

FUND FINANCE FRIDAY

Let's Be Direct

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Direct Pledges in NAV Secondaries Facilities: Common Uses and Key Considerations

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By Patrick Calves
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A quick look at the agenda for the Fund Finance Association's annual symposium (in less than two weeks!) highlights the continued growing interest in NAV secondaries facilities (*i.e.*, there are now three events dedicated to the use of NAV, hybrid and secondaries facilities, which is a welcome addition given last year's standing room only crowds for the discussions on these topics). As such, we thought it would be topical to continue our discussion on these facilities, and more specifically, the use of direct pledges in NAV secondaries facilities. For our purposes, NAV secondaries facilities are loans to "secondary" private equity funds that are supported, either on a secured or unsecured basis, by the value of the private fund interests held thereby.

In a NAV secondaries facility, almost universally, the terms of the underlying documentation governing each of the borrower's investments will stipulate that granting direct security in such investment, in addition to any future transfer of such investment (*e.g.*, in connection with a foreclosure by a secured creditor), requires the consent of the sponsor for such investment (*i.e.*, typically the issuer's general partner or manager (as applicable)). Obtaining such consent can be a cumbersome process for which there is no assurance of success, as some sponsor may be wary of pre-consenting to a transfer of an investment to an unknown third-party transferee. As a result, in most of the NAV secondaries facilities that we see, the investments themselves often are not pledged to the lenders directly. Instead, either (i) the investments are typically owned by a subsidiary holding vehicle, the equity interests of which are pledged to the lenders as collateral for the loan (*i.e.*, an "indirect pledge" of the investments) or (ii) the investments themselves are not pledged at all (neither directly or indirectly) and instead lenders rely on a pledge of the bank accounts where the investment proceeds are deposited along with a "negative pledge" with respect to the fund's investments. (See previous discussions of some of the issues associated with indirect pledge structures [here](#) and negative pledge structures [here](#)).

Nonetheless, there are still situations where direct pledges of the borrower's investments are still employed. Summarized below are certain situations where we see direct pledges more commonly utilized in the market and some of the key considerations for these structures.

Common uses for direct pledges

Concentrated portfolios. Direct pledges are most commonly utilized where the investment portfolio supporting a borrower's loan obligations is very concentrated. This could be deals where either the portfolio (i) only has a small number of investments and each of the investments are directly pledged or (ii) is heavily concentrated in a couple of anchor investments, and where only those anchor investments are directly pledged. A direct pledge

ensures that the lender can exercise rights in respect of each pledged investment, which provides lenders with additional flexibility in the manner in which sales of assets could be conducted in a foreclosure. Alternatively, for indirect pledge structures this would mean a sale of the equity interests in the holding vehicle that holds the portfolio (*i.e.*, an “indirect” foreclosure of the investments). Practically, this means that any foreclosure would require the sale of the entirety of the portfolio of investments held by such holding vehicle together. This lack of flexibility may not result in maximization of the liquidation value of the portfolio, as buyers in a foreclosure sale may be more interested in certain investments than in others (foreclosing and realizing on the investments in negative pledge structure is even more complicated, and we will leave that much lengthier discussion for another day).

Mitigating bad acts risk. Unlike other types of securities financings (think prime brokerage, securities lending and repo, or typical bank margin loans), where a lender or a third-party custodian on behalf of the lender holds or controls the securities on which the loans are underwritten, the underwritten investments for a NAV are typically owned and controlled by the borrower, either directly or through one or more subsidiary holding vehicles. As a result, because a borrower typically remains in control of its investments, such structures involve a degree of “bad acts” risk (see previous discussions on assessing and mitigating bad acts risk in NAV secondaries facilities [here](#) and [here](#)). Lenders can use direct pledges and corresponding sponsor pledge consents as a means to mitigate bad acts risk. Pledge consents from the sponsors of the underlying investments puts such sponsors on notice of the security interest and may limit transfers of the investments without lender consent and/or provide for proceeds of the investments to be paid to a pledged collateral account controlled by the lender.

Indirect pledge and transfer restrictions. The costs (in both time and money) in negotiating individual consents with the issuer of each investment for direct pledges can be material and thus one of the biggest deterrents to using direct pledges in NAV secondaries facilities. However, in addition to requiring sponsor consent for direct pledges and future transfers, the terms of the underlying documentation governing a borrower’s investments may also require sponsor consent for (i) the creation of the “indirect” security interest arising from the pledge of equity interests in a holding vehicle that is the direct owner of such investment and/or (ii) the “indirect” sale or other liquidation of such holding vehicle. Consequently, lenders and borrowers may conclude that even utilizing an indirect pledge structure will require obtaining an underlying sponsor’s consent. (We recognize that there a myriad of considerations in making such a determination and that not all market participants take the same approach on addressing indirect pledge and transfer restrictions, and thus will leave that discussion for another day and forum.) In such a situation, the typical cost savings of using an indirect pledge structure may be diminished, and lenders may want to consider whether to seek a direct pledge in lieu of or in addition to the indirect pledge for such investments.

Key considerations for direct pledges

Appropriately tailored consents. The cost of negotiating consents with underlying investment sponsors is one of the biggest deterrents to utilizing direct pledge structures. Pledge consents can cover a myriad of issues, including consent to the pledge of the investment, consent to a transfer of the investment in foreclosure, limitations on the borrower’s ability to transfer the investment without lender consent, agreement to direct investment proceeds to a pledged collateral account (or as otherwise directed by the lender), and access to information. Sponsors

may not have compliance procedures in place to agree to all of these requests and may only be willing to do so at the request of their most significant investors or in special situations. As such, lenders should consider carefully how to tailor any such consents to focus on their most sensitive issues and reduce extensive negotiations over points of less significance.

Consent to foreclosure. When utilizing direct pledges, lenders should be aware that while underlying investment sponsors may be willing to agree to a direct pledge, they are more likely to push back on providing pre-consent to a direct transfer of the investment upon a foreclosure or may impose various conditions on such consent (e.g., only consenting to a transfer to the lender, the future transferee having to satisfy the issuer's KYC and suitability requirements and/or various other legal and regulatory requirements). As a result, a lender may be in a position where its ability to foreclose on its collateral will be subject to the future cooperation of the underlying investment sponsor and satisfaction of any such conditions. Accordingly, some lenders may seek to pair the use and flexibility of direct pledge structures with an indirect pledge of a borrower's holding vehicle that holds such investments in order to have comfort that there is avenue for foreclosing on its collateral that doesn't rely on the cooperation of a third party (as presumably the lender will be able to negotiate with the borrower the appropriate consents to foreclosure over the equity interests in the holding vehicle prior to closing of the NAV secondaries facility).

Who needs to provide consent. Another key issue in direct pledge structure is determining who needs to provide the required consent. Lenders should not assume that consent from an issuer's manager or general partner will be sufficient. The consequence of not obtaining the required consents will typically be that the pledge itself is nullified, leaving a lender unsecured. While performing appropriate due diligence should mitigate this concern, given the severity of the consequences of getting this wrong, lenders (and their lawyers) should place extra emphasis on diligence of this point and making sure consents from all of the appropriate persons are provided.

While not the most commonly employed structure for NAV secondaries facilities, market participants should be aware that direct pledges are another tool in their proverbial NAV tool belt. We are very much looking forward to connecting with everyone in Miami, and please do not forget to stop by the "Secondaries and Continuations" panel featuring Cadwalader's very own Brian Foster for a lively discussion of issues pertaining to NAV secondaries facilities.

Fund Finance Market Review in the 2023 Pink Book

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Global Legal Group this week launched the 2023 edition of *Fund Finance 2023* (aka the “Pink Book”), the leading legal treatise for the fund finance industry. Now in its seventh edition, this unique publication provides in-depth analysis of market conditions, regulations and laws, covering 19 key jurisdictions, with 27 expert analysis chapters providing in-depth and up-to-date analysis. As contributing editors, Cadwalader’s Wes Misson and Sam Hutchinson co-authored the Preface and sat down for an [interview](#) with publisher James Strode to discuss this latest edition and the year ahead in finance.

Additional contributions from Cadwalader partners include:

- “Fund Finance Law and Regulations 2023 | Assessing and mitigating ‘bad acts’ risk in NAV loans,” authored by Angela Batterson, Brian Foster and Patrick Calves, available [here](#).
- “Fund Finance Law and Regulations 2023 | England & Wales,” authored by Sam Hutchinson and Nathan Parker, available [here](#).

The complete digital content is available [here](#), and hard copies will be available at the 12th Annual Fund Finance Association Symposium in Miami next month.

GLG Publisher Interview with Terry Hatton to Launch 2023 Pink Book

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As part of Global Legal Group's launch this week of the 2023 edition of the "Pink Book," publisher James Strode sat down for a video interview with Terry Hatton, Head of Fund Finance at MUFG, available [here](#).

The Corporate Collateral Package in Subscription Facilities: A Share Peg in a Round Hole

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By Caroline Barton
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By Georgina Pullinger
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Those in the subscription credit market will likely be familiar with traditional collateral arrangements over the capital call rights of Cayman funds formed as exempted limited partnerships (ELPs). Recently, however, we have seen a resurgence in the use of funds formed as Cayman exempted companies (CayCos), rather than ELPs, which gives rise to some additional considerations for a lender.

ELP vs. CayCo

There are both structural and practical differences between ELPs and CayCos in terms of contributing capital to the fund which can impact how the collateral package is structured.

In terms of the structural differences: while the governing agreement of an ELP is the limited partnership agreement (LPA) (which is a contract between the parties thereto with rights capable of assignment by the ELP), the governing agreements of a CayCo are its memorandum and articles of association (M&As), which are not of themselves capable of assignment by the CayCo. This results in one of the fundamental differences in a corporate subscription facility, as a lender will essentially receive security over the subscription documents (which are then subject to the M&As), rather than over the actual governing document of the CayCo.

In terms of the practical differences: for a CayCo, typically capital contributions are linked to the obligation of the CayCo (acting through its directors or investment managers) to issue shares. The creation of an obligation on the investors in the CayCo to purchase shares “to-be-issued” is different from the obligation of an investor in an ELP to fund the remainder of its capital commitment to the ELP as part of its existing interest. This difference results in both enforcement concerns and additional insolvency risks – the biggest potential issues for a lender (each discussed further below).

Due to these fundamental differences, security over a CayCo’s right to draw down outstanding capital commitments from its investors differs from the arrangements which have become common practice in relation to securing capital call rights of ELPs.

Further share issuances: enforcement considerations

Of utmost concern to a lender is its ability to enforce an investor's obligations to contribute to the CayCo, irrespective of the CayCo's ability to issue shares to the investor on payment. Following a capital call, the investor might expect to be issued additional shares for the capital contribution which has been made, and such issue will only then give rise to the payment obligation to the CayCo (proceeds of which are subject to claim by the lender pursuant to its security entitlements). This then leads to a practical issue for a lender on enforcement: how to issue the shares and have the register of members of the CayCo updated in order to receive payment.

Further share issuances: insolvency risk

If a winding up petition is issued before a capital call is made, there is a question as to whether section 99 of the Cayman Islands Companies Act (dealing with the avoidance of dispositions) would require a validation application to be made to the Court, because the issue of shares post-petition would be considered "an alteration of the status of the company's members." Without Court approval of the share issue, the capital call would be void and the money would be recovered for the benefit of the liquidation estate of the CayCo.

The solution

To address enforcement and insolvency concerns, we suggest that capital contributions be structured such that no further shares are required to be issued or that the CayCo has the option, but not the obligation, to issue further shares in exchange for capital contributions. Like most other concepts, this is ideally baked in from inception of the fund and should be included in the subscription documents, the M&As and any offering document. It is worth noting that we do often see this approach where subscription facilities have been contemplated when the CayCo was formed. If the fund is already in existence, this can also be achieved by way of amendment of these documents.

If the requirement to issue shares cannot be avoided, there are some innovative solutions that can be adopted. We have seen various approaches, including (i) investors being issued shares at a nominal par value on closing, coupled with a remaining obligation to fund their outstanding commitment with respect to those shares when called to do so by the CayCo (the lender was then granted a security interest over its right to enforce the investors' obligations to fund their remaining commitments), or (ii) investors waiving their right to receive shares on an insolvency pursuant to an investor letter, coupled with preapproval of any share issuance on enforcement. We note, however, that these workarounds are deal-specific and generally not as neat or straightforward for a lender as where the capital contributions are not tied to a share issuance.

Additional considerations

Of course, the ideal LPA for a lender also includes a suite of protections in addition to just the ability to make capital calls (*e.g.*, the ability to call on non-defaulting investors, the requirement to fund without setoff, counterclaim or defense, etc.), so lender's counsel will need to closely review the M&As, in conjunction with the applicable subscription documents, to ensure that the lender is also sufficiently covered in relation to the wider suite of lender protection provisions. The separate elements of the standard subscription security package (*i.e.*, security over the collateral account and the power of attorney) should not be impacted by the fund being a CayCo, rather than an ELP.

Conclusion

Given the array of unique issues and concerns around CayCo subscription financings, in our experience it is critical to engage counsel at the early stages of the transaction. As with all fund finance structures, the smoothest transactions occur where the investors are aware that subscription financing will be utilised by the fund, with the fund's documents set up at the outset to anticipate the applicable financing structures and pre-empt creditor concerns. Although not without its challenges, with careful review and relevant amendments, a robust corporate fund security package can certainly be achieved.

WFF US: 'Private Equity to Entrepreneur' NY Event Recap

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By Ashley Flaherty
Associate | Fund Finance

Last Thursday, there was a lot of purple (and rain!) as Women in Fund Finance co-hosted the first FFA event of 2023, along with Cadwalader, Wickersham & Taft and Wells Fargo, kicking off the year with an exciting evening of cocktails and a conversation with [Jenn Toyzer](#), Co-Founder and CEO of UME Plum Liqueur.

Dee Dee Sklar, the Co-Global Chair of Women in Fund Finance, opened the event with the theme of innovation. She emphasized how innovative Jenn has been in founding UME and gave examples of how she had witnessed each of the moderators – Michele Simons, Managing Director at Wells Fargo, and Cadwalader partner Leah Edelboim – as being innovative in their careers. She invited and inspired the audience to consider how they can be innovative in their own careers.

In this fireside chat moderated by Michele and Leah, Jenn, who after 10 years left a successful career in finance and co-founded UME just a few short years ago, discussed various topics surrounding the start-up, including her decision to take the leap from finance into liquor during the COVID closures. Jenn explained to the group how, among other things, the tenacity and persistence that she fine-tuned during her time in finance helped her set and achieve targets and timelines for and, ultimately, achieve her goal of launching UME back in 2020.

The packed house of attendees from across the fund finance industry was fascinated to hear Jenn touch on the similarities between her career in finance and her current role as an entrepreneur, but also how her past experience has been helpful to her present success, especially the speed at which she went from idea to bringing the product to market. Many attendees could relate when Jenn mentioned that learning to become an entrepreneur and founder of a liquor company was in many ways similar to the times in her career in finance when a structure completely new to her landed on her desk and her job involved figuring out how it worked. As an entrepreneur, Jenn had to navigate and tackle new structures – for example, setting up a supply chain for UME, something that was completely new to her.

Jenn also discussed the value of her prior experience in terms of how she handles, interprets, and negotiates various types of contracts. She is facile with legal jargon we finance folks throw around like “representations and warranties,” “indemnification” and so on, and her experience with contracts undoubtedly sets her apart as an entrepreneur as she is able to, as we say at Cadwalader, “get in the weeds” of these new contracts and, as Jenn noted, mark up and change provisions the contract drafters often note to her they haven’t had anyone ask to negotiate (until Jenn, that is).

During the conversation, Jenn was asked if she could draw any parallels between her experience as a woman in finance and a female entrepreneur. She responded by discussing the ways in which being one of few female founders and CEOs in her industry has worked to her advantage, as it has been a way to distinguish herself, allowing both her and her purple product to stand out. For example, the people she meets often remember her name and company at subsequent meetings or networking events.

Looking around during the event, which was hosted at The Raines Law Room at The William, many attendees took the opportunity to dress “on theme” and donned various shades of purple attire that complemented the purple cocktails they were sipping. Thursday’s drink menu featured three very different cocktails, each hand-picked by Jenn and mixed with the signature spirit of the evening and all of which exemplified everything that Jenn set out to achieve with UME – that is, striking a perfect balance between a beautiful plum liquor that is drinkable and delicious on its own but also excellent mixed and able to be sipped. From a business perspective, while we tasted the cocktails, Jenn explained how UME is distinct from other products on the market with its low sugar content (which is half that of traditional liquors), lightness and beautiful purple hue – which we learned, thanks to a question from the audience, is actually derived from cabbage!

All in attendance had a wonderful evening, and the Cadwalader team would like to thank Wells Fargo and Women in Fund Finance for collaborating with us on such a fun and successful event.

Top upper left photo (from left to right): *Michele Simons (Wells Fargo), Jenn Toyzer (Co-Founder and CEO of UME Plum Liqueur), Dee Dee Sklar (Co-Global Chair of Women in Fund Finance) and Leah Edelboim (Cadwalader), along with additional photos from the event’s networking portion.*



Funds Europe's Fund Financing ESG Roundtable

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ESG in 2023: Fund Finance experts discuss the evolution of ESG, its growing significance to both funds and lenders, and share predictions for the new year. The article is available [here](#).

Private Funds CFO Article on GP Financings

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Private Funds CFO this week published an article on financing the GPs themselves, including detail on the collateral packages and recourse structures GPs will likely be asked to provide from lenders. The subscription-required article is accessible [here](#).

Fund Finance Hiring

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Fund Finance Hiring

JPMorgan Chase is looking to hire both a vice president and an associate for its Alternatives - Private Credit Secondaries team. The roles will focus on the evaluation, underwriting and execution of private credit secondaries transactions, but will also include origination, marketing and operational responsibilities.

The Vice President will lead private credit secondaries project management efforts across multiple concurrent processes. To learn more and apply, click [here](#).

The associate role will evaluate a wide range of private capital transactions, but primarily underwrite LP-stake and GP-led secondary transactions. To learn more and apply, click [here](#).