

## Fund Finance Friday



### Taking Security in NAV Lending: The SPV Pledge

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When taking security over a portfolio of investments in a NAV facility, it may be difficult or costly to take security over the borrower's investments. A common solution is to implement what we refer to as the SPV pledge. Instead of getting a pledge of the investments directly, the SPV pledge entails a pledge from a fund (the "*Fund*") of its ownership interest in a wholly-owned special purpose vehicle (an "*SPV*") that in turn owns the investments themselves. The SPV pledge will also typically entail the SPV pledging its bank accounts to the lenders to which the distributions and sale proceeds in respect of the portfolio investments are required to be paid.

This article provides an overview of the SPV pledge and highlights some of the advantages and considerations that lenders should be aware of for its effective implementation.

**Practical Benefits of the Structure** The SPV pledge has a number of benefits when contrasted to taking security over each of the Fund's investments directly or foregoing asset-based security entirely. The following details certain of these benefits.

1. **Enforcement.** A key benefit of the SPV pledge is that it ensures that the lenders have a perfected security interest with respect to the portfolio of investments (albeit indirectly via the SPV). As a result, the lenders will have the ability to exercise self-help remedies with respect to the portfolio in case an event of default occurs under the NAV facility by foreclosing on the SPV (this is in contrast to collateral structures that do not include security over the portfolio). SPV pledges will include a pledge by the Fund of both its economic interests (e.g., limited partnership or membership interests) in the SPV as well as a pledge of (or otherwise the ability to acquire) the management rights over the SPV. Management rights in this context relate to the ability of the Fund and the general partner or manager (the "*GP*") of the SPV to exercise any discretionary decision making, voting or other rights relating to control of the SPV. Practically this means as part of a sale of the pledged SPV in a foreclosure, the purchaser of the SPV will acquire both the economic and management rights with respect to the SPV. This will allow the purchaser to then manage the portfolio in its discretion. It is a common misconception that the SPV pledge allows lenders to automatically take over and control a pledged SPV and its investments in a foreclosure. However, under the UCC, the sale of the pledged SPV interests are required to go through a UCC foreclosure sale process (e.g., a public or private auction where a third party purchaser might acquire the collateral instead of a secured party).
2. **Efficiency:** By taking security over the equity in the SPV, the lenders receive an *indirect* security over the pool of portfolio investments that they are lending against. This indirect pledge structure helps to avoid the additional complexities involved with obtaining direct pledge and transfer consents from the general partner, sponsor and/or issuer of each of the underlying investments that comprise the SPV's portfolio in order to ensure that the lenders have a perfected security interest. That is not to say that obtaining such written consents may not be prudent in connection with a SPV pledge (see prior coverage on this topic regarding indirect pledge restrictions in NAV secondaries facilities [here](#)), but by structuring the facility this way, it limits those considerations to commercial and risk issues and not whether the lenders have a perfected security interest in their collateral (*i.e.*, the pledged SPV).

#### Structuring the Pledge

1. Structuring the Pledge: Accessing Economic and Management Rights. For the reasons noted above, it's important for lenders to know upfront that, in the event of a foreclosure, they are able to transfer economic ownership of the pledged SPV as well as the corresponding management rights. As discussed below, there are a number of issues that lenders have to grapple with in ensuring the SPV pledge is properly structured to make sure this is the case.

*GP Replacement.* One approach is to add broad GP replacement language into the SPV's LPA (or equivalent governing document) through an amendment to the LPA, or alternatively, confirm that such replacement language is already included in the LPA. The language should provide that the limited partners or members of the SPV have an unfettered right to replace the GP upon notice at any time and for any reason (i.e., without cause). When the GP replacement language is included in the LPA, this in turn allows the economic equity owners (including purchasers of the SPV in a foreclosure sale) to ultimately have the ability to acquire the management rights over the SPV. As a result, the SPV pledge would only need to be structured to include a pledge of the limited partner or member interests.

*The GP Pledge.* Where amending the SPV's constituent documents isn't practical to permit replacement of the GP (e.g., where the GP has a material economic interest in the SPV), the common practice is to get a pledge of the GP's interest in the SPV (along with the pledge of the limited partner or member interests). This can be accomplished by either (a) a pledge by the GP of its interest in the SPV or (b) a pledge by all of the GP's owners of their equity interests in the GP. In either case, the constituent documents of both the SPV and the GP should be carefully reviewed to confirm that the contemplated pledge is permissible and that there are no restrictions on the GP's (or alternatively, the GP owners') ability to pledge their interests and any subsequent transfer of such interests in a foreclosure. The outcome of that diligence might be a key factor that determines the proper course of action to establish the security over the GP's interest in the SPV (e.g., a pledge of GP's owners' equity interests in the GP may not be available if the GP is also the general partner or manager for other funds managed by the same sponsor that are outside the scope of the NAV facility).

2. Structuring the Pledge: Necessary Consents. Lenders must also obtain any requisite consents for the direct pledges and transfer of the pledged SPV interests. In particular, the pledge and transfer restrictions set forth in the SPV's LPA should be carefully reviewed to determine the scope of the consents that may be required and who needs to provide those consents. This is a critical step in order to provide comfort to the lenders that their security interests will be valid and perfected upon the filing of a UCC financing statement and the lenders will be able to transfer the SPV in a foreclosure without further assistance from the Fund. More often than not, the result is that the GP will need to provide a written consent to both the pledge by the Fund of its interests in the SPV as well as to the transfer of such interests to a third party following an enforcement and foreclosure. Unlike the direct pledges for secondaries funds where general partners are more likely to resist pre-consenting to transfers of fund investments upon a foreclosure, the GP in the SPV structure will, as part of the consideration for the secured financing transaction, generally agree to the inclusion of the pledge and transfer language in the applicable loan document to which it is a party, or otherwise in a standalone consent letter. When possible, lenders should aim to be direct signatories to those consent documents or otherwise express third party beneficiaries.

While the SPV pledge structure is a common and practical way to approach the collateral package in a NAV facility, lenders should be mindful of the relevant structures and considerations that may come into play for each particular trade. As always, we are here to assist and answer any questions you have relating to the proper documentation requirements for your SPV pledge NAV facilities.