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# Considerations in NAV Transactions When Collateral Includes Transfer-Restricted Assets

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Net Asset Value ("NAV") transactions, where a debtor pledges its downstream assets to secure a financing, can involve a wide variety of potential collateral. In some NAV transactions, the assets to be pledged to secure the financing will be transfer-restricted assets. The form of those transfer restrictions may impact the potential structure and liquidity profile of a given transaction and, while there is no one-size-fits-all approach to structuring these deals, it can be useful to identify some potential considerations that may help market participants optimize the approach that works best for them.

As a first step, when referencing transfer-restricted assets for the purposes of this article, the reference includes several asset classes, such as (i) private investment vehicles (private equity funds, hedge funds, fund of funds), (ii) privately-traded securities (pre-IPO companies), (iii) closely-held limited liability companies and limited partnerships, and (iv) other potential assets, such as rights in certain licenses (including licenses issued by governmental authorities like the Federal Communications Commission ("FCC"). These asset classes are commonly subject to broad transfer restrictions to achieve certain goals, such as (a) compliance with certain regulatory exemptions (*i.e.*, an exemption to registering as an "investment company" under the Investment Company Act), (b) compliance with federal and state securities laws that apply to the trading of non-public securities, (c) preserving the "pick your partner" principles commonly relevant to the management of a closely-held business, and (d) avoiding transfers to "competitors" or ownership by foreign entities for companies active in sensitive business lines such as defense and space exploration, among others.

While these restrictions may be intended to achieve important company goals, the language of such restrictions can complicate other uses of such assets by investors. Where restrictions purportedly restrict the direct or indirect transfer, pledge or other disposition of such asset, that asset might not be readily accepted as collateral to secure a financing. Additionally, where restrictions require that any transfer or pledge of an asset triggers a right of first refusal or tag-along rights for other investors, the restrictions can impact the liquidity profile of such asset, either in terms of the timing for an enforcing creditor to liquidate the asset or by having other shareholders crowd out a potential sale through tag-along rights of other shareholders with respect to a potential transfer to a third party.

At the same time, these transfer-restricted assets can represent substantial stores of value, which make them ripe for use as collateral in secured financings. As a result, transfer-restricted assets often stand at the crossroads of two longstanding legal principles: (i) the freedom of contract and (ii) free alienability of property. Courts that are called on to resolve these issues are engaged in a balance of these legal principles, in the context of a highly fact-specific review of the relevant contractual provisions and the facts of the transactions that purportedly breached that contractual language. To gauge potential outcomes on these issues and optimize deal structure, market participants may want to evaluate the following considerations.

**What Law Applies?**

Legal principles across jurisdictions in the United States may have a common history but not common outcomes on specific factual scenarios. Accordingly, market participants should be aware of what law would be expected to apply to the analysis of the scope of transfer restrictions applicable to a specific transfer-restricted asset. As an example, consider this: a debtor organized under the laws of the State of Texas enters a security agreement governed by New York law pledging in favor of its creditor transfer-restricted membership interests in a limited liability company organized under Delaware law. In a claim that the pledge of the membership interests breached applicable transfer restrictions to which the membership interests are subject, what law would be expected to apply?

The answer is the law of the issuer of the asset. In this case, regardless of the jurisdiction where the claim is brought (which might be New York, Texas or Delaware), the applicable court would be expected to apply Delaware law to the analysis of the scope of the transfer restrictions and whether such restrictions were breached by the applicable pledge in favor of the creditor. One of the implications of the above outcome is that if the collateral pool for a given transaction includes transfer-restricted assets issued by issuers in a variety of jurisdictions, the law applied, as to whether a specific action (such as a pledge) breached the applicable transfer restrictions, would be expected to vary, even where the language of the transfer restrictions is similar.[1]

**Consents**

The viability of obtaining consents from issuers of transfer-restricted assets for a given transaction will vary and will be a balance of fact-specific considerations for the relevant parties. Even where a consent is a viable option, the consent may have certain limits. As a general matter, a consent might be expected to confirm that a given pledge in favor of the secured creditors is permitted and that the secured creditors (or the relevant agent for the creditors) are permitted to enforce the pledge (in terms of taking control of the assets), but what would generally go beyond the scope of a market consent is the expectation that an issuer would provide some advance consent to the transfer of its issued interests to an as-yet-unidentified third party.

Accordingly, where creditors are secured by transfer-restricted assets, they should anticipate having to comply with applicable restrictions in the relevant agreements (which relevant agreements may include shareholders' agreements, investors' rights agreements, right of first refusal agreements, operating agreements, bylaws, or other analogous documents), which restrictions may require the creditors to (i) obtain consent from the issuer with respect to specific transfers, (ii) provide evidence of compliance with applicable laws (such as securities laws) by providing legal opinions or other evidence of compliance, and/or (iii) provide advance notice to the issuer or shareholders of a potential transfer if the issuer or shareholders have a right of first refusal or analogous rights, even where a consent is obtained with respect to the pledge of such transfer-restricted asset. Such compliance with applicable restrictions could impact the liquidity profile of a given asset, but to the extent that the restrictive provisions preserve the relevant operational protection for the issuer, the interests of the issuer and creditors may well be aligned in effecting a transfer to appropriate third parties.

**A Pledge in Proceeds of Transfer-Restricted Assets**

Where obtaining a consent is not a viable option or otherwise does not serve the interest of the transaction parties, some market participants might seek to avoid taking a security interest in the transfer-restricted assets by taking a security interest in the proceeds of the transfer-restricted asset. This approach may avoid a conflict with the relevant restrictions, but case law addressing security interests in proceeds of specific transfer-restricted assets, such as Federal Communications Commission ("FCC") licenses (which licenses are not permitted to be transferred or disposed of in any manner without the prior approval of the FCC), may identify a potential vulnerability to be considered by parties. Two courts resolving cases involving FCC licenses have come to opposing conclusions on whether a bankruptcy of a borrower could cut off a creditor's security interest in the proceeds of an FCC license where there was no FCC-approved prepetition agreement to sell the relevant license.[2] The issue considered by the courts is whether a security interest in proceeds of an asset sale is sufficiently definite to permit the security interest to attach to such proceeds, where a contract for the sale of the asset does not exist prior to the pledging entity becoming subject to bankruptcy proceedings. Given the competing outcomes, parties that utilize this approach will want to put themselves in the best position to demonstrate that they have taken sufficient action to permit a court to find that the applicable security interest did attach.

**An Indirect Pledge in Transfer-Restricted Assets**

An alternative approach to taking a security interest in the sale proceeds of a transfer-restricted asset might be to take a security interest in such asset indirectly, which is often achieved by taking a security interest in the interests of an entity that holds the transfer-restricted asset. Whether an indirect security interest is a viable option for a given transaction will be a highly fact-specific inquiry into the relevant transfer restrictions. Case law suggests that courts will carefully review the express language of the transfer restrictions and, absent ambiguity, will interpret such provisions in accordance with their plain meaning. In case law addressing the scope of transfer restrictions, courts have focused on (i) which entities are expressly restricted by the relevant provisions, (ii) whether the provisions expressly cover indirect transfers, and (iii) whether the provisions address change of control concepts in the organizational structure of the relevant entities, among other considerations. Market participants may also want to consider whether the agreements that contain the restrictive provision expressly provide remedies for a breach of such provisions and what parties are involved in implementing such remedies. Ultimately, given the fact-specific nature of these issues, market participants should anticipate appropriate diligence on the transfer-restricted assets on which they are relying to secure a financing.

Where an indirect pledge structure is utilized, the entity holding the transfer-restricted asset (or group of assets) is often a special purpose vehicle ("SPV"). Creditors relying on such a pledge structure should confirm that the pledge of the entity holding the relevant assets includes control rights of such entity. In the absence of an express inclusion of such control rights, a court could determine that such control rights were not intended to be included in the pledge agreement. Where the creditors do not have the right to control (or participate in the control of) the relevant entity, a court might determine that the creditors only secured economic rights in the entity, which would only entitle them to receive funds as and when the assets of the entity are liquidated, but would not permit the creditors to vote for any such liquidation. Accordingly, any pledge agreement should expressly confirm that the pledgor's control, voting and management rights are conveyed in the pledge, and such agreement may include language that the creditors will be automatically admitted as a member, partner or other applicable equity holder of such entity.

**Assets with Different Liquidity Profiles**

Not all assets will have the same liquidity profiles. By liquidity profile, the reference here is to the expected time duration to convert a given asset into cash. Some transfer-restricted assets might only have a restriction on the direct transfer of such asset. Accordingly, where a pool of such assets are held in an SPV, the creditor might anticipate selling the equity interest in such SPV readily upon enforcement (subject, of course, to laws applicable to enforcement on collateral by secured creditors). If, however, such SPV held (in addition to the liquid assets) one or more assets that prohibited any indirect transfer without the prior consent of the applicable issuer or without complying with certain notice requirements related to right of first refusal obligations, then the enforcing creditor might not be in a position to transfer the equity of the SPV until it has complied with any applicable obligations.**[3]**

Creditors may expect to segregate assets by relevant liquidity profiles at the time of enforcement. Transfer-restricted assets may permit the transfer of such assets between affiliated parties without requiring consents or notices to applicable issuers (often called "permitted transfers"). In such cases, an enforcing creditor (to the extent the creditor can control that SPV because it was pledged management rights in the SPV as discussed above) should be able to cause the segregation of assets based on their liquidity profiles and effect the liquidation of more liquid assets in a timely manner. As part of the initial diligence and structuring process, market participants should consider the ability to segregate assets upon an enforcement and whether any segregation should occur at the start of the transaction.

**Conclusion**

Market participants in NAV financings should be aware that certain assets pledged to secure such financings may be subject to transfer restrictions. While these restrictive provisions may be intended to achieve a particular purpose of the underlying issuers, they may present questions with respect to how to optimally structure a given transaction. There is no single answer to these questions and, as with other financings, market participants may hold different views on the risks presented by specific restrictions and how best to address them. Participants in the NAV market should be aware that the scope of restrictive provisions is a highly fact-specific inquiry and, accordingly, creditors should be prepared to diligence the relevant provisions and assess the likelihood and relevance of their impact on any potential enforcement action as early as possible in the structuring process.

**[1]** It is beyond the scope of this article but worth noting that if the transfer-restricted assets were held as security entitlements in a securities account, the jurisdictional analysis with respect to the pledge of the security entitlements would be expected to be limited to a single jurisdiction – that of the securities intermediary as determined in accordance with the Uniform Commercial Code. It is also worth noting that in an analysis of whether the pledge of a securities entitlement breached a given set of transfer restrictions, the analysis will ultimately involve the law of the issuer's jurisdiction.

**[2]** See *In re Tracy Broadcasting Corp.*, 438 B.R. 323 (Bankr. D. Colo. 2010) (10th Cir.) (affirmed on appeal *In re Tracy Broadcasting Corp*., 2011 WL 3861612 (D. Colo. 2011), but see *In re TerreStar Networks, Inc.*, 2011 WL 3654543 (Bankr. S.D.N.Y. 2011).

**[3]** Consider this the "onion bagel" issue. If you bundle less liquid assets with more liquid assets, you may infect the more liquid assets with the delayed liquidity (the way one's children might claim that one onion bagel can spoil a dozen plain bagels if they are not bagged separately).