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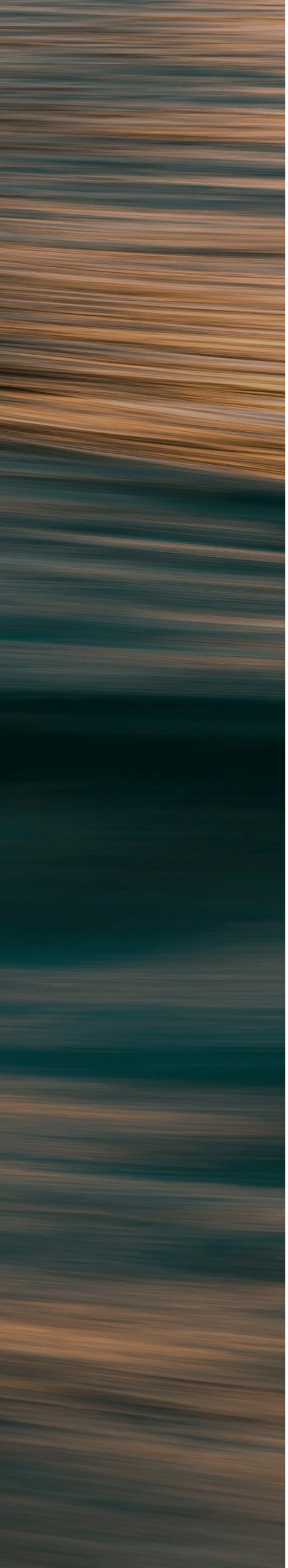
NAV CREDIT FACILITY PRIMER

A FUND FINANCE GUIDE



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NET ASSET VALUE CREDIT FACILITIES: AN OVERVIEW

JASON BAZAR, KIEL BOWEN, AND ANN RICHARDSON KNOX

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 essentially 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.

THE ADVANTAGES OF NET ASSET VALUE CREDIT FACILITIES

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The market for net asset value ("NAV") credit facilities continues to grow rapidly, with evolving features and mechanics. As the market matures, it brings new opportunities for both borrowers and lenders. Private investment funds and bank lenders are taking advantage of the various benefits that NAV credit facilities can offer. In this Legal Update, we explain the advantages of NAV credit facilities to lenders and borrower funds.

CHARACTERISTICS OF A NAV CREDIT FACILITY

A NAV credit facility is a term or revolving credit facility in which a lender provides financing to a fund, with the loan availability based on the net asset value of the fund's portfolio of investments. NAV credit facilities are often used by private equity funds after the fund has matured beyond its investment period, when it has typically exhausted most of its investor capital commitments. After the investment period, funds generally cannot access borrowing availability under a subscription-backed credit facility because they do not have sufficient remaining uncalled capital commitments. With a subscription-backed credit facility unavailable, the fund may turn to a NAV credit facility to provide the liquidity necessary to manage its portfolio and investment activities.

In NAV credit facilities, the borrowing base is typically determined by applying an advance rate against a subset of the fund's investment portfolio that are deemed to be eligible investments. To be an eligible investment, the investment must generally meet specific criteria for inclusion and not be subject to certain material investment events described in the facility. Such material investment events may include bankruptcy events, write off, or a significant decline in value. The value of eligible investments in the borrowing base may also be subject to concentration limits, such as sector limitations or thresholds for the ratio of individual investment size to the overall borrowing base.

NAV credit facilities also often include various loan-to-value ("LTV") triggers, which can result in different consequences such as mandatory prepayments, cash sweep mechanics with respect to distributions, events of default or pricing adjustments if the LTV falls below a specific threshold.

DIFFERENCES BETWEEN NAV CREDIT FACILITIES AND SUBSCRIPTION-BACKED CREDIT FACILITIES

Unlike a subscription-backed credit facility, for which uncalled capital commitments of investors in the fund serve as collateral, the investments of the fund are viewed as the primary source of repayment in a NAV credit facility. Collateral in a NAV credit facility often includes pledges of equity in holding vehicles, rights to distributions, and collateral accounts; it does not typically require pledges of capital call rights and capital commitments. While the tenors of the NAV credit facilities can be flexible to suit a borrower's needs, they are generally longer tenors than subscription-backed credit facilities and, subject to the needs of the fund, are more frequently structured as term loans rather than revolving loans.

The legal due diligence in connection with a subscription-backed credit facility will focus primarily on the investors and the fund's organizational documents relating to the underlying capital commitments of investors to the fund and the obligations thereunder of the investors to respond to a capital call by a lender. For a NAV credit facility, legal due diligence focuses on the fund's organizational documents and the ability of the fund to enter into the NAV credit facility and to pledge collateral. The legal due diligence will also focus on the ownership of the assets of the fund and the structure through which the fund holds portfolio investments. In many cases, the fund's organizational documents have been drafted to expressly provide for a subscription-backed credit facility but may not necessarily contain express provisions relating to a NAV credit facility. Assuming the organizational documents generally permit the incurrence of indebtedness and the pledge of collateral that is otherwise contemplated by the NAV credit facility, any limitations on the incurrence of indebtedness and the pledge of collateral will be the primary focus of the legal due diligence of the fund's organizational documents rather than the specific provisions typically required by a lender for a subscription-backed credit facility.

BENEFITS OF NAV CREDIT FACILITIES TO FUNDS

NAV credit facilities can provide several benefits to funds (including its sponsors and investors). Among them:

- Funds can unlock liquidity from typically illiquid assets and permit sponsors to optimize fund performance by increasing investment capacity to fund follow-on investments on the existing portfolio without the need to resort to traditional liquidity events, such as a public offering or other sale of a portfolio company.
- Funds can maintain liquidity and leverage options beyond the fund's investment period when capital commitments may no longer be available to support a subscription-backed credit facility.
- Funds can leverage their assets even when they have challenging investor bases, such as a concentrated investor pool or investors that may not typically get favorable advance rates under a subscription-backed credit facility.
- The leverage provided by a NAV credit facility may allow the fund to utilize loan proceeds for dividend recapitalizations, which often isn't permitted under a subscription-backed credit facility. A dividend recapitalization can also provide investors with an alternative to a secondary sale of their interests in the fund by receiving liquidity before the fund completes

the sale of assets and allowing the investor to continue to participate in any potential increase in the fund's value.

- Due to the enhanced margins of NAV credit facilities, private credit funds are attracted to the product. Insurance companies are also more willing to be a lender in a NAV credit facility as they are more often structured as term loans with longer tenors than subscription-backed credit facilities. As a result, the pool of leverage providers has expanded beyond traditional bank lenders that typically offer subscription-backed credit facilities.
- Sponsors can use a NAV credit facility in connection with its general partner stakes to efficiently manage its balance sheet or launch a new investment strategy by leveraging its management fees, carried interest or other income streams from the portfolio without the need for a liquidity event of its minority stake in the portfolio.

BENEFITS OF NAV CREDIT FACILITIES TO LENDERS

Lenders can also benefit from entering into NAV credit facilities. Among the benefits to lenders:

- NAV credit facilities enable lenders to provide leverage to funds at all times, and of particular relevance to private equity funds, after the investment period with longer tenors, which may facilitate the expansion of the market of NAV lenders as they identify new clients for this product.
- NAV credit facilities provide a natural transition from a subscription-backed credit facility and allow lenders to maintain longer relationships with fund sponsors.
- The enhanced margins of NAV credit facilities, compared to subscription-backed credit facilities, may help facilitate the efficient use of capital for traditional lenders and provide an attractive investment opportunity to private credit funds.
- The pool of eligible borrowers may expand to include funds that have not participated in the subscription-backed credit facility market due to a challenging investor base or the hesitation of investors to authorize the fund to utilize subscription-backed credit facilities.
- Although NAV credit facilities can be complex, lenders can often be more creative in structuring the facility because the focus is not strictly on uncalled capital commitments.

CONCLUSION

NAV credit facilities and subscription-backed credit facilities are both useful tools in the fund finance market. NAV credit facilities may be a beneficial option for providing a fund with necessary liquidity and/or leverage in instances where a subscription-backed credit facility may not be an option for a fund. Sponsors can also obtain the liquidity necessary to effectively manage the fund and maximize its performance. Fund investors can also receive a return on capital without resorting to a sale and foregoing any potential additional upside from holding the investments longer. Lenders can also benefit from the attractive structuring and pricing options that NAV credit facilities present.

NAV CREDIT FACILITIES: THE SPECTRUM OF COLLATERAL STRUCTURES

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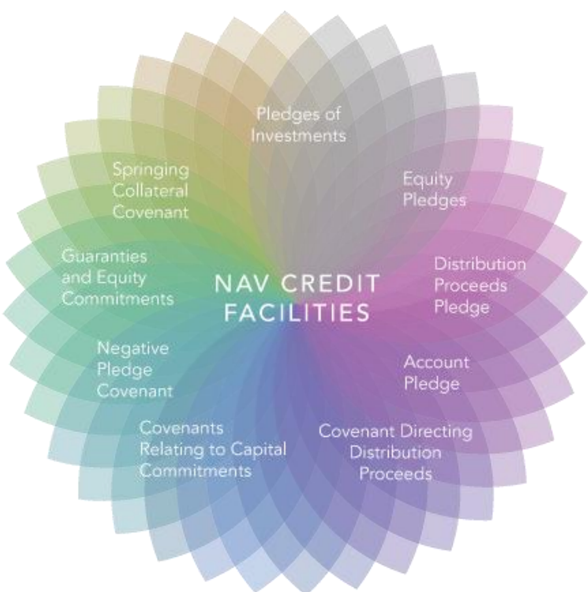
THE SPECTRUM OF COLLATERAL



EXECUTIVE SUMMARY

Net Asset Value ("*NAV*") credit facilities[1] are a tool that borrowers may use to access financing based on the value of their underlying investment portfolio. The users of these facilities are generally private equity funds, family offices, and large investors with diversified private equity holdings. Because of the structures that accompany these types of entities and constraints related to the investment portfolio, there is no one-size-fits-all approach when it comes to NAV credit facilities. Therefore, market participants should understand both the spectrum of collateral and the covenants at their disposal to effectively structure each facility to meet the borrower's needs. In this Legal Update, we explain the most common types of collateral structures used in secured NAV credit facilities and explore why some approaches are more frequently used than others based on the borrowers' structures and asset classes. While most NAV facilities that are secured include account pledges with related covenants, additional collateral structures include: (i) pledges of investments, (ii) equity pledges, whether of each entity in a structure or of a holding vehicle or aggregator entity, (iii) pledges of distribution proceeds and (iv) pledges of cash or securities accounts. Each structure is suited to different circumstances, depending on factors such as portfolio composition, transfer restrictions, and lender risk appetite.

BACKGROUND

NAV credit facilities come in a variety of shapes and sizes—with many differences driven by the asset class of the investments, the asset pool's concentration or diversification, the advance rate, and any debt or transfer restrictions imposed upon the assets. NAV lenders must take into account the diversity of collateral and restrictive covenant structures, and collateral packages must require flexibility to account for the limitations often presented by the asset pool. The NAV credit facility market has grown substantially in recent years, driving innovation in collateral structures to accommodate diverse borrower needs and asset types.

I. SECURITY STRUCTURES

While NAV credit facilities may be provided on an unsecured basis—particularly in deals involving borrowers whose investment pool consists of high-quality and liquid asset classes—most lenders require facilities that are at a minimum secured by a pledge of the collateral account into which distributions from the investments are funded. Due to the commercial challenges in obtaining a more fulsome collateral package (*i.e.*, burdensome transfer restrictions, expensive diligence costs, etc.), lenders tend to require a combination of bespoke collateral pledges and restrictive covenants designed to mitigate default risks and preserve the lenders' seniority in terms of recovery on the investments or distributions from the investments.

Before diving into the most common combinations of security structures, and which circumstances might warrant their use, the below sets forth some of the primary forms of collateral and restrictive covenants commonly used in NAV credit facilities.

A. COMPONENTS OF A COLLATERAL POOL

i. **Pledge of Investments:** Loan parties pledge the investments held by the borrower or its subsidiaries.

ii. **Equity Pledges**

   a. **Equity Pledge:** Loan parties pledge the equity interests it owns directly or indirectly in each entity sitting between the borrowers and the underlying asset (including equity in any holding company and the ultimate portfolio company, as applicable). This may include a full pledge on these entities, if wholly owned, or a partial pledge reflecting the actual look-through ownership that the borrower has in such entities.

   b. **Holding Vehicle or Aggregator Equity Pledge:** Loan parties pledge the equity interests in either (a) a subsidiary entity acting as an aggregator that, directly or indirectly, holds ownership of all, or the desired portion, of the underlying assets or (b) in multiple subsidiary entities that each own a direct equity interest in an underlying asset.[2]

iii. **Distribution Proceeds Pledge:** Loan parties grant a security interest in the right to income, distributions, and other cash flows from underlying portfolio investments, which may include negotiated disposition proceeds from the sale of investments or equity held (such cash flows, "Distribution Proceeds").

iv. **Account Pledge:** Loan parties (which may include holding vehicles or aggregators if wholly owned) pledge their accounts—this can either take the form of a pledge of (a) all accounts, (b) a specific securities account, or (c) only the collateral accounts used to collect Distribution Proceeds. Additionally, if the account is a securities account, and the assets are held in such account, one may obtain a lien on the securities entitlement, which may provide the ability to obtain an indirect pledge on the assets.

B. FORMS OF RESTRICTIVE COVENANTS

i. **Covenant Directing Distribution Proceeds:** Lenders often rely on a covenant in the loan documents requiring borrowers to deposit any Distribution Proceeds into a pledged deposit account.

ii. **Covenants Relating to Capital Commitments:**

a. **Covenant to Reserve Uncalled Capital Commitments:** Lenders may require a covenant in the loan documents requiring the loan parties to maintain sufficient uncalled capital commitments from their investors to repay any outstanding debt and any downstream capital commitments to pay for obligations required by the terms of its investments.

b. **Covenant to Call Capital:** Lenders may require a covenant in the loan documents requiring the loan parties to call capital during an event of default to repay any outstanding debt provided that such covenant does not interfere with any subscription credit facility that may exist.

iii. **Negative Pledge Covenant:** Lenders may rely on covenants in the loan documents prohibiting the borrowers from pledging their assets to a third party. Additionally, a so-called "double negative pledge" may be included to provide additional comfort. [3]

iv. **Springing Collateral Covenant:** Lenders may rely on a covenant in the loan documents requiring loan parties to pledge additional collateral if their loan-to-value ("LTV") ratio falls below a certain predetermined threshold.

C. GUARANTIES AND EQUITY COMMITMENTS

Lenders may require that a financially viable parent entity of a loan party either (i) guaranties such loan party's obligations or (ii) agrees to contribute capital or provide other financial support in favor of a loan party.

II. UNDERSTANDING EACH FORM OF COLLATERAL AND RESTRICIVE COVENANTS

Each category of collateral, restrictive covenant, or other form of credit support listed above has its own benefits and considerations, and understanding these nuances allows market participants to effectively structure NAV credit facilities to meet the specific circumstances at hand. The specific combination of collateral and restrictive covenants that a lender requires is driven largely by the borrower's unique characteristics, the borrower's anticipated creditworthiness, and the asset pool's nature and limitations. While a particular collateral and restrictive covenant structure might work in one transaction, it may be inappropriate or cost prohibitive in another.

A. PLEDGE OF INVESTMENTS

While a direct lien on the investments held by the borrower or its subsidiaries may be the ideal form of collateral, it is not always feasible, either due to the type of investments held by the borrower or because the investments are not wholly owned by the borrower or its subsidiaries.

Generally, certain types of investments lend themselves to pledges more easily, such as loans or other debt investments, and we often see liens provided on the loan portfolios of credit funds. Other types of investments, such as private equity and hedge fund interests, real estate assets, or infrastructure assets, may be more difficult to pledge directly due to (a) investment-level debt already enlisting such investments as collateral or containing negative covenants preventing such pledges or (b) the documents governing such investments preventing such pledges without the consent of the issuer of such investment.

Another factor limiting a borrower's ability to pledge its investments may be that it does not wholly own its investments, but only owns a partial interest in a holding vehicle or joint vehicle that may or may not be sponsored by the borrower, and therefore requires consents from co-owners or issuers that would be reluctant to provide such consents for tax, regulatory, or commercial reasons, including concerns about the creditworthiness of the holder of such investments (particularly where the investments require ongoing obligations to pay in funds from an investor).

A pledge of investments is therefore most often possible where (a) there is no indebtedness at the level of the investment which prevents such pledge, either because the investment is pledged to support such investment or the covenants relating to such investment do not prevent such pledge and (b) the borrower is affiliated with the sponsor of the investments and thus able to provide the consents necessary to enable a pledge of such investments.

B. PLEDGE OF EQUITY

Other than a direct pledge of investments themselves, equity pledges are the most robust form of collateral in NAV credit facilities, offering lenders the most control in default scenarios.[4] Pledges of equity can give lenders flexibility in a foreclosure scenario post-event of default. By having the ability to foreclose on the equity of an asset, lenders can foreclose on or vote the equity themselves, thereby directing the activities of the pledged entity or potentially transferring the asset to a third-party.[5]

i. **Equity Pledge.** In some cases, particularly if a significant portion of the portfolio is concentrated in a single investment, lenders may require a pledge of all equity in each entity sitting between the borrower and the underlying asset (including any holding companies and the ultimate portfolio companies, as applicable).

Pledges of equity in each entity in the structure grant lenders significant flexibility in liquidation post-event of default. Lenders may choose to sell the overall portfolio or break off and sell individual assets or parts of the structure to ensure sufficient returns to repay any outstanding debt.

A direct pledge of equity in the portfolio investment may also be beneficial because it offers a claim on the equity of the borrower and is closer to the level of the investments, reducing the risk associated with potential dilution or "leakage" of assets or funds from the structure.

ii. **Holding Vehicle or Aggregator Equity Pledge.** Alternatively, lenders may require a pledge of the holding vehicle's or aggregator's equity, particularly if the pledging fund possesses a highly diversified portfolio, borrowers may pledge their equity interests in either (a) a subsidiary aggregator entity that directly or indirectly holds all, or the desired portion, of the underlying assets on behalf of such borrower or (b) multiple subsidiary entities that each own a direct equity interest in an underlying asset.[6] If the borrower is a subsidiary holding vehicle of a larger fund, a pledge of all equity in the borrower is typically required.

A pledge of such aggregator vehicles or holding vehicles provides lenders with a liquid and versatile form of collateral that can be sold off wholesale to a third party if needed. Additionally, holding equity in an aggregator entity gives lenders potential indirect control over the underlying assets, offering greater flexibility in managing and leveraging their collateral position, thereby enhancing their risk mitigation strategy.

In either case, lenders would be lending against the net asset value of the underlying assets held through the pledged entities and, in the event of a borrower default, lenders would rely on the sale of the pledged equity of the pledged entities to recover on their loan.

A key limitation of equity pledges is that any defaults with respect to indebtedness at the level of the investment or any holding vehicles will prime the ability to obtain value relating to the equity pledged in favor of a NAV lender and the availability of distributions. Other key limitations of equity pledges, and the steps lenders can take to mitigate their effects include:

KEY CONSIDERATIONS	POTENTIAL MITIGANTS
Indebtedness at the level of the investment have pledged such equity to support such indebtedness or prevent such a pledge.	None, unless appropriate consents are received and, even if provided, may be a second lien.
The governing documents of the underlying portfolio companies may include direct or indirect transfer restrictions.[7]	Ensuring that the appropriate consents are received to facilitate such transfer or pledge. Haircutting the advance rate for the asset, requiring a concentration limit for all such assets or removing the asset borrowing base completely. Carving out of the pledge any asset that has a transfer restriction and relying on other collateral/covenants for those assets.
The governing documents of the pledged subsidiary holding vehicle can sometimes include pledge or transfer restrictions.	Amending such governing documents to permit a sale process and allow a third party to come in as the sole limited partner/sole member post-event of default.
Portfolio investments can sometimes be structured as loans, rather than equity, which may be harder to sell in a foreclosure.	Adjusting the concentration limit or haircut on, or the value assigned to, any debt portfolio investments.
The borrower may own less than 100% of a holding vehicle or may not own a majority of a holding vehicle.	If a majority of a holding vehicle is owned by the borrower (or controlled by the sponsor of the borrower) one may be able to have the general partner of the holding vehicle agree to liquidate assets of such holding vehicle on a *pro rata* basis and distribute proceeds to a borrower as liquidating distributions.

C. PLEDGE OF DISTRIBUTION PROCEEDS

In certain instances, lenders are comfortable foregoing equity pledges if they obtain a pledge by the fund of its rights to receive Distribution Proceeds from underlying portfolio investments, coupled with a pledge of an account into which such Distribution Proceeds are contractually required to be deposited.

The key limitations of a pledge of Distribution Proceeds, and the steps lenders can take to mitigate their effects, include:

KEY CONSIDERATIONS	POTENTIAL MITIGANTS
The uncertainty of these cash flows (either because of the adverse effect of market conditions or investment performance, or because the borrower chooses to sit on the asset to avoid having to pay out).	Requiring more regular financial reporting, more comprehensive and higher percentage cash sweeps, and stricter financial covenants tied to performance metrics and loan-to-value ratios. Lenders may also require forced amortization of term loans such that a required amount of loans is to be repaid each year regardless of cash flows. Requirements to use good faith efforts to sell portfolio investments to generate cash flows if requested post-event of default. Implementing cash sweep mechanisms to capture Distribution Proceeds more frequently.
The governing documents of the underlying portfolio companies (or an intermediary entity sitting between the portfolio company and the pledgor) may include direct or indirect transfer restrictions.	Ensuring that the appropriate consents are received to facilitate such pledge. Haircutting the advance rate for the asset, requiring a concentration limit for all such assets, or removing the asset borrowing base completely. Carving out of the pledge any asset that has a transfer restriction and relying on other collateral/covenants for those assets.
In a scenario where there is an insolvency proceeding with respect to the borrower, future payment streams from underlying investments may be excluded from the collateral of the lenders by a court in an insolvency proceeding on the basis that such payments are not yet due and payable or are not yet earned at the time of the filing of the bankruptcy petition.	This legal risk is hard to mitigate, but other protections, including strong negative covenant packages, can limit the likelihood of competing claims. Restructuring counsel in each relevant jurisdiction can analyze potential issues that may arise from a pledge of such future payment streams under applicable bankruptcy laws.

D. ACCOUNTS AND COVENANT TO DEPOSIT DISTRIBUTION PROCEEDS

Certain transfer restrictions contained in either the documents relating to the investments and/or with respect to indebtedness at the level of holding vehicles or the investments themselves may prohibit the pledge of Distribution Proceeds. In such circumstances, the borrowers often simply pledge their rights to a collateral account and rely on a covenant requiring Distribution Proceeds to be deposited into such account. This structure is often employed when more direct forms of collateral are unavailable due to such limitations.

The key limitations of the collateral pool consisting of only an account pledge coupled with a covenant to deposit future Distribution Proceeds into such account, and the steps lenders can take to mitigate their effects, include:

KEY CONSIDERATIONS	POTENTIAL MITIGANTS
Limiting the collateral to accounts may also restrict a lender's ability to recover funds in the event of a default, especially if the pledgor has third-party creditors (*e.g.*, with liens on the equity of underlying portfolio investments that would be the source of any funds deposited into such an account).	Strong negative covenant provisions (including limitations on incurrence of debts and liens) should be considered to reduce the likelihood of competing creditors.
If a debtor breaches a covenant to direct Distribution Proceeds, lenders would need to sue for contractual damages, which can result in protracted legal proceedings, rather than enforcing a security interest. Furthermore, once cash has left the debtor's structure, recovery may be difficult.	Particularly in instances where a borrower possesses a concentrated asset pool, lenders can require borrowers to provide irrevocable notice to a portfolio investment directing such entity to deposit Distribution Proceeds into a pledged collateral account.
In a scenario where there is an insolvency proceeding with respect to the borrower, future payment streams may be viewed as property of the estate (available for creditors generally) and not required to be deposited into a pledged account.	This legal risk is hard to mitigate, but other protections include strong negative covenant packages that can limit the likelihood of competing claims. Restructuring counsel in each relevant jurisdiction can analyze potential issues that may arise from a pledge of such future payment streams under applicable bankruptcy laws.

E. COVENANTS RELATING TO CAPITAL COMMITMENTS

In some instances when the loan is made to a fund, lenders may underwrite the loan parties' uncalled capital commitments, if any, that is available at that time to ensure the creditworthiness of a borrower (even if the lender does not take security therein). In such a situation, the loan parties often covenant to (a) maintain sufficient uncalled capital commitments from their investors to repay any outstanding debt and any downstream capital commitments to investments and/or

(b) call capital from their investors during an event of default to repay the lender. While such covenants ensure that the loan parties will maintain an alternative pool of liquidity from which to repay the debt owed to the lender, there are some key limitations and steps lenders should consider taking when relying on such covenants:

KEY CONSIDERATIONS	POTENTIAL MITIGANTS
Investors could have excuse or refusal rights with respect to certain calls, which could reduce the amount of capital contributions the loan parties can use to repay the lender.	Conduct thorough due diligence on any excuse, withdrawal, or refusal rights of investors under the loan parties' governing documents, and increase the reserves required to be maintained to account for any excuse or refusal rights. Require the loan parties to maintain other cash liquidity reserves as a buffer to account for any shortfalls in funding of capital contributions.
In a scenario where there is an insolvency proceeding with respect to the borrower, future payment streams from underlying investments may be excluded from the collateral of the lenders by a court in an insolvency proceeding on the basis that such payments are not yet due and payable or are not yet earned at the time of the filing of the bankruptcy petition.	This legal risk is hard to mitigate, but other protections including strong negative covenant packages that can limit the likelihood of competing claims. Restructuring counsel in each relevant jurisdiction can analyze potential issues that may arise from a pledge of such future payment streams under applicable bankruptcy laws.

F. NEGATIVE PLEDGE COVENANTS AND SPRINGING COLLATERAL ARRANGEMENTS

Lenders can often include a strong negative pledge (*i.e.*, a covenant that prohibits the borrower from pledging its assets to another party) or double negative pledge (*i.e.*, a covenant that goes further than the standard negative pledge by also requiring the borrower to abstain from granting any other negative pledges to third parties) in the loan documentation. This approach helps safeguard the lender's interests by ensuring that the borrower should have sufficient unencumbered assets to repay the lender.

The primary potential drawback of relying solely on a negative pledge covenant in the absence of other collateral is that the lender has unsecured exposure and must ensure compliance with the negative pledge through strict and ongoing monitoring of the borrower's debt and assets. This may potentially impose additional administrative costs on the lender and the borrower. Furthermore, while a covenant can provide some protection to lenders, it does not provide the same level of protection as being secured by collateral, especially vis-à-vis third-party creditors. Lenders must carefully balance the benefits of relying on a negative pledge covenant with the potential constraints and operational implications of such an approach. Lenders should be aware that negative pledge covenants, while useful, do not provide the same level of protection as direct security interests.

A key mitigant to these concerns can be a covenant requiring borrowers to pledge collateral if their LTV ratio falls below a certain threshold. Lenders get comfortable with such arrangements because the borrowers' assets would be kept available through use of the negative pledge, and if the borrowers' financial performance drops, the collateral would spring into place to protect the lenders. This is especially preferable where taking security interest in the intended collateral is laborious or cost-intensive (*e.g.*, in cases where the intended collateral consists of real property).[8]

If employing such an approach, lenders should ensure that strict financial covenants and reporting are used to monitor fund performance. Covenants requiring specific staggered LTV ratios can also be used to require borrowers to seek consents from the sponsors of pledged assets or make repayments well in advance of a default.

G. GUARANTIES AND EQUITY COMMITMENT

Lenders can also look to a financially viable parent entity or investor of such borrower to financially backstop such borrower's obligations. This support typically comes in the form of either a guaranty or an equity commitment.[9]

A guaranty is an agreement by a financially viable parent entity to support the repayment of a borrower's outstanding obligations to a lender. Guaranties can come in many forms, including (a) payment guaranties, whereby a lender may seek payment directly from the fund without any obligation to first seek payment from the borrower; (b) collection guaranties, under which a lender must exhaust its remedies against the borrower prior to seeking payment from the fund; and (c) "bad-boy" guaranties, whereby payments from the fund will only be required if the lender's losses result from certain bad-acts or misrepresentations of the guaranteed borrower.

Often, however, a guaranty is not a viable solution as it counts as debt on the books and records of the fund. As an alterative, however, parent funds will often provide an equity commitment to a NAV borrower (either directly in the NAV borrower's constituent documents or via an equity commitment letter). Unlike a guaranty, which is made in favor of a lender and where the fund is a direct counterparty of a lender, relying on an equity commitment borrows the collateral structure of a traditional subscription facility (*i.e.*, the borrower pledges its rights to call, enforce and collect on the parent fund's equity commitment). Any approach using an equity commitment should focus on the same "key" provisions that are required for subscription credit facilities (*i.e.*, the obligation to fund without setoff, counterclaim or defense, having the lender being an express third-party beneficiary, etc.), and when structuring equity commitments, careful attention should be paid to ensure they are enforceable and provide meaningful recourse to the lender.

CONCLUSION

The diverse collateral and restrictive covenant options available in NAV credit facilities present both opportunities and challenges for lenders and borrowers. NAV lenders may be able to leverage different forms of collateral, such as equity interests, payment streams, and deposit accounts, to secure their loans while borrowers can access needed liquidity without disrupting their investment positions. A thorough understanding of the benefits and potential challenges associated with each form of collateral and restrictive covenant is essential for successfully structuring NAV credit facilities. Lenders must carefully assess the unique characteristics of each deal, the borrower's financial health, indebtedness that may exist that may pose restrictions, and the asset pool's nature and limitations to determine the most effective combination of collateral and covenants.

Ultimately, the key to a successful NAV credit facility lies in the flexibility and customization of its structure. By tailoring the collateral and covenant package to the specific circumstances at hand, lenders can mitigate risks and borrowers can achieve their financing goals. Both parties should engage in ongoing dialogue and due diligence to adapt to changing market conditions and ensure the long-term success of the facility. NAV credit facilities offer a powerful financing tool for sophisticated investors, provided that both lenders and borrowers are well-versed in the intricacies of collateral structures and restrictive covenants. By staying informed and agile, market participants can navigate the complexities of NAV credit facilities and capitalize on their potential benefits.

As the NAV credit facility market continues to evolve, we anticipate further innovations in collateral structures, potentially including increased use of hybrid structures that combine elements of traditional NAV and subscription line facilities.

ENDNOTES

[1] For information on NAV credit facilities generally, *see* "The Advantages of Net Asset Value Credit Facilities"

[2] Often, if the borrower is a subsidiary aggregator vehicle of a larger fund, lenders will seek an equity interest in the borrower itself, accompanied by a guaranty or other fund-level recourse, such as the right to call capital form the fund.

[3] For more information on double negative pledges, see "Double Negative Pledges in NAV Credit Facilities: What Fund Finance Lenders Need to Know"

[4] In light of certain jurisdictional differences, the granting language with respect to the security interest in the equity interests should be explicit that such interests include all related economic rights, voting, management and control rights, and the right to be admitted as a member or limited partner (as applicable).

[5] Bank lenders should be prepared to address any Volcker Rule-related concerns to the extent they determine to hold or control the equity themselves. Additionally, consents to transfer and foreclose may need to be obtained depending on the type of investment held by the borrower.

[6] If structured as a limited partnership, this would include a pledge of both the limited partnership and general partnership interests in such entity.

[7] Private equity funds almost always include restrictions on the rights of an investor to transfer their equity interests to third parties. Those restrictions typically take the form of a general prohibition on sales to third parties without the general partner or manager's prior written consent, but may also include restrictions on the ability of an investor to pledge their equity interests (or the economic rights arising from such equity interests).

[8] Note, however, that one potential downside to this approach is that, in the event of subsequent bankruptcy or insolvency proceedings, applicable lookback periods (such as the 90-day or one year lookback period for preferential transfers under the U.S. Bankruptcy Code) typically will run from the time of grant and perfection of the springing collateral rather than the date of the initial agreement.

[9] For more information on the differences between a guaranty and an equity commitment letter, *see* "Equity Commitment Letters: Understanding How They Differ From Guaranties"

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NAV FACILITIES: APPRAISAL AND VALUATION CHALLENGE RIGHTS

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EXECUTIVE SUMMARY

Net Asset Value ("NAV") credit facilities are lending arrangements underwritten on the borrower's portfolio of investments, where the amount available for borrowing is based on the value of such underlying portfolio investments. The borrowing base may be calculated based on the net value of the borrower—its total assets minus total liabilities—or it may comprise a selected subset of eligible assets. The determination of the borrowing base depends on the borrower's reported value of its investments, which may originate from the sponsor or borrower's reporting, a third-party appraiser, the third-party sponsor issuing the investment, or a purchase or market value (in the case of publicly available marks). Because the reported value may come from the borrower and not an impartial source, lenders may require a periodic third-party valuation or the right to challenge the borrower's valuation by obtaining a third-party appraisal of some or all relevant investments included in the borrowing base. This Legal Update explores the scope and mechanics of asset valuation challenges, focusing on what lenders and borrowers need to consider when framing and negotiating provisions for valuation challenges in credit facility documentation.

BACKGROUND

NAV facilities are credit facilities underwritten by reference to the borrower's investments, such as equity interests in portfolio or holding companies, securities, and other investment assets. For this reason, NAV facilities typically have financial covenants, mandatory prepayments, and events of default tied to the valuation of these assets.

Effective underwriting of NAV facilities requires that asset valuations of investments (and often the assets that underlie those investments) are both current and accurate. To this end, borrowers are required to provide audited annual financial statements along with quarterly financial statements and compliance certificates, which certify the net asset value, loan-to-value ratios, and borrowing base calculations. Additionally, NAV facilities may mandate additional monthly or quarterly reporting requirements that provide specific details on the assets comprising the borrowing base, ensuring lenders have comprehensive reporting of the current value of investments.

WHAT NAV FACILITY LENDERS AND BORROWERS NEED TO KNOW ABOUT VALUATION CHALLENGES

SCOPE AND MECHANICS OF VALUATION CHALLENGES

Lenders often negotiate valuation challenge rights in transactions where the underlying assets are not otherwise subject to an annual third-party valuation or validation per the fund's partnership agreement or if the investments are illiquid and lack a readily available market valuation.

When lenders negotiate the right to challenge the reported value of the borrower's assets, they may negotiate the ability to do so on a regular basis and/or upon the occurrence of certain triggering events. For example, if a lender believes the value of an asset pool or an individual asset is overstated based on a periodic valuation provided by the borrower, the lender may negotiate the right to initiate a valuation challenge. Similarly, certain triggering events (such as a bankruptcy of an investment's sponsor or a default on debt and/or foreclosure on liens at the underlying investment or asset) could occur between regular reporting periods, and if so, lenders could require a revaluation to ensure the reported values remain accurate and reflect current market conditions.

These rights are important for lenders whose underwriting standards require adjustment of asset valuations in response to material changes, especially for certain assets where reporting can lag behind the reporting date, due to certifications not being due until well after the close of a fiscal quarter. This lag can be significant for fiscal quarter evaluations and even longer for year-end evaluations, during which reported valuations might become outdated.

The terms negotiated in the NAV facility will determine the scope of the assets subject to the lenders' valuation challenge. Generally, lenders may either challenge the valuation of the entire asset pool or select specific assets within it.

FREQUENCY OF VALUATION CHALLENGES

The ability of a lender to request and the frequency with which it may request a valuation challenge varies by facility. Some agreements allow lenders to request a third-party revaluation at any time. However, most facilities with valuation challenges set specific limits on how often the borrower's reported valuations can be challenged to maintain stability and predictability. Such limits could be temporal, like once per year unless an event of default occurs, or could be based on a good faith belief by the lenders that the actual valuation of an asset (or the pool of assets) is off by more than a specified percentage.

Lenders may also negotiate additional rights to address circumstances that provide a reasonable basis for further scrutiny—such as significant market fluctuations or changes in the operational performance of an asset or asset classes. This approach permits asset valuations to be more responsive to market conditions and/or specific asset performance while preventing excessive or arbitrary revaluations, which can be disruptive or costly for a fund.

SELECTION OF APPRAISERS

Borrowers and lenders typically negotiate a preapproved list of third-party appraisers, although borrowers may sometimes engage a second appraiser to contest the initial appraisal. When multiple appraisals are involved, the market is divided on how to determine the final valuation. We have seen both the median value of the three appraisals used (the borrower's original valuation and the two third-party appraisals), and some agreements use the median of just the two third-party appraisals. Additionally, we have seen situations where if multiple third-party valuations within a period vary significantly from the borrower's valuations, additional consequences may result, such as the agent being able to substitute its reasonable valuations on a go-forward basis, requiring a permanent haircut to the advance rate for the borrower's valuations, or requiring mandatory prepayment of the facility.

HANDLING VALUATION RANGES

For some asset classes, third-party appraisers may provide a range of possible values for an asset. In such events, the NAV facility documentation can address which value within this range will apply. Typically, the median value is used; however, the parties may agree to use either the higher or lower end of the range based on specific terms negotiated in the facility agreement.

COMPENSATION FOR APPRAISALS

Generally, the borrower will be required to pay for the third-party valuation if an event of default is in effect or the appraised valuation is a material deviation from the borrower's reported valuation; otherwise, the cost of the appraiser is borne by the lenders. We have also seen payment responsibility shift based on the percentage difference between the two valuations. For example, if the discrepancy exceeds a predetermined threshold, the borrower pays; if it is below, the lender pays.

IMPACT OF DISPARITIES WITH APPRAISED VALUE

Borrowers can negotiate a threshold requirement for how much the borrower's appraised valuation must deviate from the third-party appraisal for such appraised value to apply. For instance, if the difference between the borrower's valuation and the lender's third-party appraiser's valuation is less than a certain threshold, the NAV facility documentation may stipulate that there is no change to the valuation or that the median value of the borrower and third-party valuations should apply.

DURATION OF VALUATION APPRAISALS

In the absence of a valuation challenge, the appraised value remains valid until the next quarterly financial report is received. When a lender successfully challenges a valuation, the third-party appraised value will typically apply for a specified minimum duration, which may be longer than the next quarterly period. This minimum period is designed to avoid dissuading lenders from utilizing their appraisal right because of a short-lived impact on the borrowing base. It also ensures that the borrower cannot quickly revert to its valuation in an expedited manner depending on the timing of the third-party valuation in relation to the next regular quarterly or annual financial reporting date.

KEY TAKEAWAYS

Valuation challenge rights can be a helpful tool for lenders in NAV facilities to ensure reliable borrowing base calculations. Having the ability to challenge asset valuations can provide lenders with more comfort in underwriting certain types of NAV facilities. Additionally, proper valuations can be helpful to both borrowers and lenders as incorrect asset valuations may impact the availability or operation of such facilities due to their effect on pricing and advance rates. Effective structuring of these rights strikes a balance between the need for reliable and timely valuations and the associated costs and administrative burdens. Lenders, borrowers, and their counsel should carefully review NAV facility documentation to ensure clear terms for the selection of appraisers, breadth-of-valuation triggers, applicability of valuation ranges, allocation of third-party appraisal costs, and the duration of third-party appraisals.

THE INTERSECTION OF NAV AND MARGIN LOANS: SINGLE ASSET AND CONCENTRATED ASSET POOLS

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EXECUTIVE SUMMARY

Over the last several years, a need has arisen in the fund finance market, which caters to private equity, venture capital, family offices, and other investment funds ("Funds") and their sponsors, for financing to support and leverage investment portfolios of highly concentrated asset pools or even single assets, in each case, with limited liquidity. These portfolios present challenges for financings, including issues with valuation, enforcement, and liquidation. To overcome these challenges, the market has looked to a combination of tools from the traditional net asset value ("NAV") and the margin loan markets. This Legal Update addresses the advantages of deploying these tools in a concentrated or single-asset financing market.

BACKGROUND

TYPICAL NAV FACILITY STRUCTURE

In a typical NAV facility, a lender or group of lenders provides a credit facility secured by the underlying portfolio investments of the Fund and related cash flows. The investment portfolio usually consists of various equity interests in non-public companies. NAV facility borrowers can vary and may be the Fund itself, a Fund subsidiary, or a special purpose vehicle. The collateral security structure may include a pledge of the equity interests of the borrower and/or the borrower's investments, as well as one or more deposit or securities accounts pledged in favor of and controlled by the lender, into which distributions from portfolio investments are routed.

Cash proceeds of investments deposited to the controlled accounts are available to prepay the NAV facility per the requirements of the specific facility, which may include a requirement to pay down the loan to maintain the required loan-to-value ratio and/or a cash sweep of some portion of the portfolio proceeds. So long as no default has occurred, controlled funds remaining after periodic facility prepayments are available for distribution to the Fund and its investors. Additional credit support may include guaranties from affiliated entities.

The amount of credit advanced typically is determined as a percentage of the fair market value of Fund assets that are approved as eligible collateral. Eligibility depends on factors such as the creditworthiness of the underlying obligor, the liquidity of the assets, and the investment strategies/relevant market sector of the assets. Additionally, limits may attach to such eligible assets to introduce haircuts on the portfolio value where limits are exceeded (such as an excess concentration in a specific market sector). Limits are reflected in the NAV facility and measured periodically (typically quarterly, depending on whether a liquid secondary market for the owned securities exists).

While setting the parameters of the eligible portfolio pool can involve negotiations, often the real challenge is the baseline value of the assets in the eligible collateral pool because these assets usually do not have an objective fair market value. Instead, the Fund sponsor typically performs the valuation based on an agreed-upon policy. Because this valuation takes place at monthly or quarterly intervals, there is an inherent lag in the valuation component of NAV facilities. To address this lag, lenders often negotiate the right to dispute the Fund sponsor's valuation and substitute an independent valuation by a third party.

In some NAV facilities, if valuation is disputed, borrowings may be limited and mandatory prepayments/cash sweep requirements may be paused. If, based on the revised valuations, a prepayment would be due, NAV facilities often include mechanics to permit the borrowing base to return to compliance over a specified period, as opposed to immediate prepayment, where the underlying assets are not liquid enough to allow an immediate sale and prepayment.

MARGIN LOAN STRUCTURE

In a margin loan structure, a lender extends credit to a borrower against the value of investment securities owned by the Fund. The investment securities are typically traded on a public stock exchange. As with NAV facilities, margin loans have a borrowing base against which the loans are made and may have eligibility criteria (including the relevant exchanges on which the investment securities trade), as well as other eligibility criteria, such as concentration limits related to the market categories of the investments (e.g., energy, technology, hospitality). The lender often requires an account be designated to receive proceeds of the investment securities, with the account pledged to the lender and available to make required prepayments.

The publicly traded nature of the collateral in margin loans allows the borrowing base to be calculated daily by the lender on a mark-to-market basis. Accordingly, the lender does not need to negotiate valuation dispute rights because the valuations are publicly available and objective.

If a deficiency arises, the lender can require immediate action to redress the issue. In this scenario, the borrower will typically receive a "margin call" and be required to immediately prepay the loan or provide additional collateral or sponsor support to bring the margin facility into compliance. If the borrower fails to bring the facility into compliance, the lender is generally authorized to take immediate action and sell the investment securities (or provide instructions to the relevant prime-broker to make such sale) to repay some or all of the loan.[1]

The transaction structure of margin loan lending varies in two material ways from the standard approach in NAV facilities. First, the collateral has an immediate and reliable valuation. Second, because the collateral is liquid and has a reliable real-time valuation, the lender can readily enforce on the margin loan collateral. As noted above, in NAV facilities, lenders are not positioned to take immediate action on the collateral and may permit the borrower to devise a plan to redress any shortfall over a specified period, or the lender may simply stop extending additional credit and await dividends or other proceeds from the underlying collateral assets to be paid into the pledged account and swept to the lender.[2]

WHAT TO KNOW ABOUT COUPLING NAV AND MARGIN APPROACHES

To address the complications of financings secured by a single or concentrated asset portfolio, market participants have sought to deploy tools that combine elements of traditional NAV lending and margin loan lending. While the complications presented by these portfolios cannot be resolved by a single approach, combining tools from both markets can help advisors structure bespoke solutions. Specific options include:

- Price Proxy for Hard-to-Value Collateral. The traditional margin loan market benefits from having an immediate and reliable valuation of the underlying assets securing the financing, while in the typical NAV facility, the value of the collateral can lag the advancing of the loans. One solution is to seek price proxies for the underlying collateral. If the equity interests of a privately held company do not have a valuation that can be readily marked-to-market, there may be an alternative proxy, such as the trading price of the debt instruments of such private company. These proxies, if available, can act as a stand-in for the price of the applicable equity interests or could be used to simplify the negotiations of a lender's valuation dispute rights by stipulating that the dispute rights are only exercisable if there is a material movement in the price of the proxy asset. The price proxy approach borrows a tool from the margin lending market - namely, a real-time valuation - to make the valuation structure more reliable, which could impact advance rates, simplify negotiations around dispute rights, and facilitate more efficient remedial actions.

- Additional Collateral/Margin Calls. As noted above, in traditional margin lending, if there is a margin call, a borrower is generally permitted to provide additional collateral to support or repay the loan. In single or concentrated asset NAV facilities, the borrower may have limited liquidity with respect to the primary collateral. Accordingly, liquidating the asset pool may not be feasible or may require a steep discount to raise liquidity. Single or concentrated asset NAV facilities might apply the margin tool of supplemental collateral to redress any borrowing base deficiency. The collateral could be negotiated in advance or subject to lender's discretion. Incorporating this approach into single or concentrated asset NAV facilities may be more attractive to market participants because it may permit a more timely redress of any borrowing base deficiencies and may afford the borrower an opportunity to avoid steeply discounting assets during a market downturn to bring the facility into compliance.

- Alternative Credit Support Options. To achieve the same benefits as the additional alternative collateral approach noted above, participants in the single asset or highly concentrated asset market might consider using separate credit support strategies, such as equity support letters, guaranties, letters of credit, and/or comfort letters. The recourse under these strategies can vary and the provider's creditworthiness would be a key consideration, but these approaches may alleviate the complications arising from a single or concentrated asset-secured transaction, particularly where the collateral is difficult to value. These strategies may be more prevalent in traditional NAV facilities than margin loan structures but can benefit margin loans where the underlying securities are not publicly traded.

- Anticipatory Consents. Because the sale of non-public equity interests may trigger shareholder agreement provisions relating to change of control, drag along, tag along, rights of first refusal, and similar transfer restrictions, or regulatory consents, it may be advisable to obtain blanket consents in favor of the lenders exercising rights in collateral as a condition to the loan. As with the credit support options, this strategy may be used in NAV facilities more often than margin lending structures, but it could be constructively deployed in both types of facilities where the assets are highly concentrated and have limited liquidity profiles.

TAKEAWAYS

There is a wealth of experience in the fund finance market from which to draw and creatively address issues posed by an evolving market seeking liquidity. Traditional NAV and margin loan features can be combined in the case of single and concentrated asset portfolios to efficiently resolve potential complications arising from these facilities and permit borrowers to monetize valuable assets while providing lenders with timely and adequate downside protections.

ENDNOTES

[1] In some margin facilities, the investment securities are not fully liquid because they may be held subject to certain restrictions (such as shares issued to insiders in a company in connection with a public offering), but those special circumstances are not the focus on this update.

[2] Note that publicly traded securities will often be held by a Fund in a prime-brokerage account and if the relevant lender is not the same as the prime broker, the lender will be unable to have a pledge of the prime brokerage account itself but rather make arrangements to instruct the prime broker on dispositions of the asset in certain instances. Note that a lender should consider any lien and or margin loan arrangements between the prime broker and the Fund in such instance.

DOUBLE NEGATIVE PLEDGES IN NAV CREDIT FACILITIES: WHAT FUND FINANCE LENDERS NEED TO KNOW

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EXECUTIVE SUMMARY

With more borrowers and lenders entering into net asset value ("NAV") credit facilities, lenders may want to consider including a double negative pledge within the covenant provisions of NAV credit facility documentation. In this Legal Update, we explain:

- What a double negative pledge is;
- How using a double negative pledge can protect a lender's right to seek additional collateral, deter the borrower from granting other negative pledges, and protect the lender's place as a senior creditor; and
- Why a lender should make sure to have adequate security interests in new collateral even if a double negative pledge is included.

BACKGROUND

The market for NAV credit facilities continues to grow and evolve. With their increased use, fund finance lenders should be aware of a helpful covenant provision: double negative pledges.

A negative pledge, often included in traditional loan documentation, is a covenant that prohibits the borrower from pledging assets of the borrower to another party, whether or not such assets are pledged as collateral.

The following is an example of negative pledge language in a credit agreement:

> No Borrower shall, directly or indirectly, create, incur, assume or suffer to exist any Lien (other than in connection with this Agreement) upon or with respect to any of the property or assets (including the Collateral) of any kind, real or personal, tangible or intangible (including, but not limited to, the capital stock or other equity interest, as the case may be) of such Borrower.

A double negative pledge is a covenant which goes further than the standard negative pledge by also including language requiring the borrower to abstain from granting any other negative pledges to third parties. In other words, the borrower agrees to refrain from (1) granting liens on assets pledged to such lender to any other existing or prospective lender (i.e., the negative pledge) and

(2) including negative pledge covenants in any loan documentation relating to other existing or prospective credit facilities.

The following is an example of double negative pledge language in a credit agreement:

> No Borrower shall, directly or indirectly, (a) create, incur, assume or suffer to exist any Lien (other than Permitted Liens) upon any property or assets (including the Collateral) of any kind, real or personal, tangible or intangible, of such Borrower or (b) enter into, or suffer to exist, any agreement with any Person that prohibits or limits the ability of a Borrower to create, incur, assume or suffer to exist any Lien upon or with respect to any of the property or assets (including the Collateral) of any kind, real or personal, tangible or intangible, of such Borrower.

WHAT YOU NEED TO KNOW

With NAV credit facilities becoming more prevalent in the fund finance market, lenders to private equity funds whose loan documentation permits the incurrence of other indebtedness and does not already require liens on all of the borrower's assets to secure the facility may want to consider including a double negative pledge within the covenant provisions of its NAV credit facility documentation.

PRIMARY PURPOSES

In addition to providing the protections created by a standard negative pledge, a double negative pledge has the following primary purposes in NAV credit facilities where other indebtedness is permitted to be incurred:

1. **Ensures prospective creditors cannot restrict the senior lender's ability to seek additional collateral when necessary**. A negative pledge keeps the assets of the borrower, including the collateral pledged to a NAV lender, free and clear of liens in the future. A double negative pledge achieves this result as well, but goes further which can be useful in the event the NAV lender seeks to obtain additional collateral in the future. Common scenarios are where a borrower's financial condition deteriorates and the lender requires additional comfort or where the borrower seeks additional borrowing capacity and additional security is needed to support the credit. To the extent that other debt is permitted by the terms of the NAV credit facility, the terms of that third-party credit facility could otherwise include a negative pledge on the assets of the borrower that are not already subject to the liens of the NAV credit facility, thereby restricting the ability of the borrower to provide liens on additional collateral in support of the NAV credit facility. These provisions can therefore be a helpful tool for lenders to ensure future borrowing base capacity and to bolster the credit profile of a facility.
2. **Avoids issues with Acquired Asset Provisions**. While NAV credit facilities are generally secured by collateral accounts into which proceeds of, and distributions from, investments are held, there is variation in other assets on which a NAV credit facility may have liens. In those facilities where it is anticipated that as assets are added to the borrowing base (or acquired by the Borrower in the future) additional liens on these assets (or liens on the equity of vehicles holding these assets) will be required, a double negative pledge will be helpful in preserving the ability to put liens on those assets.
3. **Acts as a deterrent**. The covenant would deter borrowers from offering multiple negative pledges to additional lenders and bolster the NAV lender's priority position in

the capital stack to the extent that additional collateral is required (or additional collateral becomes available). To the extent that other creditors emerge, the borrower would be prevented from permitting them to include such provisions, and in the event a negative pledge is requested by them from such borrower, the borrower would need to notify the other creditors of the presence of the existing debt which contains the double negative pledge restriction.

POTENTIAL CONSIDERATIONS

When a lender in a NAV credit facility seeks to include a double negative pledge in the loan documentation, there are a few considerations to keep in mind:

1. Double negative pledges are not a substitute for a security interest. While the double negative pledge can keep future collateral unencumbered if the lender needs to acquire a security interest in the future, the double negative pledge itself does not create that security interest. To obtain a security interest in newly acquired assets, the lender must get a pledge of those specific assets as collateral.
2. Although the double negative pledge may have the effect of putting other lenders on notice that they cannot enter into negative pledges with the borrower, this deterrent effect can be minimized if other lenders don't have access to the facility documentation of the borrower. While other lenders may request this documentation from the borrower as part of their diligence process, there may be confidentiality restrictions on providing such documentation. Therefore, lenders may:
    a. have to rely upon the borrower keeping track of their debt and collateral restrictions, including double negative pledges, and while a lender would likely have a legal claim for breach if the borrower breaches the double negative pledge, the complexities of the resulting situation can be avoided if subsequent lenders have access to all previous loan documentation, or
    b. consider requesting a precautionary filing of an all assets UCC-1 financing statement that puts potential creditors on notice that assets have been pledged, even though no corresponding security interest has been created. However, in this case, lenders should also be prepared for the need to potentially modify the filing if needed and/or provide representations or other evidence to subsequent lenders that the corresponding security agreement does not exist.
3. Since double negative pledges typically operate only at, or immediately below, the level of the parties to the loan documentation, lenders in most NAV credit facilities will be structurally subordinated to liens incurred at a level at or below the underlying investment. Accordingly, lenders should keep in mind that double negative pledges may not prevent the issues that relate to subordination from subsidiary-level debt.

NEXT STEPS

Fund finance lenders entering into NAV credit facilities with borrowers that permit the incurrence of other indebtedness may want to consider whether it would be worthwhile to include a double negative pledge in their NAV credit facility documentation. Doing so can protect the lender's right to seek additional collateral, deter the borrower from granting other negative pledges, and protect the lender's place as a senior creditor.

HOW THE AUTOMATIC STAY IN BANKRUPTCY CAN AFFECT NET ASSET VALUE FACILITIES

SEAN SCOTT AND RYAN MICHALKO

EXECUTIVE SUMMARY

In net asset value (NAV) facilities, the borrowing capacity typically adjusts to reflect changes to the value of the underlying investment portfolio, and borrowers face the risk of potential borrowing base deficiencies or minimum net asset value/loan-to-value covenant breaches if the value of such assets sharply drops. These risks can become particularly pronounced during a financial downturn or in the event of a bankruptcy or other credit event relating to a borrower or an underlying portfolio asset. In either circumstance, the automatic stay can inhibit a borrower's access to distribution proceeds, affecting its liquidity and ability to meet financial obligations. In this Legal Update, we discuss the purpose of the automatic stay, share options for relief from the stay, and offer recommendations for navigating the complications that the automatic stay can create for NAV facility lenders.

BACKGROUND: OVERVIEW OF BANKRUPTCY PROCEEDINGS AND THE AUTOMATIC STAY

NAV facilities allow investment funds to manage cash flow fluctuations and meet investor redemptions without selling underlying assets, which enables funds with illiquid investments to maintain their investment strategies and avoid forced liquidations during periods of repayment pressure.

Financial institutions may also use NAV facilities to optimize capital usage and enhance liquidity management. By leveraging their investment portfolios, institutions can access additional funding at favorable terms, enabling them to deploy capital more efficiently while maintaining diversified asset holdings.

In NAV facilities, the borrowing capacity typically adjusts to reflect changes to the value of the underlying investment portfolio, but borrowers face the risk of potential mandatory repayments if the value of pledged assets sharply drops. These risks become particularly pronounced in the event of significant financial downturns. In such circumstances, it is possible that either the borrower or certain of its underlying investments could become the subject of bankruptcy proceedings.

As a general rule, US bankruptcy proceedings aim to facilitate the debtor's financial rehabilitation by allowing them to reorganize their capital structure in an organized manner and potentially obtain a "fresh start" by deleveraging pursuant to a court-ordered reorganization plan. Bankruptcy proceedings also strive to achieve fairness and equity in the treatment of both debtors and creditors, balancing the interests of all parties involved.

When a debtor files a bankruptcy petition, Section 362 of the US Bankruptcy Code imposes an "automatic stay" with respect to a debtor. The automatic stay is effectively a statutory injunction that prohibits creditors from taking most actions to collect against or obtain possession or control over the debtor's property; among other things, the stay will prevent lenders from repossessing or foreclosing on collateral pledged by a debtor, otherwise perfecting or enforcing liens, or commencing or continuing litigation against the debtor or its assets (including its owned investment portfolio) until the bankruptcy proceedings are completed, unless the lender obtains "relief" from the automatic stay through a bankruptcy court order.

The automatic stay applies across the principal chapters of the US Bankruptcy Code both for individual and corporate debtors, but does not extend by its terms to non-debtor entities such as officers, guarantors, or non-debtor corporate affiliates.[1]

WHAT TO KNOW: THE INTERSECTION OF AUTOMATIC STAYS AND NAV FACILITIES

As a general rule, the automatic stay remains in place as long as the bankruptcy proceeding is ongoing, and the debtor can seek substantial sanctions (including punitive damages) against parties that violate the automatic stay. However, creditors can request the bankruptcy court to lift the automatic stay "for cause," which can include situations in which the debtor's assets are expected to substantially devalue before the case is resolved or if there is inadequate protection of the creditors' interests in collateral. In the context of a NAV borrower's bankruptcy proceedings, lenders that have obtained a pledge of equity in underlying investments may be able to argue that the stay should be lifted to allow the sale of such investments in an orderly fashion to avoid risks of further decline in value, particularly if the borrower is unable to effectively manage or operate such assets because of its own bankruptcy.

Moreover, creditors and debtors may agree to allow relief from the automatic stay to potentially liquidate collateral on a negotiated basis, along with an agreement that the proceeds of the sale may be applied to the secured debt. Such agreements are often reached in exchange for consideration or concessions to the debtor, which could include additional financing or the use of cash collateral to facilitate the debtor's reorganization.

In the context of an underlying asset's bankruptcy proceeding, the automatic stay could potentially inhibit a NAV borrower's continuing access to liquidity and ability to meet financial obligations, particularly because the risk of fluctuations in asset values during bankruptcy makes it difficult to accurately assess the collateral's worth and consequent borrowing capacity. Additionally, where an underlying asset has become the subject of a bankruptcy, it likely will have entity-level debt (secured and unsecured) that will need to be paid or satisfied before any distribution can likely be made to the NAV borrower.

MITIGATING RISKS AND STRATEGIES FOR NAV FACILITIES

To mitigate risks associated with potential NAV borrower bankruptcies, NAV facility lenders should conduct thorough due diligence on the borrower's financial health and the underlying asset quality before extending credit. By regularly monitoring asset values and ensuring sufficient collateral coverage, lenders can potentially detect early indicators of financial distress at the borrower and investment level and implement proactive measures to safeguard their interests in case of borrower default, including the potential bankruptcy of the borrower or an underlying asset.

During bankruptcy proceedings, NAV debtors can negotiate with creditors to propose viable repayment plans or asset-restructuring alternatives aimed at safeguarding the interests of both parties while maximizing asset value. In such circumstances, adhering to the legal mandates and regulations regarding any automatic stay is essential to mitigate legal risks and uphold stakeholders' interests. To ensure compliance with relevant laws and protect against potential liabilities and disputes, lenders and borrowers should consult with an attorney when navigating the intricacies of insolvency or bankruptcy proceedings involving a NAV borrower or one of its underlying investments.

KEY TAKEAWAYS

Successfully managing bankruptcy proceedings that involve NAV facilities requires a sound understanding of bankruptcy laws to tackle challenges such as the scope of the automatic stay, potential grounds for stay relief, bankruptcy financing, and treatment of competing claims and interests. Stakeholders should implement advanced risk assessment models to evaluate the effects of potential bankruptcies and delays in enforcement due to the automatic stay. Alternative financing structures, including hybrid models, can also be considered as a way to diversify bankruptcy risk. But in the event of a bankruptcy, lenders should be mindful of the likely need for cooperation with the borrower and other stakeholders to maximize recoveries, particularly given the leverage that the automatic stay provides. In sum, understanding the impact of potential bankruptcy scenarios, including at various levels of the structure, is critical to the effective management of NAV facilities.

ENDNOTES

[1] Section 105 of the US Bankruptcy Code does allow the automatic stay to be extended by courts to non-debtors, but such relief is rarely granted and requires a heightened showing that such relief is warranted and necessary to protect and preserve assets of the debtor's estate.

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