CADWALADER

FUND FINANCE FRIDAY

Fund Financing in Australia

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Australia and the United States have much in common. We have a shared history, a common language, and a similar common law-based legal system governing a federated nation occupying a large land mass blessed with abundant natural and human resources. The United States is one of Australia's greatest trading partners, and we welcome inward investment from the U.S. with most favoured nation trade terms. We also enjoy a friendship and strategic alliance that goes back over a century.

Even our commercial laws are similar. For example, in 2009 we rewrote our personal property security laws to bring them closer to your UCC Article 9. But looks can be deceiving. Similarities, particularly in our respective laws, are sometimes found to be misleading on closer inspection. Let us offer the following examples relevant in the fund financing space.

Our corporate insolvency laws, like the United Kingdom's, are notoriously more creditor-friendly than those in the U.S., which, by comparison, are more debtor-friendly. We have a process for companies in distress that looks, on its surface, a little like your USC Chapter 11. An insolvent or near-insolvent company and its directors may seek shelter from enforcing creditors by putting the company into "voluntary administration." At that point, an enforcement moratorium descends to give the company and its administrators some breathing space to make decisions about the company and, hopefully, to restructure and salvage it. However, it contains an important exception. Creditors who have security over *all or substantially all* of the assets may still enforce despite the moratorium, so long as they commence enforcement within 13 business days. This exception is based on the policy position that a creditor with that security has the greatest economic interest in the company and should be allowed to enforce its rights. Naturally, this creates a strong incentive for creditors to seek that security where they can.

However, all-assets security is not always available or feasible. Sometimes all that is on offer is security over specific assets, whether it be “hard” assets like real estate or equipment or intangible assets like rights to capital calls. That obviously puts the creditor at risk in a voluntary administration; while the moratorium does not extinguish their rights, they may not be able to enforce them for many months while the administration plays out. To address that risk, the market here has developed a technique called a “featherweight” security (although, in fact, its origins can be traced back to London in the early 1990s). That gives the creditor with only partial “real” security a security interest over all of the other assets of the company. But that interest is so “light” that it self-subordinates to any existing security over those assets, and allows the company to deal freely with the assets, including by giving later security that will rank ahead of the featherweight security. This is acceptable because it is not intended to operate as valuable security in the conventional sense. It serves a single purpose – to give the creditor security over all of the company’s assets so as to engage the exception to the moratorium and allow it to enforce against the *real* security if the company goes into voluntary administration.

Another significant difference is the way we use trusts here in ways that are not often seen elsewhere. Among other things, they are the vehicle of choice for investment firms and appear often in fund and subscription financing. In part, that is because we do not have the benefit of some of the tax-advantaged entity forms (for example, LLPs) that are available in the U.S. and other jurisdictions like the Cayman Islands. The trust’s inherent flexibility and tax advantages (particularly tax transparency and flow-through status) make it a convenient alternative to the only other option, the registered corporation. However, the trade-off is a range of issues that are unique to the trust, arising from the fact that it does not have separate legal personality and is not regulated by a single statutory regime. Some of those issues can be dealt with contractually by including additional representations, covenants and events of default in the credit agreement, but risks remain. However, that is for another time and another discussion.