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Fund Finance Security Guide

The main aspects of the security package, in the most common jurisdictions involved in fund finance transactions.

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Praxio's Fund Finance Security Guide

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INTRODUCTION

Dear Friends,

This is with a great pleasure that we release this Praxio's Fund Finance Security Guide.

We thought that it would be helpful for lenders, borrowers and lawyers to have a document describing the key aspects of the security package for the most common jurisdictions involved in fund finance transactions. Indeed one of the features which ensures a reliable fund finance transaction is the security package.

We want to thank all the contributors around the globe for joining us in this initiative.

Michael Mbayi

THANKS FOR THEIR CONTRIBUTIONS

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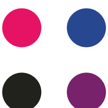

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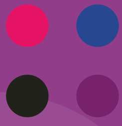
Michael Mbayi is the Head of Banking & Finance at Praxio Law & Tax. **Michael** is one of the most experienced fund finance lawyers and advises leading financial institutions, private funds sponsors and alternative lenders on a wide variety of transactions including subscription facilities, hybrid/NAV facilities, as well as GP and management fee facilities.

Michael was **awarded** in 2021 by **Fund Finance Association** for his contribution to the industry. **Michael** has been **recognised** in 2022 by "**The Drawdown**" as one of the most influential Fund Finance experts. **Michael** has been **quoted** by **Legal 500 EMEA 2022** as "very knowledgeable on Fund Finance matters", "responsive" and "particularly active on behalf of a lender-focused client base".

Michael is the author of various Fund Finance publications and a member of the Diversity Committee of the Fund Finance Association.



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We are an independent multi-service law firm in Luxembourg. As corporate, finance, investment funds and tax attorneys, we service clients in all matters related to business law and both direct and indirect taxation. We are able to handle the most complex cross-border legal, regulatory and tax structuring matters, along with any commercial or business litigation. Our senior professionals have significant experience in advising private equity houses, multinationals, family offices and high-net worth individuals during their entire business and private estate life cycle from initial acquisition structuring and financing through restructuring and refinancing to exit, disposals and estate transmission.

We advise the leading financial institutions acting as lenders, on a wide range of fund finance, real estate finance, leverage finance and structure finance transactions.

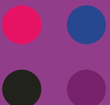
Our legal teams have longstanding expertise in helping clients to structure private equity and venture capital transactions within regulated and non-regulated investment vehicles. This support includes negotiating the acquisition and financing, and subsequently drafting the relevant documents. We also assist with the drafting and tax structuring of management incentive arrangements and their implementation. Our clients appreciate us for our clarity, practical solutions, timeliness and efficiency.

The members of our firm have completed high-level academic training in the Luxembourg, French and Anglo-Saxon legal systems and are able to work in a trilingual environment. Our business lawyers work closely with fellow professionals in key foreign jurisdictions, enabling us to coordinate investment and structuring/restructuring projects in Luxembourg and abroad. We see ourselves as business partners and not solely as lawyers.

We are committed to providing our clients with:

• A full understanding of their business and culture
• A thorough focus on their objectives, both short-term and long-term
• An unwavering commitment to helping them solve their problems in the most efficient and cost-effective way. If something does not make commercial sense to our clients, it does not make sense to us.

Highly committed to the fund finance industry, Praxio's fund finance team, led by our Head of Banking & Finance, Michael Mbayi, is involved on a wide range of transactions including subscription facilities, NAV facilities, hybrid facilities, and GP and management fee facilities.



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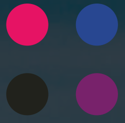

LUXEMBOURG

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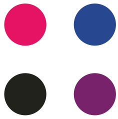

LUXEMBOURG

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Subscription Facilities

Description of the security package

One of the key elements that differentiates fund finance products is the credit underwriting process. On a subscription facility transaction, the lenders underwrite the credit of the investors of the fund. As a consequence, in the event of default, the lenders want to have the possibility to step into the shoes of the fund or its general partner and claim payment to the investors for their undrawn commitments.

This objective, from a Luxembourg perspective, is commonly covered by a **pledge over the claims** of the fund against its investors (*gage sur créances*). Furthermore, article 5 (4) of the Luxembourg law of 5 August 2005 on financial collateral arrangements ("**Luxembourg Collateral Law**"), states that "*the pledge of a claim implies the right for the pledgee to exercise the rights of the collateral provider linked to the pledged claim*". On such a basis, where a claim of the fund against an investor is pledged, it may be considered that it encompasses the right to claim payment to the investor as well (i.e. in practice the right to send a drawdown notice to an investor to claim such a payment).

The security package would be incomplete without a **pledge over the bank accounts** where the commitments of the investors are to be paid. Hence a Luxembourg pledge over the relevant Luxembourg bank account of the fund is as well required.

The standard Luxembourg security package includes then a pledge over undrawn commitments (technically a pledge over claims) and a pledge over bank accounts. However, in light of the fund documents or the fund structure, adaptations to the security package may be necessary (for instance "cascading pledges", additional guarantees, etc.).

To close this section, we may mention that Luxembourg collateral law is the most advanced implementation of the EU Financial Collateral Directive [1] and offers generally "bankruptcy remote" security interests for the pledges under its scope.

Perfection Formalities

Pledge over claims: Article 5 (4) of Luxembourg Collateral Law states that "the transfer of possession is effected as against the debtor and the third parties by the mere conclusion of the pledge contract".
Although, the debtor may be validly discharged if such a debtor pays the initial creditor as long as such debtor is not aware of the pledge.

Hence, from a strict Luxembourg law perspective, the perfection (*dépossession*), is effected by the mere execution of the pledge. However, a notification, should be considered so that the investors are aware of the pledge as from the outset.

This being said, an important caveat, is that fund finance transactions are generally global and involve investors located in a wide variety of jurisdictions. Consequently, Luxembourg specific conflict law rules concerning the enforceability of pledges over claims vis-à-vis third parties must also be taken into consideration. In this respect, there is a traditional view and a modern view.

According to traditional Luxembourg conflict law rules, the perfection formalities of the domicile of the debtor (i.e. the investor in the context of a subscription facility) are considered.

[1] *Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements.*

According to the modern view, supported by a decision of the Luxembourg Court of Appeal of 18 February 2009, the perfection formalities of the law governing the claim (i.e. Luxembourg law, in the context of Luxembourg law investor commitments) are to be considered.

A route to address this is to require a notification of the pledge to the investors, since the notification is an appropriate perfection formality in many jurisdictions. The local Luxembourg counsel should be involved at the outset of the transaction to consider these questions and structure the security appropriately.

Pledge over bank accounts: the account bank takes generally a pledge over the accounts by virtue of the general terms and conditions concerning those accounts. Hence, the fund or its general partner send a notice to the account bank and the account bank send back an acknowledgment of the pledge whereby the account bank will release its pledge so that the lenders may have a pledge on those accounts.

Fund finance provisions vs investor letters

One of the key assumptions of a subscription facility is that the investors will pay their commitments to the lenders without exercising any right of set-off, counterclaims or other type of legal defences, in the event of default under the facility agreement. Lenders also want that the investors commit to fund their commitments on the collateral account.

Nowadays, the typical way to cover these two elements is to have specific fund finance provisions, expressed for the benefit of the lenders, in the limited partnership agreement or in the subscription agreements or other contractual documents between the fund and the investors (depending on the type of fund, corporate form or fund structure). This is implemented technically using two concepts, one provided by Luxembourg collateral law in its article 2 (5) which provides *that:* "*the debtor of a claim provided as financial collateral may waive, in writing or in a legally equivalent manner, his rights of set-off as well as any other exceptions vis-à-vis the creditor of the claim provided as collateral and vis-à-vis persons to whom the creditor assigned, pledged or otherwise mobilised the claim as collateral*"*.* The second concept is provided by the Luxembourg civil code and is the third party stipulation (*stipulation pour autrui*).

Where there is no waiver of defence, set off, counterclaims or others specific fund finance provisions in the contractual fund documents, a solution to address this, is to request investor letters issued to the lenders, where such waivers are provided. The legal due diligence will be an important step to determine whether this is requested. In addition, on separately managed accounts transactions or where there is an important concentration in terms of investors (for instance, for funds of one), investors letters are typically requested.

NAV Facilities

Description of the security package

On a NAV facility transaction, the lenders perform the credit underwriting process considering the assets of the fund. This is a totally different exercise than for the subscription facilities since the focus is looking down in the structure towards the assets. This exercise may differ as well in light of the asset class concerned.

Therefore, understanding the fund structure, the underlying assets as well as undertaking a comprehensive legal due diligence are steps of paramount importance to determine the security package.

Luxembourg counsel is typically involved in NAV transactions where the borrower is a Luxembourg entity. Luxembourg counsel is as well involved when the borrower is not a Luxembourg entity but that the assets which are subject to the security are located or deemed to be located in Luxembourg.

For private equity funds, the holding company and the portfolio companies, down in the structure as well as the bank accounts where the proceeds of the investments are paid may be pledged. In practice, this means that Luxembourg **pledges over shares** are taken in respect of Luxembourg companies and Luxembourg **bank account pledges** for the accounts located in Luxembourg.

For debt funds, **pledge over receivables/claims** and **pledge over bank accounts** may be taken. Where there is a holding company in the structure possessing the assets, **a pledge over shares** may be taken as well.

For secondary funds, a pledge over the **limited partnership interests** owned by the secondary fund may be taken as well as a **pledge over the accounts** where the proceeds deriving from the investments are to be paid.

All the above is stated under the caveat that the security package may change in light of the relevant fund structure or the relevant assets, since NAV transactions tend to be bespoke.

- **Perfection Formalities**

Pledge over shares: In practice, a copy of the shareholders' register of the relevant company whose shares are pledged, is requested, with a mention of the pledge.

Pledge over limited partnership interests: a copy of the register of the limited partners, with a mention of the pledge, is requested.

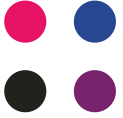
A particular attention must be made where reviewing the relevant constitutional documents, to check whether there are particular transfer restrictions such as, typically, a consent from the general partner.

Where the relevant limited partnership is a fund, and depending of the type of fund, there may be as well legal transfer restrictions (in other words, investing into a particular fund may be limited by law to certain type of investors only).

Pledge over claims: we refer to the considerations developed under the section "Perfection formalities" of the section "Subscription Facilities", which applies *mutatis mutandis*, with the reference here to a debtor instead of an investor.

Pledge over bank accounts: we refer to the developments made under the section "Perfection formalities" of the section "Subscription Facilities".

The present does not constitute a legal advice and is provided for information purpose only. No one should act upon such information without appropriate advice after a detailed analysis of the particular transaction.



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UNITED STATES

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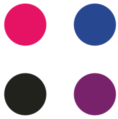


UNITED STATES

Contributed by **Monika Sanford and Camille Gibeault - Haynes Boone LLP**

Subscription Facilities

Security Package

A typical US subscription facility incorporates a pledge by a fund (e.g., a borrower, guarantor, blocker, and/or feeder), along with a pledge by the general partner of such fund. This pledge broadly covers all rights, titles, interests, powers, and privileges associated with:

(i) making capital calls on the fund's investors, the proceeds of capital calls and the enforcement of capital capitals;

(ii) the capital commitments and the capital contributions; and

(iii) the bank account(s) where investors are required to deposit capital contributions.

The documentation securing this collateral may consist of a security agreement and collateral account pledge, or an agreement combining both.

Perfection Formalities

Perfection of the collateral described above is governed by Article 9 of the Uniform Commercial Code (or, in the case of a collateral account characterized as a securities account, Articles 8 and 9 of the Uniform Commercial Code) adopted in the state governing the relevant collateral documentation. While most US subscription facility documentation falls under the law of the State of New York, all 50 states and the District of Columbia have adopted analogous versions of Articles 8 and 9 of the Uniform Commercial Code in all respects relevant to perfecting this collateral.

UCC Financing Statement

The collateral outlined in (i) and (ii) above is categorized as a general intangible or payment intangible under the Uniform Commercial Code. A lender's security interest in this collateral can be perfected by filing a UCC financing statement in the appropriate jurisdiction, determined by the debtor's location according to Article 9 of the Uniform Commercial Code. For funds organized under the laws of a certain state, the proper jurisdiction is their state of organization. For foreign funds, it is the jurisdiction of their place of business or, if multiple places exist, their chief executive office. If a foreign fund lacks a place of business or chief executive office in the United States, the proper jurisdiction is the District of Columbia.

The form of UCC financing statements adopted by each state varies. The International Association of Commercial Administrators drafts forms that states may adopt. Recently, various states, including Delaware and the District of Columbia, adopted IACA forms with a revision date of July 1, 2023. Some states only allow e-filing, while New York continues to use an older IACA form revised on May 22, 2002. It is essential to use the correct form as a filing jurisdiction may reject a UCC financing statement filing if administrative requirements are not met.

UCC financing statements lapse five years after their original filing date. Therefore, a UCC continuation statement must be filed prior to lapsing, and no more than six months in advance. UCC financing statements may also be amended, assigned and terminated by filing the appropriate form with the filing jurisdiction.

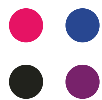
Control Agreements

The collateral outlined in (iii) above may be considered a deposit account or both a securities account (with respect to property other than cash) and a deposit account (with respect to cash). A lender's security interest in a securities account can be perfected by filing a UCC financing statement in the appropriate jurisdiction. Concerning cash in the collateral account and deposited capital contributions, perfection requires control. Control can be attained if the lender is the bank holding the control account or through an account control agreement executed by the lender, the fund, and the account bank. Although not obligatory, some lenders prefer and require an account control agreement even when the collateral account is held with the lender.

To adhere to the Uniform Commercial Code, an account control agreement must stipulate the account bank's compliance with instructions originating from the lender regarding the disposition of funds in the account without further consent from the fund. Consequently, account control agreements typically provide for the lender gaining exclusive control of the collateral account following notice of certain events, such as a default under the subscription facility.

Cascading Security

In certain cases, the fund to which investors commit capital may be unable to directly pledge security to the lender due to ERISA, tax, or other US legal considerations. In such instances, the security package may be structured as a "cascade", where the fund indirectly pledges collateral to the lender through other funds in its structure.



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