution meeting specified criteria (an "Eligible Institution"). Generally, the Eligible Institution must hold a minimum threshold dollar amount in capital reserves, possess maximum FDIC deposit insurance coverage, be subject to state or federal regulatory oversight and receive minimum credit ratings from approved ratings agencies. Similarly, where the Account Bank is located outside of the United States, the Facility documents may require the Account Bank to satisfy certain requirements, including minimum credit ratings.

Collateral Account Monitoring

Timely and accurate financial reporting enables the lender to monitor the financial condition of the Fund and the status of the Facility's collateral. For this reason, the Facility documents may require the Fund to agree to promptly deliver information relating to the collateral, including capital call notices, notices of transfers, investor downgrades and similar requirements.

To enhance its ability to effectively monitor the collateral within the Collateral Account, the lender may require electronic account access or periodic delivery of account statements by the Fund. In the event the Fund fails to provide the information requested, the Control Agreement should include language providing the Fund's consent to the Account Bank's delivery of such information directly to the lender.

CONCLUSION

While the suggestions for drafting and best practices contained in this article may assist a lender in mitigating certain problems associated with Collateral Accounts in Facilities, the facts and circumstances of each Facility may call for variations of any approach suggested above. For this reason, each lender or other secured party should confer with experienced counsel to ensure that the applicable Facility documents and Control Agreement are drafted to address its specific needs in addition to the risks for lenders relating to Collateral Accounts.