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Fund Finance Friday

Considerations for Post-IPO NAV Financing

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By **Brian Foster**
Partner | Fund Finance

With a surge in asset-based lending to private equity funds since the start of the pandemic and a historic run of IPO fundraising, it is not surprising that we are increasingly seeing post-IPO shares being pledged as collateral in support of asset-based loans. While private equity funds often invest in companies with the goal of later taking those companies public, the occurrence of the initial public offering doesn't necessarily lead to the immediate divestment of a fund's investment in that company. As part of the IPO process, key investors often agree to maintain all or a portion of their investment in a company for a specified period after the occurrence of the IPO. It is not unusual for such investors to monetize their investments during that period by obtaining a loan secured by the investment. The issues that must be addressed in structuring a financing of such post-IPO shares are materially different from the issues that arise for a financing of pre-IPO shares. We highlight certain key considerations below:

- Shares that are listed on a U.S. exchange generally constitute "margin stock." Lending secured by margin stock is subject to regulations under U.S. law that may impose limits on the amount of credit that can be extended relative to the value of such shares.
- Listed shares have real-time pricing based on sales on the stock exchange. Whereas prior to the IPO (where a valuation is only provided once every 3 months), a lender might have focused on issues such as valuation methodology, valuation source and appraisal rights, lenders for post-IPO shares typically focus on issues such as price volatility and daily trading volume, delisting, and exchange and market disruption events generally.
- The borrower's shares in the company may not be covered by the registration statement that was filed by the company in connection with the IPO. In order to sell the shares, a new or amended registration statement must be filed, or the borrower (or lender in the case of a foreclosure) must effect the sale pursuant to an exemption from registration under applicable securities laws.
- The borrower may have entered into a registration rights agreement under which it can cause the company to file a registration statement to facilitate a public sale of the borrower's shares. Where possible, the lender will want to receive a pledge of the borrower's rights under the registration rights agreement.
- If the borrower provides or appoints officers or directors to the company, or owns a material portion of the shares (10% or more), it may be deemed an affiliate of the company and may be subject to certain requirements and limitations under securities laws, such as ownership disclosure requirements and short-swing profits limitations under Section 13 and Section 16 of the Securities Exchange Act of 1934. The lender will want to structure its rights under the loan documentation and exercise its remedies in a way that it will not itself be deemed an affiliate of the company.
- The borrower may have entered into a lock-up agreement with the company, the principal underwriter for the IPO and other key investors that prohibits the borrower from pledging and/or selling its shares for a specified period after the IPO. It is critical that the lender review and understand the restrictions contained in the lock-up agreements, including under what circumstances (if any) a sale of the borrower's shares may be permitted prior to the end of the lock-up period. It is not uncommon for investors to negotiate flexibility within the terms of the lock-up, and some lock-up agreements will have carveouts for margin loans. Others may permit a sale of shares during the lock-up period as long as the purchaser agrees to receive the shares subject to the terms of the lock-up.

- In order to discourage illegal insider trading, the company will likely have a detailed policy regarding trading of the company's stock by its directors, officers, employees and entities (including investment funds) affiliated with such persons. The lender will want to review the insider trading policy of the company to ensure that the margin loan (and any resulting foreclosure on the shares) is not prohibited under the insider trading policy, and to determine whether additional consents or approvals should be obtained as a condition to providing the margin loan.
- The lender will be sensitive to receipt of material non-public information about the company from the borrower. The loan documentation will typically include a covenant for the borrower to identify any information as material non-public information prior to disclosure to the lender, and shall allow the lender to decline to receive such information. If the lender is in possession of material non-public information at the time of a foreclosure, it may need to disclose that information prior to effecting a foreclosure sale.
- The borrower's shares may be held in the form of physical certificates that bear restrictive legends. Prior to a public sale of the shares, the legends will need to be removed and the shares may be converted to electronic form. This will require the cooperation of the company and/or its transfer agent.
- It is not uncommon for the lender to enter into an agreement with the company addressing the issues above, including confirming that the margin loan complies with the insider trading policy, that there are no restrictions on transfers of the borrower's shares (other than the lock-up agreement and securities laws), that the company will cooperate with the lender to de-legend the certificated shares, and that the company will not treat the lender as an affiliate of the company in connection with a foreclosure on the shares. The purpose of this letter is to provide the lender comfort that if a default occurs under the margin loan, it will be able to effect a timely sale of the shares in order to repay the loan.