NAV Financing: To Secure or Not To Secure, That is the Question

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As noted in Angie Batterson's wonderful panel at our Finance Forum in Charlotte last month, the term NAV loan means different things to different people, and can encompass a diverse mix of structures and asset classes in the market. Borrowers under "NAV loans" can include private equity funds, secondaries funds, hedge funds, funds of funds, private credit funds, real estate funds or infrastructure funds, to name a few. Examples of asset classes we see underwritten in connection with NAV loans include equity and debt interests in private companies, private funds or exchange-listed companies, preferred shares, bonds, loans and real estate. Regardless of the type of NAV transaction and the type of assets being underwritten by the lender, one fundamental aspect of all NAV deals is the level of security provided to the lender in respect of the investment assets. This article highlights some of the key characteristics of secured loans and so-called "negative pledge" loans.

To Secure

Most NAV fund financing transactions take the form of secured transactions. The initial series of questions to be asked in evaluating and executing a secured NAV financing will include (i) what are the assets to be pledged, (ii) what is the law governing a pledge of such assets and (iii) what obstacles exist for the effective pledge and potential foreclosure of such assets. While the first two questions tend to be straightforward, answering the last question can require a substantial amount of legal diligence regarding the following:

- Pledge and Transfer Restrictions. Lenders must understand the terms of underlying assets to determine whether there are limitations on the ability of a lender to perfect a pledge on such assets and to foreclose on the assets following a default under the financing. Where the holding structure for the assets is complex, review of the constituent documents for multiple layers of holding vehicles may be required in addition to reviewing the terms of the investments.
- Form of Pledge. The jurisdiction of formation of the assets being pledged will generally govern the creation and perfection of a security interest over such assets. In addition, applicable law in certain foreign jurisdictions may not easily provide for a pledge on some assets and may instead require an assignment or other transfer of the interest, which could, among other potential issues, raise questions of liability for the lender under the governing documents of such investment if not properly addressed in the collateral documents. As a result, local counsel should always be consulted to ensure compliance with applicable law and to address potential issues.
- Other Contractual Requirements. Along with contractual restrictions related to the initial pledge, additional requirements may apply to an actual transfer upon foreclosure of the

pledged asset. These can include third-party consents (including from regulators, depending on the type of pledged asset), contractual rights for other investors to participate in any transfer or sale (e.g., rights of first refusal, drag along, tag along and/or similar rights), legal restrictions on transfers (including under securities laws) and/or specified eligibility requirements that any potential transferee, including the lender, would be required to meet in order to effect a transfer.

Failure to properly address any of these points can result in an invalid pledge, limit the lender's enforcement rights and/or negatively impact the value of the pledged assets – see our prior **article** for a more detailed discussion of these concerns.

Despite the potential complexity involved with taking security over a borrower's assets in a NAV loan, a valid security interest and robust collateral package can provide a lender with a number of benefits. A perfected security interest crystallizes the priority of the lender's interest in the borrower's assets and enhances the lender's ability to realize the value of such assets. The collateral documents will typically provide the lender with self-help remedies that would enable the lender to dispose of or otherwise liquidate the pledged assets without cooperation of the borrower and without having to seek court intervention to obtain a judgment. This can lead to a quicker recovery than waiting for the assets to pay principal or interest or make distributions (as applicable) or for the borrower to achieve a realization event with respect to the asset. And in a bankruptcy scenario, while the lender may be subject to a stay on enforcement, a lender with a perfected security interest would be able to petition the court for a release of the stay and then, once the stay is lifted, enforce against the pledged assets (again, without any need to obtain a judgment). Even if a lender doesn't exercise enforcement rights, the existence of such rights can be a powerful incentive for a borrower to proactively resolve a default under a loan facility.

There may also be benefits to borrowers of a secured facility. For example, a lender may be willing to provide a higher loan-to-value ratio or to lend against a more concentrated portfolio if the facility is secured. It may also be easier to get such facilities rated, which may result in lower pricing.

Not To Secure

To be clear, "unsecured" NAV transactions are not truly unsecured transactions – as typically the lender obtains a security interest over the bank account of the borrower. These are often referred to as "negative pledge" facilities. The distinction here is that the lender does not obtain a security interest over the portfolio of investments that has been underwritten by the lender to support the loan, but is instead relying on, among other things, contractual protections (including a commitment not to pledge the assets to other creditors, the requirement that proceeds of the assets be directed to the pledged bank account and cash sweep requirements, to name a few) and the lender's structural seniority (even as an unsecured creditor, the lender will have a priority claim against the borrower and the asset proceeds compared to the borrower's investors, so the borrower would need to repay the lender before making any distributions to its investors) (see our previous **article** for a detailed discussion of negative pledge facilities).

Because of the necessary reliance on contractual protections and the lack of self-help remedies to liquidate assets, unsecured NAV transactions typically have lower loan-to-value ratios and are provided to more fund borrowers with more diversified portfolios. Also, these facilities tend

to be at the fund level in order to benefit from the entire investment portfolio of the fund (*i.e.*, as opposed to loans to specific vehicles further down the fund structure, where loan proceeds may be used for a very specific purpose and only underwritten on the basis of a subset of the fund's portfolio). We have especially seen interest in negative pledge facilities from traditional subscription facility lenders, who are accustomed to providing facilities at the fund level (and may already have a subscription line with the same borrower) and who may not be interested in underwriting more concentrated pools of investment assets or working through some of the issued discussed above involved in taking asset-based security. These facilities are also typically provided to sponsors that a lender feels comfortable will abide by the relevant contractual restrictions (which may include repeat clients and more institutional level sponsors).

Conclusion

While not presenting the stark choice (and high stakes) of Hamlet's famous question, to secure or not to secure is a fundamental question that needs to be answered for all NAV transactions. Given the many recent changes in the fund finance industry this year, many lenders that are new to the industry and/or new to NAV transactions may want to take the above discussion into consideration in determining whether to include either or both in the product mix they offer to their clients (and potential clients).

Moody’s Publishes Proposed Subline Rating Methodology

November 10, 2023

Moody's Investors Service recently published its new proposed methodology for rating subscription credit facilities.

The proposal is available on the web at this **link** and the comment period will be open until December 4.

What We're Reading

November 10, 2023

Here’s what we’re reading these days.

Less than half of private credit borrowers would generate positive free cash flow in a mild stress scenario, according to a recent analysis by S&P Global Ratings that reviewed more than 2,000 issuers with more than $400 billion of outstanding debt. In the near term, liquidity looks sufficient and covenant relief can help lenders navigate potential issues. The analysis is available **here**.

The Dean of Valuation, Aswath Damodaran, takes inventory of the impact investing movement, more a decade and several trillions of dollars into the project in ***Good Intentions, Perverse Outcomes: The Impact of Impact Investing****,* Damodaran arrives at a number of constructive suggestions for rescuing the effort by focusing more on results than intentions.

Lenders are updating sustainability-linked loan documents as maturities are set to increase and scrutiny of sustainability claims is intensifying. More details in Bloomberg’s ***Potential Greenwashing Claims Have ESG Bankers Seeking Legal Advice.***

The sale of Signature Bank’s commercial real estate portfolio may be a test of private market appetite for bank CRE loans, and the sale could cast a pall over property values according to the WSJ’s ***Signature Loan Sale Likely to Lower Commercial-Property Values***.

Sponsors are running a full-court press for high new worth investors, as the number our U.S. households with a new worth between $1 million and $5 million has ramped up in the past decade, according to a recent Bloomberg **article**. Streamlined, predictable capital calls will have as much importance to individuals as to institutional investors and will continue to be a challenge that fund finance lenders are asked to solve.

Next Week: SuperInvestor 2023

November 10, 2023

SuperInvestor 2023
The LP/GP Relations Event
14 - 17 November 2023
Zurich

Cadwalader Fund Finance partner **Samantha Hutchinson** will be speaking at **SuperInvestor's LP/GP Relations Event** taking place next week from 14 - 17 November 2023.

The LP/GP Relations Event focuses on the latest on fundraising, secondaries, LP allocations, co-invests and more.

Samantha will participate in the Secondaries Summit on the "Fund and GP financing: how does the world of fund financing play into the secondary market?" panel on 14 November 15:50 - 16:25 PM.

Learn more **here**.

APAC End of the Year Networking Celebrations

November 10, 2023

The FFA APAC team invites you to join them for an evening of networking! Please join for drinks, canapes, and an opportunity to socialize and celebrate the year with colleagues and associates in the fund finance industry.

The event will be hosted simultaneously in Hong Kong, Singapore, and Sydney on December 7, 2023.

Register to attend in Hong Kong **here**.

Register to attend in Singapore **here**.

Register to attend in Sydney **here**.

Join FFA NextGen for Christmas Drinks!

November 10, 2023

The EMEA Fund Finance Association NextGen Committee invites you to join them for 2023 Christmas Drinks, hosted by Simmons & Simmons.

This will be a great opportunity for the industry to get together and celebrate a busy 2023 over drinks and canapes, and in true Christmas spirit, the event will feature a charity raffle!

Register **here**.

Event Details:

Date: Wednesday, 13th December

Time: 6:30pm - 11:00 pm

Location: Simmons & Simmons - 1 Ropemaker Street, London EC2Y 9SS