Getting the Balance Right – Lender Controls Over Eligible Investments in NAV Facilities

January 24, 2025

By **John Donnelly**
Senior Attorney

Introduction

NAV facilities operate by taking a portfolio of assets owned by a borrower and selecting which assets within that portfolio a lender is willing to lend against. This pool of approved assets becomes the “Eligible Pool” of assets, against which the financial covenants can be set. The lenders will likely undertake an extensive due diligence on such “day one” eligible assets and most facilities will have an ability to add further eligible assets during the term of the facility (provided they meet the relevant criteria and the lenders are happy with the relevant diligence). This structure regulates how eligible assets can be added to the pool of assets for which the lenders are happy they can rely on for credit support.

Once that Eligible Pool is created, it needs to evolve throughout the term of the facility. One of the points on this Eligible Pool that will be the most heavily negotiated is how eligible assets can be removed from the pool (so their value is no longer given credit for financial covenant purposes). Most NAV facilities will have a concept of an “Investment Event” (or similar) which will specify certain events which would cause an eligible investment to be removed from the Eligible Pool and then the financial covenants to be automatically re-tested when that asset is removed. If such tests are failed, then there will likely be a mandatory prepayment triggered to bring the facility back into covenant compliance.

Events which trigger a removal

A number of the limbs of such an Investment Event are fairly settled and are not heavily negotiated (beyond agreeing a de-minimis level, where relevant). Clearly, these will depend on the class of underlying assets (the events which are relevant for a secondaries fund will be different to a PE buyout fund or a venture capital fund). These typically include: (i) a fall in investment value below an agreed threshold; (ii) an insolvency event at an asset level; (iii) a default of financial indebtedness owed at asset level; (iv) illegality/unlawfulness/reduplication (etc.) of the relevant investment documents; and (v) any material litigation at asset level. These are generally accepted items that go to the value of the underlying asset. Typically on the occurrence of one of these events, lenders would want to test the strength of the remaining pool of assets, to ensure they are suitably covered.

Amendments to investment documents

Where the drafting often becomes more heavily negotiated is around amendments to the relevant investment documents that would (if not approved by the lender) cause an investment to be removed from the Eligible Pool. Lenders will (logically) argue that they have gone through an extensive diligence process on the relevant investment documents detailing exactly how the borrower holds that asset and exactly how returns should be realised from that asset. Once they are comfortable with this on day 1, borrowers cannot simply go out on day 2 and amend the investment documents.

Flexibility required to manage a fund

This creates an inherent tension in the document. Borrowers will argue that they must be allowed the flexibility to operate their portfolio. In a large portfolio of assets, amendments to the relevant investment documents will likely be needed during the term of the facility. These may need to be done on tight time scales and, practically, deal teams may not be likely to remember the parameters on their amendment powers that a lender has put on them.

From a borrower perspective, the point is often raised that lenders have done diligence on the track record of the borrower to manage a portfolio and therefore the lenders should be willing to allow that fund to operate as it should (NAV lenders often receive some information on the investors in the fund, to investigate which investors have confidence in them and some NAV deals do still include a separate undrawn commitment ratio or liquidity covenant). NAV facilities will often include "Key Man" and similar provisions ensuring that the correct people remain in charge of the fund. For these reasons borrowers will negotiate to limit the scope of the amendments for which they will have to seek lender approval. Fears of hair triggers and constant requirements for lender consents hampering the operation of the fund, are legitimate points for a borrower to raise.

That said, for the reasons outlined above, lenders will insist on having some control over amendments to the investment documents relating to the assets that they have reviewed and are willing to give credit against. Term sheets will often include a refence to an Investment Event occurring "if amendments are made to investment documents out with agreed parameters" and the drafting is left for the long form documents stage.

Long form drafting

Long form documents usually deal with this in two ways. Firstly, some documents try to include all of the relevant line items that require lender consent. This provides clarity, but inevitably means agreeing a long laundry list of items (each of which is kept open ended). There is often a time and cost implications to this. The other way is to start the list with a generic reference to an event that could impact the investment documents in an adverse way for the lenders and then to agree a shorter (but not conclusive) list of items that would constitute such an event. This allows for a shorter list without the lenders needing to explicitly cover all bases.

Who makes the determination

It will often be a negotiated point as to who makes such a determination that there is an adverse impact on the lenders. Lenders will ask for this to be in their discretion (often "acting reasonably"); however, the practical implication of this is that all such documents would need to be sent to them for pre-approval, to make that determination. In order to give borrowers certain discretion over this, and to avoid unnecessary lender request, the discretion can sometimes be left subjective in the facility (rather than being solely in the discretion of the lender).

Amendments that are typically caught

In terms of the actual amendments that would require lender approval, in general terms these are amendments which go to the: (i) pricing; (ii) order of payment; (iii) the process for receiving distributions from that investment; and (iv) anything that would impact the way in which the lenders would seek recovery under their anticipated enforcement strategy (that should line up directly with the diligence they have done prior to entering into that facility). As a general rule, it could be said that these should mirror the events that would require a borrower to go to its own investment committee to approve an amendment (though clearly this would not cover point (iv) above). Negotiations on this often need to go into detail about exactly what the requirements on the borrower will be going forward and lenders need to be willing to understand exactly what situations the borrowers may face when managing that portfolio.

Requirements on lenders

Finally, where lenders have successfully argued that their sign-off is required on an amendment, they will also need to agree that they will approve those amendments (or not) within a reasonable time period after receiving sufficient information on that amendment. Borrowers could be frustrated if lenders hinder their ability to operate their existing pool of assets due to delays in this process.