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Fund Finance Friday

# Upstream and Affiliate Guaranties in NAV Loans

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Guaranties are a common feature in fund finance transactions. Particularly in NAV loans, upstream and affiliate (or “sideways”) guaranties are used. Below we discuss some of the context for the use of these types of guaranties, as well as some of the issues that lenders should consider in relying on them.

**Upstream Guaranties**

It is not uncommon in NAV loan transactions for the borrower to hold the underwritten assets for the financing (*i.e.*, the fund’s portfolio of investments) through one or more controlled subsidiary holding vehicles (each, a “HoldCo”). Lenders may take a pledge of the management and economic interests in the HoldCos (rather than the underlying investments). In order to get as close to the underlying investments as possible (without taking a pledge), lenders may require that a HoldCo issue a guaranty directly to the lenders (or the administrative agent, on behalf of the lenders), guaranteeing the borrower’s obligations under the NAV loan facility. This “upstream” guaranty provides the lenders a direct claim against the HoldCo for amounts due under the loan, mitigating some of the risk of structural subordination to potential creditors (expected or unexpected) at the level of the HoldCo.[1]

**Affiliate Guaranties**

It is also common in NAV loan facilities for the borrower’s portfolio of investments to be held by multiple subsidiaries and/or affiliates of the borrower. Each such subsidiary or affiliate may be designated as a guarantor for repayment of the loan. As a result, such entities end up guaranteeing the obligations of their affiliates. The purpose of these affiliate guaranties is the same as the upstream guaranties discussed above – namely, to provide the lenders with a more direct enforcement claim in a default scenario.

**Use of Such Guaranties**

Motivations for the use of such upstream and affiliate guaranties may include:

- a lender’s desire to underwrite a broader portfolio of investments, mitigating concentration risk to the portfolio of a single holding entity;
- a lender’s desire to ensure that it is not subordinate to creditors that may arise at the level of the entity that directly owns the investment; or

- a borrower's desire to obtain a higher loan-to-value ratio than the lenders would otherwise provide based on the investments alone.

While upstream and affiliate guaranties can help to address these issues, they may raise nuanced legal issues that should be discussed with counsel in light of the relevant facts and circumstances.

**Enforceability Considerations**

Guaranties constitute the assumption of the liabilities of another entity and are contingent claims against the guarantor. Under certain insolvency laws, guaranties may be subject to challenge, and payments under guaranties may be subject to avoidance. Upstream or affiliate guaranties may be subject to heightened scrutiny and challenge in a bankruptcy or distress scenario. Below are a few potential issues lenders should bear in mind with respect to upstream and affiliate guaranties.

*1. Constructively Fraudulent Transfer Avoidance*. Under Bankruptcy Code section 548 and certain state laws, (a) transfers of property (including grants of security interests or liens), or (b) obligations assumed (such as incurring a loan or guaranty obligation) may be avoided as constructively fraudulent if BOTH of the following requirements are satisfied:[2]

- (i) the transferor/guarantor does not receive reasonably equivalent value; AND
- (ii) the transferor/guarantor is insolvent or undercapitalized or rendered insolvent, undercapitalized or unable to pay its debts because of the transfer or the assumed liability.

A guaranty by a parent of the obligations of a wholly owned and solvent subsidiary, a so-called downstream guaranty, is generally regarded as providing the parent with reasonably equivalent value through an enhancement of the value of its equity ownership of the subsidiary.

Upstream and affiliate guaranties require more scrutiny than guaranties by a borrower parent to determine whether any potential enforceability issues are present.

a. <u>Reasonably Equivalent Value</u>. The determination of value is not formulaic or mechanical, but rather generally determined by the substance of the transaction. Value or benefits from a transfer may be direct (*e.g.*, receipt of loan proceeds) or indirect. But if indirect, they must be "fairly concrete."

In each of the above scenarios, we are assuming that the upstream or affiliate guarantor would not use the proceeds of any loans and, consequently, would not be added to the loan facility as a borrower. However, other indirect but tangible benefits or value to the guarantor should be identified, *e.g.*, favorable loan terms or amendments, use of the NAV facility proceeds that may indirectly but materially benefit the guarantor, maintenance of the entire fund group of entities that benefits the guarantor, etc.

b. <u>Financial Condition of Guarantor</u>. The financial condition of the transferor/guarantor is evaluated at the time of the incurrence of the guaranty. The evaluation is made from the debtor/guarantor – in what condition was the guarantor left after giving effect to the transfer or assumption of the obligation. Diligence regarding a guarantor's financial condition may demonstrate that such guarantor is sufficiently creditworthy to undertake the guaranty and remain solvent and able to conduct its respective businesses. Representations from the guarantor may be sought to confirm its financial condition.

c. <u>Potential Mitigants</u>. In addition to performing diligence with respect to the above points, lenders and their counsel will often include contractual provisions to mitigate the possibility that a guaranty may be found to constitute a fraudulent transfer. Savings clauses, limited recourse guaranties, and net worth guaranties are all tools that can be used to address the issues noted above. The scope and appropriateness of such provisions is beyond the scope of this article and should be discussed with external deal and restructuring counsel.

*2. Preference Challenge*. Under Bankruptcy Code section 547, a transfer made by a debtor to a creditor, on account of an antecedent debt, that is made while the debtor was insolvent and within 90 days before the bankruptcy case has been commenced may be subject to avoidance as a preferential transfer. Certain defenses may apply to a potential preferential transfer, including the simultaneous exchange of "new value" by the creditor. However, note that any pre-bankruptcy transfers of value, like payments under a guaranty, may be subject to scrutiny and potential challenge by the guarantor/debtor or a bankruptcy trustee.

Guaranties can be an important element in structuring NAV loan transactions to achieve the terms desired by the parties and to provide necessary protections for the lenders, but consideration needs to be given to the legal issues, such as the ones mentioned here, that their inclusion can present.

**[1]** Lenders will typically also require the HoldCo to pledge its accounts to which proceeds of the underlying investments are paid, allowing lenders to foreclose on such cash at the HoldCo level, without the need for such cash to first be distributed up to the borrower.

**[2]** Note that the precise language of certain state fraudulent transfer laws may differ, but conceptually, most state statutes require a showing of (i) insufficient or unreasonably small consideration in exchange for the transfer or liability incurred, and (ii) the transferor/debtor being insolvent at the time of the transfer, or becoming insolvent or subject to financial distress as a result of the transfer.