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Mitigating ‘Bad Acts’ Risk in NAV Facilities (Part 2 of 2)

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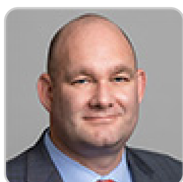

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This article continues our prior discussion of the risk of “bad acts” by a borrower in certain NAV loan structures. For our purposes, NAV loans are loans to alternative investment entities (*e.g.*, private equity funds, secondaries funds, hedge funds, funds of hedge funds, pension funds and family office vehicles) that are underwritten, either on a secured or unsecured basis, by the value of the entity’s investments. Even in secured NAV loan facilities, rather than a direct pledge of the underwritten assets for the financing (*i.e.*, the fund’s portfolio of investments), lenders typically will only receive a pledge of the management and economic interests in one or more controlled subsidiary holding vehicles (“HoldCo”) that hold the investments (*i.e.*, an “indirect pledge” of the investments). As a result, the borrowers typically maintain complete control over the assets that the lenders are underwriting.

As a result, on top of the “market risk” inherent in NAV loans (*i.e.*, the risk that the value of the borrower’s investments will decline), because a borrower typically remains in control of its investments, such structures involve a degree of “bad acts” risk. For our purposes, “bad acts” refer to actions by the borrower that cause or result in the investments ceasing to be owned by the borrower, or becoming subject to the claims of other creditors, in each case, in contravention of the terms of the NAV loan. Examples of bad acts might include a borrower (i) transferring an investment to an affiliate, (ii) selling an investment at less than full value or for illiquid consideration, (iii) pledging an investment to another creditor or (iv) directing proceeds of an investment to an account other than the pledged account. Lenders will negotiate detailed covenants limiting such actions, but since the lenders do not control these assets, they are heavily reliant on the borrower to comply with such negotiated limits. While breach of the covenants may give rise to an event of default, such breach already may have impaired the

value of the investment pool (and the creditworthiness of the borrower) in a way that makes it less likely that the loan will be repaid in full.

Factors we identified for consideration in Part 1 of this article (see here) to assess the risk of bad acts occurring included (i) the profile of the borrower; (ii) the scope of the lenders' relationships with the borrower; and (iii) the nature of the investment portfolio on which the loan is underwritten. In Part 2 of this article, we explore approaches lenders can take to mitigate bad acts risk. Unfortunately, there is no one-size-fits-all solution. Whether one or more of these approaches is appropriate for a given transaction will depend heavily on the facts and circumstances of the parties, the borrower's investment structure and the collateral.

Structural Mitigants

Custody Arrangements. Lenders can require that investments be transferred to a custodian and held in a custody account. Under this approach, the custodian becomes the registered owner of the investment and has the sole right to give instructions to the issuer of the investment. The custodian will be party to an account control agreement detailing the circumstances under which the custodian will take instructions from the borrower and the lenders in respect of the investments. Given that there is an independent third party in control of the investments, custody arrangements are the most effective approach to ensuring bad acts do not occur; however, they are not a practical solution for some transactions. They impose additional costs on the borrower, and they require the borrower to interact with its underlying investments through the custodian. And not all investments can be held with a custodian. (For example, most custodians will not custody interests in private equity funds due to concerns around liability for unfunded capital commitments.) Further, custody arrangements may also have drawbacks from a lender perspective. Where an investment portfolio is held by a HoldCo, the entire portfolio typically can be sold in foreclosure via a sale of the interests in the HoldCo to the extent pledged as collateral for the NAV loan. However, a custody account cannot simply be transferred to a third party. Instead, a transfer of the custodied investments will often require the custodian to approach the issuer of each investment for consent to a transfer.

Direct Pledge. While secured NAV loans most commonly use indirect pledge structures, in certain instances lenders may insist on direct pledges of the underwritten investments. A direct pledge ensures that the lender can exercise rights in respect of each investment. Pledge consents from the issuers of the underlying investments may limit transfers of the investments without lender consent, and may provide for proceeds of the investments to be paid to a pledged collateral account controlled by the lender. Negotiating individual consents with the issuer of each investment can be time-consuming and difficult, though, so this approach is often limited to financings of investment portfolios with a limited number of positions.

Modification of Constituent Documents. Protections against bad acts can be addressed in the constituent documents of the HoldCo. One approach is to disclose the existence of the financing in the constituent documents and to disclose that certain actions (such as a sale of an investment, incurrence of debt or a distribution of assets to equity holders) may only be taken with the consent of the lenders, or in accordance with other conditions specified in the loan documents. The goal of including such provisions is to condition the authority of the HoldCo to engage in certain transactions and activities that could be adverse to the lenders, and to put potential creditors or transaction counterparties on notice as to negotiated limitations in the loan

documents. Going a step further, the constituent documents may be revised to require the HoldCo to have an independent manager or director that will be responsible for protecting the interests of the lenders in certain instances. In these structures, the independent manager's or director's consent would be required for certain transactions or activities consistent with the terms of the NAV loan documents.

Additional Credit Support

Often, the borrower in a NAV loan is owned by a more creditworthy parent fund. The risk of a loss resulting from bad acts in respect of the underwritten investments can be mitigated where the lenders have recourse to the parent fund. This recourse typically comes in one of two forms:

Formal Credit Support. The parent fund may guaranty the obligations of the borrower under the facility or commit to fund capital to the borrower to enable it to pay its debts. Such capital commitments often arise under the constituent documents of the borrower (in which case the borrower may pledge those capital commitments, or may merely covenant to maintain a minimum level of uncalled capital relevant to the amount of the loan). They also may arise in the context of an equity commitment letter, which the parent fund provides in connection with the NAV loan. In each case, the recourse to the parent fund mitigates the lenders’ complete reliance on the underlying investment assets as the sole source of repayment. Such recourse also may incentivize the parent fund to ensure that the borrower does not engage in bad acts in respect of the underlying investments, since it will be on the hook for any deficiency that results in repaying the loan.

Conditional/Bad Boy Guaranty. Where a parent fund is unwilling to fully guaranty repayment of the loan, a contingent, or “bad boy,” guaranty may be appropriate. Under a contingent guaranty, the obligation of the parent fund to repay the loan only arises upon the occurrence of specified bad acts. These bad acts generally are within the control of the parent fund to prevent. Given the contingent nature of the payment obligation, the parent fund may not have to record a debt liability as a result of providing such a guaranty.

Due Diligence and Reporting

Lenders can also rely on various reporting and diligence measures to monitor for any potential bad acts. This has the benefit of both (i) deterring bad acts by ensuring that any such actions will ultimately be detected and (ii) alerting lenders to any bad acts as soon as possible, so that appropriate remedies can be implemented. These measures can take on a number of forms, and below we discuss a few of these.

Audited Financial Statements. Requiring borrowers to deliver audited financial statements on an annual and/or quarterly basis provides lenders with the comfort that an independent party has reviewed and confirmed the composition of the borrower’s and/or HoldCo’s assets. Lenders can then use the audited financials to confirm a borrower’s compliance/non-compliance with NAV loan covenants regarding dispositions of investments and the veracity of borrower-provided reporting regarding its investment portfolio. However, relying on audited financials as a third-party check on bad acts has one glaring shortcoming: timing. Audited financial statements take significant time and resources to prepare. As a result, they are often provided on a significant time lag for the period that they are covering *(i.e.*, several months).

Additionally, funds typically will only provide audited financial statements on an annual basis. So while audited financial statements do provide an independently verified snapshot of a borrower's assets, this comfort is typically only available on an annual basis and, even then, the information is typically stale by several months by the time of delivery.

NAV Statements. For NAV loans where the underwritten assets are third-party managed investments (*e.g.*, secondaries funds, funds of hedge funds, REITS, third-party managed co-investments, etc.), lenders also may require NAV or capital account statements from the manager or issuer of the investments. As with audited financial statements, these third-party-provided statements will similarly provide lenders with the comfort that an independent party is confirming the borrower's ownership of the relevant investment. While the independent party here won't be a regulated and reputable accounting firm (as with audited financial statements), NAV and capital account statements have the added benefit of typically being provided more frequently (*e.g.*, on quarterly basis) and with less of a time lag than audited financial statements.

Transfer Agreements and Law Firm Letters. Another example of independent documentation that lenders can look to for verification of a borrower's ownership of its purported investments are copies of the transfer agreements or subscription documentation governing the relevant investment. These will typically will be prepared or at least countersigned by the issuer, manager, general partner, etc. of the relevant investment. From time to time, we also see lenders require letters from law firms that worked on the borrower's acquisition of the relevant investments confirming that the relevant acquisition was successfully closed. In each of these cases, the lenders receive some form of independent comfort that the borrower did own the relevant investments at some point; however, the obvious limitation here is that these are not forms of ongoing/periodic verification of the borrower's continued ownership of the relevant investments.

Periodic Portfolio Audits/Inspection. Lenders sometimes will also require borrowers to agree to periodic audits/inspections of a borrower's portfolio (whether in whole or in part) to verify ownership. This can either be structured as a right for the lenders or their agents to audit the borrower's portfolio or for a reputable independent firm to perform the audit. We most commonly see this agreed to by family office borrowers that may not otherwise prepare audited financial statements.

Notwithstanding the inherent risk of "bad acts" in certain NAV loan structures, there are a number of different tools (as discussed above) that lenders can employ to mitigate these risks. While this article seeks to summarize these tools, we continue to see market participants come up with novel approaches to address these concerns and ensure that lender and borrower interests are aligned. We will be sure to keep you updated.