C A D W A L A D E R

# Fund Finance Friday

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

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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 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.