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Article

Net Asset Value Credit Facilities

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As real estate, buyout, infrastructure, debt, secondary, energy and other closed-end funds mature beyond their investment or commitment periods (the "Investment Period"), they have often called and deployed the majority of their uncalled capital commitments on the acquisition of their investment portfolio (each, an "Investment").

As a result, they often have greatly diminished borrowing availability under the borrowing base ("Borrowing Base") of a traditional subscription credit facility (a "Subscription Facility", often referred to as an "Aftercare Facility" when provided post-Investment Period). However, these post-Investment Period Funds still have significant ongoing liquidity needs, including funding follow-on Investments, letters of credit, ongoing fund expenses and the costs of maintenance and liquidation of their Investments. To address these needs, certain banks (each, a "Lender") have been working to structure financing solutions for Funds, recognizing that a fully invested Fund has inherent equity value in its Investment portfolio. Of course, lending against a Fund's equity value is a far different credit underwrite than a traditional Subscription Facility, so Lenders have historically been cautious in their approach. One solution we have seen has been to leave the Subscription Facility largely intact, but extend the Borrowing Base significantly to add borrowing availability. Under this approach, the Lender may set the advance rate for included investors ("Included Investors") to 100% with no concentration limits or even set the Borrowing Base itself equal to 100% of the Unfunded Commitments of all investors ("Investors") (i.e., not just Included Investors), but couple the increase with a covenant that the Fund must at all times maintain a certain minimum net asset value ("NAV"). The NAV covenant is typically steep from the Fund's perspective, and is designed to near fully mitigate the additional risk incurred by the Lender in connection with the more generous Borrowing Base. This Aftercare Facility approach is merely a way to extend the life of an existing Subscription Facility and, of course, provides no borrowing availability if the Fund has exhausted its remaining Unfunded Commitments. Similarly, some Funds' organizational documentation prohibits the entry of a Subscription Facility (or perhaps does not authorize the Fund to call capital to repay debt incurred after the end of the Investment Period). These limitations therefore require Lenders to take a different approach, and one type of facility that certain Lenders are considering in these contexts is primarily based on the NAV of the Fund's Investment portfolio (hereinafter, an "NAV Credit Facility"). In this Legal Update, we set out the basic structure and likely issues that may present in an NAV Credit Facility.

Basic Structure

NAV Credit Facilities may take different forms based upon the structure of the Fund and its investments ("Investments") and the terms and structure of such facilities are typically underwritten on a case-by-case basis. However, such facilities share key structuring concerns as further described below.

BORROWING BASE

While NAV Credit Facilities may or may not explicitly articulate a Borrowing Base, they certainly have its components. Availability under an NAV Credit Facility is traditionally limited to an amount equal to the "Eligible NAV" of the "Eligible Investments," multiplied by an advance rate. The "Eligible NAV" typically equals the NAV of the Eligible Investments, less any concentration limit excesses deemed appropriate by the Lender under the circumstances. Typically the advance rates for these facilities are low in comparison to other asset-based facilities, reflective of both the lack of immediate liquidity of the Investments and the Lender's view of the Investments' likely cash flow and related value. "Eligible Investments" will typically be a subset of Investments that are not subject to certain specific adverse credit events as described below.

INVESTMENT PORTFOLIO

Many Funds that enter NAV Credit Facilities have a mature portfolio of Investments, so the Lender may assess at the outset which Investments should be included as "Eligible Investments" for the NAV Credit Facility. To the extent additional Investments may be added from time to time, Lender consent is generally required and criteria for inclusion may need to be met. Generally speaking however, "Eligible Investments" will typically be defined as those Investments that are not subject to any liens (although depending on the facility, leverage at the operating company level may be permitted and considered in the Lender's calculation of NAV) and that are not subject to certain specific adverse credit events. Assessing what credit events are relevant will turn on the particular asset class of the Investment. For example, standard eligibility criteria for Investments of a buyout fund will require that the underlying portfolio company not be in bankruptcy, not be in breach of any of its material contractual obligations, etc. Additionally, to the extent the Investment portfolio is made up of debt or equity issued by one or more third-party issuers, the status of the Investment itself as a performing or non-performing asset and the status of the issuer of such Investment may trigger the exclusion of the Investment from the Borrowing Base.

SECURITY PACKAGE

Some Lenders in certain high-quality asset classes will consider NAV Credit Facilities on an unsecured basis. But while most Lenders recognize that complete security over all the Investments is commercially challenging, there is a strong preference among Lenders towards a secured facility. Thus, while NAV Credit Facilities are not typically secured by all the underlying Investments, they are often structured with a collateral package that does provide the Lender with a certain level of comfort compared to an unsecured exposure. The collateral for these Facilities varies on a case-by-case basis, often depending on the nature of the Investments the Fund holds. In many NAV Credit Facilities the collateral includes: (1) distributions and liquidation proceeds from the Fund's Investments, (2) equity interests of holding companies through which the Fund may hold such Investments or (3) in some cases, equity interests relating to the Investments themselves. The method of obtaining the security interest in cash distributions and liquidation proceeds is similar to traditional Subscription Facilities. The Fund covenants that all cash from its

Investments will be directed into (or immediately deposited into if received directly) an account that is pledged to the Lender and governed by an account control agreement. The Fund is prohibited from making withdrawals from the account unless the Borrowing Base is satisfied on a pro forma basis. Likewise, the steps needed to secure the pledge of equity are similar to equity pledges common in the leveraged loan market. Thus, in a workout scenario, the Lender could foreclose on the equity interest collateral, and either take ownership control of the interests in the holding companies or sell such equity interests and apply the foreclosure sale proceeds to its debt.

Key Issues

As with all asset-based credit facilities, NAV Credit Facilities have their share of issues and challenges. Two of the more common are: (1) the proper valuation/calculation of NAV for inclusion in the calculation of the Borrowing Base and (2) the legal challenges associated with an equity pledge, especially in the case where the pledge is the primary collateral support for the facility.

VALUATION

One of the primary challenges in an NAV Credit Facility is the Lender's comfort around the calculation of the NAV of the Investments, as Funds often invest in illiquid positions with no readily available mark. This risk may be somewhat mitigated by the Fund's historical performance track record, as well as the valuation procedures built into the Fund's organization documents (which procedures were likely blessed by the Fund's Investors at the outset of their initial investment). That said, Lenders typically require the ability to remark the Investments if they either disagree with the valuation provided by the Fund or if certain adverse credit events happen with respect to the Investments. Lenders may therefore require a third-party valuation process or even the ability to revalue the Investments themselves based on their own good faith judgment. Similarly, valuation timing is a related challenge because there is frequently a time lag between a valuation and a reporting date. Lenders often want certain covenants to report interim adverse credit events to mitigate inter-period risks.

PLEDGED EQUITY LIMITATIONS

When a pledge of holding company equity is included in the collateral package of an NAV Credit Facility, there are three primary legal challenges that Lenders may confront in an NAV Credit Facility: (1) perfection issues, (2) transfer restrictions and change of control provisions and (3) tax implications for the Fund.

Perfection Issues

The manner in which a Lender obtains a valid security interest in equity interests requires a legal analysis on how the equity interests should be categorized for perfection purposes. Equity interests in corporations are "securities" for purposes of Article 9 of the Uniform Commercial Code ("UCC") and, if such equity were represented by a certificate, the Lender would ordinarily perfect its security interest by taking possession of the certificate.[1] Portfolio companies formed as limited liability companies or partnerships raise different issues, in that the equity securities issued by such companies would ordinarily be characterized for UCC purposes as "general intangibles" (as to which the proper perfection method is the filing of a UCC financing statement); however, the UCC also permits such an entity to "opt into" Article 8 of the UCC, in which case the equity of such entity would be considered a security for UCC purposes instead of a general intangible.[2]

To the extent that obtaining a direct lien on the Investments is sought and all or part of the Investments of a portfolio company are held in street name in a securities account, the Lender may seek to obtain a securities account control agreement over the underlying account or a lien over the securities entitlement relating thereto in order to have the best means of perfection. In a case where custodial arrangements are used, the Lender will want to understand how such arrangements work.

Different perfection issues will arise if the equity to be pledged is issued by a non-US entity or is held in a non-US account. In such cases, laws of non-US jurisdictions may apply.

Transfer Restrictions and Change of Control Provisions

Lenders should be aware that the governing documents of the entity whose equity is being pledged, or even the credit agreements of the underlying portfolio companies or other Investments, may have transfer restrictions that prohibit some of the proposed collateral from being transferred or even pledged. Lenders should consider whether their counsel should review the governing documentation of the pledged equity (or the Investments) to identify such risks or if representations from the Fund will suffice. Similarly, in the case of buyout funds, because the value of the equity interest is derivative of the underlying business operations, Lenders may want to diligence material agreements (e.g. credit agreements, sale agreements, purchase agreements, etc.) of the pledged entity to identify any problematic "change of control" provisions. In the event these issues are present, a Lender could be deprived of the actual value of its pledged collateral when it sought to foreclose.[3]

Tax Implications

There can be significant tax implications for certain Funds that pledge their equity interests, including a "deemed dividend" issue in the case of certain controlled non-US entities[4] and, with respect to pledges of equity in certain non-US entities, such entities being treated as "Passive Foreign Investment Companies" ("PFICs") for US tax purposes.[5] Determining the applicability and impact of these tax concepts requires an in-depth look and understanding of both the Fund and the NAV Credit Facility. While these issues are beyond the scope of this Legal Update, there are certain structuring techniques that can be used to mitigate the impact to the Fund and the Lender.

Conclusion

As more Funds look to unlock the value of their underlying Investments to support credit facilities, we expect that Lenders will receive increased inquiries for NAV Credit Facilities. And while the underwriting process of NAV Credit Facilities is materially different from that of Subscription Facilities and requires different expertise, when structured properly, NAV Credit Facilities can offer an attractive risk-adjusted return for a Lender, while providing Funds needed liquidity and flexibility. We expect this financing market to expand in the future.

Endnotes

[1] See UCC §8-103(a). A security interest in securities may be perfected by filing or by control. UCC §§9-312(a), 9-314(a). A security interest in securities perfected by control has priority over a security interest perfected by a method other than control. UCC §9-328(1).

[2] See UCC §8-103(c).

[3] Note that in certain instances these types of restrictions on transfer, to the extent contained in the organization documents of the issuers of the pledged equity, may be invalidated by the UCC. See UCC §9-406 and §9-408. Certain states, including Delaware and Texas, have non-uniform UCC provisions that make §9-406 and §9-408 inapplicable to equity in limited liability companies and limited partnerships. In other states, where the UCC provisions apply, the better view would seem to be that an anti-assignment provision would be completely invalidated by the UCC to the extent it applied to the pledge of an economic interest (right to receive distributions and other payments) but only partially invalidated as to a pledge of governance rights (in which case the secured party could take the pledge without causing a default under the limited partnership or limited liability company agreement, but could not enforce the pledge against the issuer, such as by having the issuer recognize the secured party as a member or partner). These issues are beyond the scope of this Legal Update, but could be relevant under the circumstances.

[4] Subject to certain exceptions, a pledge of equity of a "controlled foreign corporation" (a "CFC") to secure an obligation of a US party related to such CFC may be considered a repatriation of the CFC's earnings to its shareholder and thereby taxed as a dividend. Generally, a CFC is a foreign entity (treated as a corporation for US tax purposes) the equity of which is characterized as more than 50% owned by "US shareholders." For purposes of this test, "US shareholders" are generally US persons treated as owning more than 10% of the voting equity in the foreign corporation.

[5] A PFIC is generally any foreign corporation if (i) 75% or more of the income for the taxable year is passive income or (ii) the average percentage of the assets held by such corporation during the taxable year that produce passive income is at least 50%. Pursuant to the US Internal Revenue Code, if a US taxpayer pledges PFIC stock as security for a loan, the US taxpayer will be treated as having disposed of such PFIC stock (a "Deemed Disposition"). Consequently, such a Deemed Disposition may result in a taxable event for the US taxpayer.