CADWALADER

FUND FINANCE FRIDAY

Happy NAV Year!

January 6, 2023 | Issue No. 205

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NAV Financing – What Was Old Is New Again

January 6, 2023 | Issue No. 205

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Happy New Year! As we begin the new year and look back at the developments in the fund finance market in 2022, and look forward to what 2023 has in store for us, one common theme is the continued increase in the use of NAV financing products, both in the U.S. and European markets. Several market participants noted (in our **European market predictions** article last month) the rise of the use of NAV facilities in 2022 and their expectations that this will continue in 2023 as funds look to manage their liquidity in the current environment and as funds, sponsors and lenders become more comfortable with these products.

For purposes of the above, NAV financing products are primarily loans to private equity (PE) funds where the value of the portfolio companies comprising the investment assets of the PE fund provide support for the borrower's loan obligations. Whether the security interest provided to the lenders is directly over the borrower's investment assets or merely supported by those assets (*e.g.*, by taking a pledge over the accounts into which proceeds from those assets are paid, or by obtaining some other indirect support provided by the investment assets) depends on a number of factors, and requires an analysis and understanding of the PE fund's holding structure for those assets and sometimes diligence of the assets themselves. See our more detailed discussion of these products and the potential pitfalls that lenders in this space need to be aware of **here.** One factor supporting the increased use of NAV financing products that was seen in 2021 and 2022, and that is expected to continue in 2023, is the ability to customize these products for the particular holdings and to meet the specific investment strategy of a PE fund – see **here** for a discussion of the varied uses of NAV facilities.

For those of us who cut our teeth in the hedge fund financing space, NAV financing is nothing new. Similar to PE funds' use of subscription credit facilities, funds of hedge funds (FoHFs) have been using NAV financing for more than two decades. NAV facilities in the context of FoHF borrowers refer to loans that are secured by the pledge of a portfolio of hedge funds owned (directly or indirectly) by the borrower. In addition to FoHFs, borrowers under these facilities often include family offices, pension funds and mutual funds, but the collateral structure and primary legal considerations are similar regardless of borrower type. These facilities appear in various forms − loans, note purchase transactions and derivatives transactions − though the primary structuring considerations are common across these products.

Bare necessity is the primary driver for the use of NAV facilities by FoHFs. Unlike PE funds, which have investor commitments that provide a liquid form of collateral that can be pledged as security for loans, most FoHFs require commitments from investors to be fully funded at the time of subscription, and those subscription proceeds are used by a FoHF to simultaneously acquire its underlying portfolio of hedge funds. As a result, a FoHF has no meaningful assets to pledge as security other than its underlying portfolio of hedge funds in which it invests, necessitating the use of NAV financing products. (Note that while some FoHFs have adopted a hybrid investment model in the past several years, taking some subscriptions as investor commitments, this is still not common in the hedge fund market.)

Because both types of facilities are ultimately looking to the borrower's investments as the source of repayment, there is significant overlap in the key issues facing both PE NAV facilities and FoHF NAV facilities, although, as discussed below, these are often addressed in different ways:

- The collateral structure, and the ability to control and ultimately dispose of the investment portfolio, ideally without recourse to the court system and without interference from or the need for action by any third parties, is key for each type of facility, though the means for achieving this are substantively different. The collateral structure for PE NAV financings typically either looks to force distributions from those investments into a deposit account that is pledged to the lenders or requires entity-level direct or indirect pledges and consents that will allow the lenders to transfer or dispose of the investments or the entity that holds the investments as part of their enforcement. (See **here** for a discussion of some issues that arise from such collateral structures.) FoHF NAV financings structures typically require the pledged hedge fund portfolio to be held in a securities custody account that is pledged to the lenders, as discussed below.
- The borrowing power and/or loan-to-value maintenance requirements in each are based on the value of the underlying investment portfolios, so the ability to obtain regular valuations from an independent source (*e.g.*, the managers of the underlying investments for FoHF NAV and PE NAV secondary financings, or the administrator of the fund borrower), and to potentially discount or dispute those valuations, are critical elements of the reporting and covenant provisions, as is the ability to deem certain investments as ineligible (*i.e.*, give them a value of zero for purposes of determining borrowing power and to calculate collateral coverage ratios). The importance of these provisions was highlighted during the Financial Crisis – when many hedge funds suspended publication of NAVs and/or gated redemptions, resulting in discounts being applied by lenders and loan-to-value breaches in FoHF NAV facilities – and during the early days of COVID-19, when concerns about the timeliness and accuracy of fund valuations led to a slowdown in PE NAV financings until the next cycle of valuation reports.
- Because the collateral value in each is tied to the borrower fund's investment portfolio, the negative covenants and other restrictions limit the ability of the borrower to dispose of these assets and/or make distributions to equity holders. The life cycle, and the withdrawal rights of their investors, of the two different types of funds becomes relevant here. Whereas a PE fund will ultimately dispose of its investment portfolio and make a final distribution to its investors (even if just to roll them into the next fund), FoHFs have no natural "end" and therefore FoHF NAV financings can remain outstanding indefinitely, and their investors can choose to remain in the fund (or exercise their regular redemption rights to exit the FoHF). One result of this is that amortization provisions, requiring that distributions and sale proceeds from underlying investments be used, at least in part, to pay down the loan well in advance of the loan's maturity, are a common feature of PE NAV financings, while they are rare in FoHF NAV financings.

- And because the pledged assets in both cases are subject to market risks and fluctuations, diversity of investments (or, said another way, lack of concentration) is typically factored into the borrowing power calculations. This mitigates somewhat the risk of gating and NAV suspensions that is inherent in FoHF NAV financing structures.

Possibly the single biggest difference between PE NAV financings and FoHF NAV financings, at least from a structural perspective, is the central role played by the custodian in FoHF NAV financing transactions. PE funds infrequently hold their investments in a custodial account (for structural reasons and due to the nature of the underlying investments). FoHF NAV financings, conversely, almost uniformly require the borrower's portfolio of hedge funds to be held in a securities custody account that is pledged to the lenders and that is subject to a control agreement in favor of the lenders. This allows the lenders to enforce against the portfolio of hedge funds by directing the custodian, who is the registered owner of the hedge funds and who has contractually agreed to follow the instructions of the lenders upon the occurrence of certain events, to submit redemption requests (or transfer requests, if desired) to the underlying hedge funds, with the redemption or sale proceeds paid to the pledged account. A discussion of the indirect holding system (*i.e.*, holding assets through a securities intermediary) is beyond the scope of this article, but note that it is generally accepted in the FoHF NAV financing space that pledge and/or transfer restrictions at the level of the underlying hedge funds are not implicated by the pledge by a borrower of its custodial account to which such hedge fund interests are credited. Note additionally, however, that the involvement of a custodian implicates the Hague Securities Convention and requires legal analysis on that front.

While there are substantive differences between PE NAV and FoHF NAV financings, there are enough similarities that the 20-plus years of existence of the FoHF NAV financing market, including in particular the experience gained working out defaulted transactions during the Financial Crisis, can inform the continued development of the PE NAV financing market. Prior to the Financial Crisis, FoHF NAV facilities were primarily used to provide leverage on the borrower's portfolio of hedge funds, so FoHFs that did not use leverage as part of their investment strategy would often not have a facility in place. However, during and coming out of the Financial Crisis, these products were increasingly seen as a needed source of liquidity, both to bridge expected liquidity requirements and during times of market distress, and even FoHFs with no intention to deploy leverage began to put FoHF NAV liquidity facilities in place. With the focus on liquidity in the PE space in the current market environment, it's no surprise that PE funds are also increasingly looking to NAV facilities to similarly manage their own liquidity needs.

FFF Sovereign Immunity Series – Part IV

January 6, 2023 | Issue No. 205

By Eric Starr
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We continue our alphabetical 50-state survey of sovereign immunity with our fourth installment in the series – this week summarizing sovereign immunity in Kansas, Kentucky, Louisiana, Maine and Maryland.

We start with a quick refresher. While sovereign immunity can be a complex area of the law, at a high level, it's a rather simple principle: the government cannot be sued unless it first consents. As we have noted in prior articles and further detail below, many state governments do in fact voluntarily waive their Eleventh Amendment rights to sovereign immunity in particular situations. Courts and lawmakers have recognized and created exceptions to the principle of sovereign immunity in part because of the perceived injustice such immunity would otherwise inject into commercial transactions.

While this series is intended to provide a high-level overview of the issue of sovereign immunity, the issues involved can be quite nuanced; the potential impact of sovereign immunity is significant and warrants the careful consideration of counsel when government entities (such as state pension funds) are invested in a fund seeking a credit facility. In addition to understanding the sovereign immunity issues for the applicable state, a careful review of any applicable side letter is also critical to properly assessing the risk and mitigating factors of lending against the capital commitment of a government entity.

Links to the prior three installments in this series may be found **here**, **here** and **here**.

KANSAS

A state entity in Kansas cannot claim a defense of sovereign immunity in business transactions. The Kansas Supreme Court has consistently held that government entities should be held to the same standards and have the "same responsibilities and liabilities" as a private entity when engaged in business transactions. Effectively, sovereign immunity shall not apply when assessing a breach of express contract.

The Kansas Supreme Court has elsewhere held that where "the state legislature has consented that one of its agencies may be sued on its express contracts, the waiver of sovereign immunity should extend to every aspect of its contractual liability."

In addition to court-recognized waivers of sovereign immunity, the legislature has also created a statutory right to sue the Kansas Public Employees Retirement System. However the system can only be sued in Shawnee County.

KENTUCKY

Kentucky has legislatively waived its immunity for contract claims. However, in so waiving its immunity, the Kentucky lawmakers also specified a set of special rules applicable to actions for breach or enforcement of a contract against the Commonwealth. The following list contains the highlights of those rules:

- The waiver of immunity only applies to *written contracts*.
- The action will be tried by the court sitting without a jury.
- Generally, the contract claim must be brought within one year from the date of completion specified in the contract.
- Damages are capped at twice the amount of the original contract.
- The suit must be brought in the Franklin Circuit Court.

LOUISIANA

In Louisiana, there is no sovereign immunity defense available against a breach of contract claim. Louisiana is one of a handful of states that waives sovereign immunity in its Constitution. The wording of such waiver does provide that the Legislature may limit the extent of the waiver by statute, and further subjects the waiver to the appropriation of funds by the Legislature to cover any judgment obligations.

The legislature has exercised this constitutional authority by enacting certain limitations on the general immunity waiver; notably, none of these limitations inhibit breach of contract claims. The only substantive limits imposed by the applicable statute apply to personal injury and wrongful death claims, bond issuance challenges, and workers compensation claims or tax refund claims – none of which are likely to be implicated when enforcing a capital commitment to a fund.

For example, all claims brought against the state must be brought only in Louisiana state court.

MAINE

Maine has waived contractual sovereign immunity in some instances. The state can be sued on contract claims when there is “(A) an explicit waiver of sovereign immunity or (B) a general statutory scheme permits the [State] to enter into contracts and which abrogates immunity for a breach.” This case law underscores the importance of a side letter provision waiving sovereign immunity in mitigating risk when contracting with a Maine state entity – meaning the safest bet is to have express language waiving sovereign immunity.

However, courts have also held that the requirement for waivers of immunity to be explicit has exceptions. A 2005 case expresses this consistently upheld principle, stating “a general statute allowing the State to enter into contracts implies a waiver of sovereign immunity by the Legislature when the State is sued for breach of that contract.”

MARYLAND

The State of Maryland expressly waives sovereign immunity as a defense to contract claims by statute. The relevant statute provides that “the State... may not raise the defense of sovereign immunity in a contract action, in a court of the State, based on a written contract that an official or employee executed for the State or one of its units while the official or employee was acting within the scope of the authority of the official or employee."

In order to bring such a claim against the state, the claim must be filed within a year after the later of: (1) the date of the claim; or (2) the completion of the contract on which the claim is being based.

CONCLUSION

In the next installment of our Sovereign Immunity Series, we will discuss the sovereign immunity status of Massachusetts, Michigan, Minnesota, Mississippi and Missouri.

PFCFO Article on Subscription Line Lending Activity

January 6, 2023 | Issue No. 205

Private Funds CFO speaks with fund finance industry professionals, including Cadwalader's Wes Misson and FFA chair Jeff Johnston, about some reasons for the increasing diversification of subscription line lenders to private funds in the **article**, "Big Banks Dial Back on Sub Lines, but Market Shows Signs of Resilience."

No Limit Capital Market Update

January 6, 2023 | Issue No. 205

No Limit Capital this week released its 2022 Annual Market Update, which can be requested from this **link**.

APAC’s Access to the Broader Alternatives Market

January 6, 2023 | Issue No. 205

The liquidity squeeze you should have seen coming: Asian markets such as Hong Kong *“squeeze”* their way back into being global players in the fund finance space as other banks across the globe scale down due to capital constraints. Read more about how these key players are taking advantage of their competitors in *PFCFO* **here**.

On the Move – Fund Finance Tidbits

January 6, 2023 | Issue No. 205

On the Move

Fi Dinh has been named Head of Fund Finance for the Asia Pacific (APAC) Region at MUFG Investor Services, where she will focus on expanding the fund financing business in APAC and supporting the overall growth of the global asset servicing and fund administration business. Click **here** to read the full MUFG press release.

Congratulations to Our New Partners and Special Counsel

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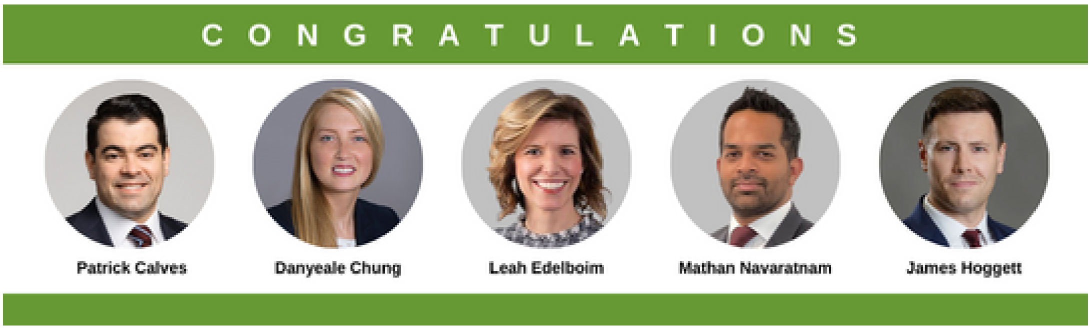

Congratulations once again to our attorneys whose promotions are effective this week:

Patrick Calves, Partner – New York

Danyeale Chung, Partner – Charlotte

Leah Edelboim, Partner – New York

Mathan Navaratnam, Partner – London

James Hoggett, Special Counsel – London