

# Fund Finance Friday



## Payment Direction Letters: Their Role and Usage in NAV Financings

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In net asset value (“NAV”) financings, a payment direction letter (“PDL”) is a useful tool that may be entered into in order to control the flow of cash from the underlying portfolio investments directly to a lender controlled account. As noted previously (see [here](#)), in a NAV facility, borrowers often operate within a corporate structure where portfolio investments are held by holding vehicle subsidiaries (“Intermediate Entities”).

In such structures, a PDL is often important because NAV facilities are often underwritten in large part based on the cash flows from the underlying portfolio investments (i.e., distributions and liquidation proceeds). Additionally, NAV facilities are often structured to be self-liquidating in the event the loan is not repaid on time, such that, the outstanding loan is paid back automatically without the fund manager having to take any manual action as cash flows are received from the underlying portfolio investments.

PDLs:

1. bridge-the-gap between (x) the security interest over the controlled account in favor of the lenders, which, subject to the terms of the applicable Account Control Agreement, contemplates either “springing” control, whereby the lenders are able to take full control of the account upon the occurrence of an event of default under the NAV facility or “blocked” control, whereby prior lender consent is required in order to move funds out of the controlled account and (y) the receipt of distributions and proceeds from the underlying portfolio investments;
2. reduce (x) commingling risk (e.g., cash which should be deposited into the controlled account being diverted to another account) and (y) foreign jurisdiction risk (e.g., local garnishment orders or foreign seizures of underlying portfolio investment assets at the Intermediate Entity level);<sup>[1]</sup>
3. ensure that the Intermediate Entities are required periodically (usually monthly or quarterly) to promptly (and no later than a set number of days following such period end date) distribute funds into the controlled account; and
4. by virtue of redirecting funds into the verified controlled account, operate as a secondary check for AML and KYC requirements, ensuring that funds originate from or flow from authorized/screened entities.

The common use cases for PDLs are:

1. Where the underlying corporate structure contains multiple layers of Intermediate Entities and the underlying portfolio assets are held at the lowest Intermediate Entity level and such Intermediate Entities are not pledging collateral in connection with the NAV facility;
2. Where the sponsor of the underlying portfolio investment(s) does not have a robust relationship with the lenders;  
or
3. Where the distribution of funds are coming from the issuances of portfolio investors in a concentrated portfolio.

## Key Functions and Structural Considerations of PDLs in NAV Facilities

PDLs provide irrevocable instructions to the Intermediate Entity to pay distributions directly to the controlled account. In addition to the aforementioned, PDLs should contain:

1. an irrevocability clause which explicitly states the instructions are irrevocable and cannot be rescinded or modified by the borrower or the Intermediate Entities without the lenders' prior written consent;
2. detailed banking information for the controlled account, including the account name, number, routing/SWIFT details;
3. a description of the scope of proceeds required to be funneled into the controlled account, which typically includes any and all distributions, dividends, returns of capital and other payments (including, for the avoidance of doubt, any sale proceeds) received by an Intermediate Entity for the benefit of the borrower or applicable loan party; and
4. a direction to the Intermediate Entities for periodic (usually monthly or quarterly) distributions of funds (i.e., held for the benefit of the borrower or applicable loan party) into the controlled account.

It is important to ensure that the terms of the PDL are consistent with the constituent documentation of the Intermediate Entity. For example, in scenarios involving a general partner authorizing payment directions in which said general partner required a consent or authorization from another party (i.e., not privy to the PDL) pursuant to the terms of the constituent documentation and such consent or authorization was not obtained, a lender may find the PDL declared void or unenforceable by a court.<sup>[2]</sup>

Additionally, if a PDL directs 100% of an asset's proceeds to a lender to pay down a NAV loan, but the constituent documentation require certain "tax distributions" or management fees to be paid first, the general partner (i.e. of the Intermediate Entity) may be in breach of its fiduciary duties and payments made via such PDL might be subject to "clawback" by the Intermediate Entity's liquidator or other creditors if the fund later becomes insolvent, arguing the payment violated the Intermediate Entity's internal priority rules.

In such scenarios, the lender's "first priority" claim is legally subordinated and, as a consequence, a court may rule that the PDL was an illegal "preference" or a breach of the contractual waterfall, forcing the lender to return the funds to the estate unless the lenders ensure that said manager agrees to subordinate its management fees, on or prior to entering into the PDL. That said, the abovementioned issues can be mitigated by drafting to permit netting of certain amounts in appropriate circumstances.

It is commonplace for PDLs to be used by lenders to facilitate "cash sweeps". Such PDLs will often contain provisions specifying that if an event of default or cash control event has occurred and is continuing, managing vehicles of the Intermediate Entity will procure that all monies received are promptly (and, no later than a specified time (usually three (3) to five (5) Business Days)) paid into the controlled account.

A PDL is often the primary mechanism for securing repayment and, as such, any failure to properly execute or enforce it undermines the facility's security structure. Lenders may be held liable for failing to follow an irrevocable direction contained in a PDL (e.g., misdirecting a distribution or failing to sweep a controlled account or sweeping an account without sufficient notice after previously allowing funds to pass through) pursuant to the implied covenant of good faith and fair dealing.<sup>[3]</sup>

<sup>[1]</sup> See *In re SunEdison, Inc.*, 576 B.R. 453 (Bankr. S.D.N.Y. 2017). Whilst this case centered on whether LPAC approval was required prior to the elimination of a limited partner's partnership interest for failure to comply with a capital call required by the limited partnership agreement, it provides a strong argument that courts will hold the terms of the underlying constituent documentation paramount in situations where a managing party breaches its terms by entering into third party arrangements or acting on behalf of the partnership.

<sup>[2]</sup> See § 1-304; **§ 1-201(b)(20)**. Importantly, under the UCC § 1-302, the obligation of good faith **cannot be disclaimed** or waived by agreement.

<sup>[3]</sup> Foreclosure on foreign assets often requires approval from local regulators or triggers "rights of first refusal" from other local investors, which can effectively block a lender from taking control of the asset.