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NAV Finance Due Diligence: Current Themes From the European Market

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Due diligence is a key aspect of the legal structuring and execution of fund finance facilities. In the subscription line market, there are generally well established conventions for performing due diligence on, in particular, the capital call mechanisms.

By contrast, in this article, we look at due diligence considerations in NAV financing; while this segment of the market is less settled in its approach, there are emerging trends in terms of approach to due diligence. Here, we consider these issues primarily from the perspective of the European market, though many of the issues will apply generally.

In that light, here are some issues to consider, on a non-exhaustive basis:

- **Key fund document parameters:** The limited partnership agreement (LPA) for the master fund partnerships should be reviewed for provisions that would be inconsistent with the financing. Where the Borrower of the NAV facilities is the master fund itself, and ideally even where it is not, lenders will want to understand the termination date of the fund (which should not fall earlier than the maturity of the facilities) and any restrictions on borrowing and/or granting of security. It is common for LPAs to confer permission to borrow and pledge assets subject to conditions, for instance that the debt must be short term and/or for managing working capital or liquidity. This may not easily encompass the incurrence of term debt. While a “non-conflict” opinion is often obtained from the fund’s counsel, this will inevitably make substantial assumptions of fact as to the compliance of the facility with any borrowing limits. And such an opinion may not be offered at all where the fund itself is not the Borrower. But even where the borrower is a subsidiary of the fund, such as an aggregator or a “finco”, consider whether, properly construed, any borrowing limitations in the fund LPA are intended to apply to it.
- **Limited partnership borrowers:** Wherever the borrower is a limited partnership, as well as addressing usual issues of power, capacity and authority to enter into the Finance Documents, lenders and their counsel should also consider a number of issues specific to this type of entity, including:
  - whether limited partners have the right to demand redemption of their interests, and subject to what restrictions; where such provisions exist, consideration will need to be given as to how to cope with any attendant liquidity risk;
  - what consents, if any, may be required from any general partner (GP), investment manager, investment manager, depositary or other office-holder in respect of the partnership, to permit the entry into of the finance documents; and
  - whether claims of the limited partners on the partnership are effectively subordinated to the debts of the partnership, under the terms of the LPA and/or under applicable law.

- **Other indebtedness:** Where the obligors under the NAV facility also have material other indebtedness (for instance, where a fund borrower also has a subscription line facility in place), it will be necessary to establish what credit recourse (e.g. guarantees and security) benefits that indebtedness, and whether any consents are required from the other financier(s). In some cases, intercreditor or lien recognition arrangements will be prudent.
- **Investments:** In a NAV financing – particularly in deals with security over investments – it's common for lenders to require due diligence on the investments and their holding structure. Selected issues typically addressed include:
- **Control of assets**: Lenders will typically want to consider the degree to which the interests being pledged to them confer control over the underlying investments. By way of example, pledged interests may include shareholdings in asset-specific holding companies, or shares or limited partnership interests in aggregator vehicles. Issues to consider include:
    - Where the relevant holdings represent minority stakes in investments, what level of protection does the borrower, as a minority investor, enjoy in terms of protection of its economic rights, including its right to participate in any exit? So, for instance, are there any reserved matters requiring consent of the minority investor? Are there tag-along rights, or pre-emption rights?
    - The pledged interest may not consist of a voting position. Quite commonly, it is a passive economic interest, such as a limited partnership interest. Such an interest will not, of itself, confer control of the pledged entity on the lenders, or any buyer in the event of enforcement. In such cases, consider what, if anything, should be done to provide assurance that the general partner of such an entity will take reasonable steps to liquidate assets in order to provide distributions to the holder. Taking security over the GP entity itself is sometimes an option. Where not, a "GP cooperation letter" may be considered, stipulating that, particularly after an event of default on the NAV loan, the GP will make appropriate efforts to realise assets. We have seen such cooperation letters on recent deals in the European market. In our view they may become more common as a lender protection.
- **Pre-closing reorganisations**: In NAV financings, it's reasonably common for the fund to reorganise its investment holding structure before completing the financing, for instance by moving the investments under an aggregator. These reorganisations may be complex and bespoke, and are not necessarily risk free for lenders. Lenders should obtain evidence of the legal completion of any asset transfers. Is there any material risk of such transfers being unwound? Consideration should be given as to the tax impact of any such reorganisation; as ever, tax issues may be more or less complex depending on the nature of the assets, their location and the fund's jurisdiction of domicile. In some cases, lenders may seek reliance on a tax report.
- **Issues affecting the taking and enforcement of security:** Lenders who are taking security over NAV assets will wish to be assured that the documents in the chain through which the investments are held – so, constitutional documents, investment agreements and shareholders' agreements, among other things - do not contain provisions that would preclude or impede the taking or enforcement of the security. Lenders may also wish to consider whether there could be any regulatory impediments to a sale on enforcement. While lenders will sometimes rely on representations covering these matters, it's still relatively common to perform due diligence. This is often in the form of a report completed by the fund's own counsel, who will be most familiar with the documents. Examples of relevant issues include:
    - **Documentary issues:** Are any consents required (e.g. from co-investors) to take the security or transfer the pledged assets? What documentation would a transferee need to accede to, and who needs to sign it? What action (such as KYC approval) might be required by parties not under the control of the enforcing lenders or their proposed transferee? Would the taking or enforcement of the transaction security render the fund a defaulting investor under any relevant documents, and with what consequences? Are there any drag, tag or pre-emption rights that would be activated on the taking or enforcement of the security, and what are their terms?
- **Regulatory issues:** Enforcing security over private investments, whether by the lenders taking or control or by a sale to a third party, may raise regulatory issues of kinds common in private M&A. Anti-trust filings may be required, as may consents or notifications under national security and inbound investment legislation (such as the UK's National Security and Investment Act 2021). In some cases, for instance where invested businesses operate in regulated sectors, there may be licensing conditions that need to be fulfilled by any transferee. Defining exactly what the relevant factors are, and how they would apply in any specific scenario, is complex and may be difficult, dependent as it will be on the nature of the investments, the jurisdictions in which they operate, the identity of any transferee, and possible future changes in law. In our experience, this is an area of increasing interest for lenders, who may seek practical solutions such as obtaining information at the outset as to how such issues were addressed when the borrower fund acquired the assets. Lenders may with the borrower information and assistance

undertakings designed to improve the lenders' ability to navigate such issues if they ever enforce. Where there are particular sensitivities given the nature of the portfolio, more bespoke solutions may be required.

Approaches to due diligence in practice vary widely, reflecting the complexity of fund structures and the bespoke nature of NAV financings. The range of issues to be covered, and how due diligence is performed, will always depend on the particular circumstances and on discussion between the parties. But whatever approach is taken, in a world as complex as NAV financing, there will always be a need to evaluate the structure, the documentation, where any risks lie, and how to mitigate them.