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Structuring Security for NAV Loans

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We continue our focus this week on NAV loans, discussing common issues that arise in evaluating the security structures for such loans. For our purposes, NAV loans refer to loans to private equity funds where the value of the portfolio companies comprising the investment assets of the fund support the private equity fund borrower’s loan obligations. In other words, lenders are underwriting the value of the private equity fund borrower’s investments in its portfolio companies, as opposed to another asset of the fund (*e.g.*, capital call rights). NAV loans take on different structures and serve a variety of purposes for the private equity funds using this form of financing. In some cases, the security for these loans may be limited to the proceeds of the fund’s investment assets (which may come in the form of interest, dividends, IPO proceeds or sale proceeds), along with a pledge of the cash account to which such proceeds are paid (typically accompanied by a negative pledge covenant with respect to the borrowers’ assets and other financial and indebtedness restrictions on the borrower). But lenders often seek a more fulsome pledge of a borrower’s rights and ownership with respect to its investment assets. This approach has a number of benefits to lenders, including crystallizing the priority of the lenders’ interest in the borrower’s assets and facilitating easier enforcement of remedies and recovery of loan obligations after a default. However, taking a pledge directly over the borrower’s investment assets isn’t without its potential pitfalls. As discussed below, understanding the requirements for such a pledge, the accompanying legal and contractual implications, and the limitations that may exist in connection with enforcement upon a default is critical to constructing an effective security package that works for both borrowers and lenders.

Whether a security interest can be validly obtained requires an analysis of (i) the terms of the interests that are being pledged and (ii) the law governing a pledge of such interests.

- The constituent documents of the entities to be pledged (whether an investment aggregator vehicle, holding company or the portfolio company itself) may contain provisions governing pledges and transfers that range from outright prohibitions to requirements for consent to any such pledge or transfer, either by the manager of the entity (*e.g.*, the general partner, investment manager or board of directors) or the other investors in the entity. A valid pledge generally requires compliance with such provisions. In some cases, where the pledged entity is under the direct control of a borrower or its affiliates (*e.g.*, a top-level holding company established by the borrower), obtaining any required consents to the pledge may be simple. In other cases, the borrower may need to seek waivers of such restrictions or obtain consents from unaffiliated parties to the pledge, which may be cumbersome and is often a topic of discussion when borrowers and lenders structure these types of loans.

- Depending on the jurisdiction of the entity being pledged, the legal regime for the pledge will vary. Local counsel should be consulted in all instances to understand and ensure compliance with local legal requirements. By way of example, some jurisdictions provide for pledge by title transfer, which may not be practical for a NAV loan. A title transfer may create tax complications or may require the pledgee to assume any outstanding financial commitments associated with the pledged interests, even prior to formal foreclosure on the asset. In some jurisdictions, this issue may be addressed by bifurcating the pledge between a pledge of receivables with respect to the asset and a springing pledge that takes effect upon default with respect to the ownership rights of the pledgor. In addition, in some jurisdictions, it may be necessary to register the pledge, submit regulatory filings detailing the pledge, or satisfy various other legal or regulatory requirements.

Should lenders seek to dispose of pledged interests following a default, it is important to understand in advance what requirements may apply and what consequences may ensue in respect of underlying assets. Below is a description of some common issues that may arise in this respect.

Contractual Consent Requirements. The investment agreements setting for the terms of a borrower's investment in a portfolio company (*i.e.,* a shareholders agreement, purchase agreement, limited partnership agreement or similar agreement) may prohibit the borrower from transferring its ownership in the company without advance consent. Such consent requirement may be narrowly tailored (requiring consent only in respect of a change of the direct investor in the portfolio company) or may be broadly constructed (requiring consents for transfers of beneficial ownership, including transfers of interests in upstream holding companies). Further, such consent requirements may apply to any transfer or only to a transfer resulting in a change of control of the company. Additionally, such agreements may include punitive consequences for violations of the terms thereof, such as a loss of voting rights, a forced transfer of interests in the company or a diminution of the value of the investment. Such punitive provisions are more likely to exist (and apply to the borrower) for investments where the borrower is a minority investor and are less likely to exist where the borrower is the majority (or sole) investor. In addition, loan agreements and bond indentures governing the debt of a portfolio company or its holding company may contain similar provisions. Violating such restrictions may result in acceleration of such debt and liquidation of any accompanying collateral, which could adversely impact the value of the borrower's investment (and the lenders' collateral). Lenders and borrowers should be apprised as to the scope of transfer restrictions, the identity of any parties that must provide consent and the consequences of effecting a transfer without first obtaining such consent. In some cases, it may be possible to obtain advance consent to certain transfers upon foreclosure.

Transfer Conditions and Deliverables. Investments in holding companies or portfolio companies may be limited to certain types of investors (*e.g.,* U.S./non-U.S. persons or non-

ERISA investors) and may be prohibited if certain adverse tax or regulatory consequences would result, or onerous registration or licensing requirements would arise. Further, transfers may require delivery of legal opinions, subscription agreements, transfer or joinder agreements or similar deliverables.

Buy-Sell Provisions. The investment agreements governing an investment in a portfolio company may also confer upon investors certain rights in respect of sales of interests by other investors, such as rights of first refusal (ROFR) or first offer (ROFO), shotgun clauses, tag-along rights or drag-along rights. A ROFR provides a non-selling investor a right to accept or refuse an offer by a selling investor after the selling investor has received a third-party purchaser offer. A ROFO provides a non-selling investor a right to be offered the interests to be sold prior to any solicitation of external offers commences. Shotgun clauses are provisions that force an investor to either buy out an offering investor or sell its interests to an offering investor. Tag-along rights allow minority investors to participate in a sale by a larger investor that is selling its shares, and drag-along rights require a minority investor to sell its shares alongside a sale by a majority investor – in each case on the same price, terms and conditions of the majority investor. The existence of such rights may impact the timing for any sale and/or the ability of the lenders to maximize value from third-party offers.

Regulatory and Self-Regulatory Requirements. The investment portfolio of a borrower may include portfolio companies that are subject to regulation, and changes of ownership may require notice to and/or prior consent from regulators, self-regulatory bodies or other interested persons (*e.g.*, clients, in the case of an investment adviser). Examples that we have encountered recently include gaming companies, insurance companies, banks, broker-dealers, investment advisers, professional sports franchises, defense contractors and foreign listed entities. Such requirements may impose additional time and cost burdens and may limit the scope of potential purchasers of pledged assets. In many cases, transfers of interests in regulated entities will also require proactive cooperation by the borrower.

In order to identify, assess and address potential issues in crafting a deal structure, and to avoid late-stage surprises that could derail a deal, the parties should have a clear understanding of the borrower's investment structure early in the process. This requires identifying all ownership layers, relevant jurisdictions, material contracts and regulatory touchpoints. We'll leave for another day the various strategies that are employed to address the restrictions, requirements and limitations described above.