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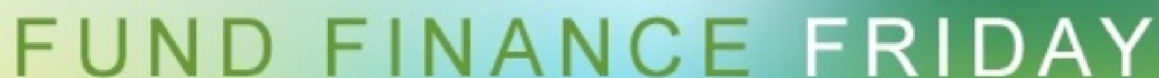

Honoring and Remembering

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Structural Risks for NAV Secondaries Facilities: The 'Indirect Pledge'

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This week we continue our focus on NAV loans and, more specifically, a common structuring issue for NAV secondaries facilities: the "indirect pledge." For our purposes, NAV secondaries facilities refer to loans to secondary private equity funds (*i.e.*, funds that invest in other private equity funds, primarily by purchasing existing commitments from limited partners seeking to exit their investments). For these types of facilities, the value of the borrower's portfolio of fund investments ("Portfolio Investments") support its loan obligations. As discussed below in greater detail, the primary structural risk for a transaction of this type is that lenders typically will not have a direct security interest in the assets that support the borrower's loan obligations (*i.e.*, the Portfolio Investments themselves), instead taking an "indirect pledge."

Almost universally, the terms of the underlying fund documentation governing each of the Portfolio Investments will stipulate that granting direct security in the Portfolio Investment, in addition to any future transfer of such Portfolio Investment (*i.e.*, in connection with a foreclosure by a secured creditor), will require the consent of the portfolio fund's general partner or manager (as applicable). Obtaining such consents can be a cumbersome process for which there is no assurance of success, as some general partners may be wary of pre-consenting to a transfer of a Portfolio Investment to an unknown third-party transferee in a foreclosure scenario without imposing conditions. In order to mitigate these issues, NAV secondaries facilities are typically structured so that the borrower will hold the Portfolio Investments in a wholly owned special purpose vehicle ("SPV"). This structure allows the borrower to pledge the equity interests in the SPV to the lenders as collateral for its loan obligations. In other words, by pledging the equity interests in the SPV, the borrower provides the lenders with an "indirect pledge" of the Portfolio Investments. Note that in addition to the pledge of the limited partnership interests (or equivalent) in the SPV, the lenders would also typically receive a pledge of the management rights of the SPV. This would be obtained either via a pledge by the SPV's general partner of its general partnership interest therein or a pledge by the SPV general partner's parent entity of its equity interests in the general partner. To avoid any leakage of value from the underlying fund portfolio, the SPV will also complete the collateral package by providing the lenders with security over the SPV's cash accounts to which distributions from the Portfolio Investments are paid. It is also worth pointing out that what we have described here is the most common/simple structure for NAV secondaries facilities and that there are variations of this structure, with the common theme being an "indirect" (as opposed to direct) pledge of the Portfolio Investments supporting the loan obligations.

There are a number of issues that lenders must be cognizant of when dealing with "indirect pledge" structures. We have highlighted a couple of these key considerations below:

Indirect pledge means indirect foreclosure. Since there is no direct pledge of any of the Portfolio Investments, lenders will not be in a position to unilaterally liquidate individual Portfolio Investments in a foreclosure. It is a fairly common misconception that upon an event of default, the lenders can just take "control" of the SPV and liquidate the Portfolio Investments as they see fit, then returning the SPV (with the remaining assets) to the pledgor. However, secured creditors may not necessarily be afforded such rights under applicable law, at least not without the consent and cooperation of the borrower and the SPV. Instead, upon an event of default, the lenders are limited to foreclosing on the assets that actually constitute the collateral, which in this scenario would be a sale of the equity interests in the SPV (*i.e.*, an "indirect" foreclosure of the Portfolio Investments). What this means practically is that any foreclosure would require the sale of the entirety of the portfolio of Portfolio Investments together. This lack of flexibility may not result in maximization of the liquidation value of the portfolio, as buyers in a foreclosure sale may be more interested in certain Portfolio Investments than in others. In order to mitigate this concern, we frequently see contractual obligations for the borrower to take the lenders' instructions following an event of default regarding the disposition of individual Portfolio Investments. More so, given that these facilities are typically significantly over-collateralized, the borrower is incentivized to work cooperatively with lenders in identifying specific Portfolio Investments to be liquidated in order to maximize the residual value to the borrower following a foreclosure.

Indirect pledge and transfer restrictions. Just as the general partner of a Portfolio Investment may object to the borrower's grant of a direct security interest in such Portfolio Investment, that same general partner may similarly object to (a) the creation of the "indirect" security interest arising from the pledge of equity interests in the SPV and/or (b) the "indirect" sale or other liquidation of the Portfolio Investments via a foreclosure sale of the equity interests in the SPV. Taken together, if it sought to interfere, a motivated general partner may adversely affect the timing, process and (potentially) the ultimate ability of the lenders to practically implement certain of its enforcement rights provided under the collateral documentation (as described above). Lenders may seek to mitigate this risk by conducting additional due diligence of the underlying fund documentation governing each of the Portfolio Investments. In particular, the substance of such review should focus on: (i) whether such underlying fund documentation prohibits indirect pledges and transfers (either generically or with a detailed prohibition that more clearly describes the facility's collateral package) and (ii) the specified consequences of a breach of such a prohibition. For example, the limited partnership agreement for a Portfolio Investment may simply specify that an indirect pledge or transfer is "null and void"; alternatively, it may specify more punitive consequences, such as deeming the relevant limited partner (in this scenario, the SPV) a defaulting partner that loses voting rights and/or rights to distributions, that is subject to a forced sale of its interest, and/or that is subject to a write-down of its equity by the general partner of such portfolio fund. While lenders may take different views as to the significance of a portfolio fund's limited partnership agreement declaring an indirect pledge or transfer "null and void" (*i.e.*, a pledge or transfer where the relevant persons are not actually parties to the limited partnership agreement in the first place), lenders and borrowers both want to avoid violating any such prohibition that has specific punitive contractual consequences for such violations. Borrowers do not want their financing arrangements negatively impacting the value of their investments, and lenders do not want to lend against assets whose value will be impaired either by the existence of the indirect security or the lenders' attempts to foreclose thereon. In these instances, the parties should seek the upfront consent of the relevant Portfolio

Investment's general partner to the indirect pledge (and, if possible,) the indirect transfer of such Portfolio Investment upon foreclosure. If the borrower is unable to obtain such a consent for such a Portfolio Investment, lenders may assign a reduced value (which may be zero) to that Portfolio Investment in calculating the borrowing base for the loan.

As should be clear from the discussion above, the indirect pledge structure that is commonly used for NAV secondaries facilities is an imperfect solution to the issues that arise when seeking to lend against, and take security over, private equity fund interests. However, most of the resulting concerns can be significantly mitigated by careful structuring to ensure lender and borrower incentives are aligned, and by doing thoughtful diligence of the Portfolio Investments.

Private Fund Disclosure – Times Are Changing

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Recent days have offered us a couple of data points indicating that the private fund disclosure regime is under review at the SEC and that this review is a priority at the agency.

SEC Chair Gary Gensler discussed the review and its priority in House committee **testimony** this week, stating, “Given the growth and changes in private funds, I’ve asked staff for recommendations for consideration of enhanced reporting and disclosure through Form ADV, Form PF, or possible other reforms.” Days earlier, SEC Commissioner Allison Herren Lee discussed the imperative of “ensuring investors are protected and small businesses are supported in the private markets” in a **speech** to state securities regulators.

The rapid growth in private markets in recent years poses challenges to regulators. The historic approach of simply excluding certain investors has become less practical as the amount of capital raised in private markets now far exceeds capital formation in public markets. According to SEC data, exempt offerings accounted for approximately $2.7 trillion of new capital raised in 2019, compared to $1.2 trillion in registered offerings in the year.

In response, the SEC moved last year to broaden the Accredited Investor definition, allowing a wider group of non-institutional investors access to private markets. The comments made in recent days suggest broadened market access may come with strings attached over time, potentially starting with heightened disclosure requirements.

FFA Announces Upcoming ESG Fund Finance Webinar

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Details are out on the FFA NextGen's upcoming webinar, "Spreading the mESsaGe – ESG's Rise in Fund Finance." Speakers include representatives from Bank of America, Citibank, The Carlyle Group and our own Wes Misson. The discussion will cover ESG loan features, notable recent transactions, pricing considerations, and LP approaches to investing and is set to take place on June 9 at 12:00 p.m. Eastern via Zoom. Registration is open at this **link**.

To learn more about Cadwalader's Environmental, Social & Governance (ESG) Task Force, **click here**.

WFF Global – The Israeli Private Equity Space from a Female Perspective

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Join Women In Fund Finance on Wednesday, June 2 to learn more about Israel's growing private equity industry from women involved in the Israeli finance and innovation scene. The event begins at 11:00 a.m. EDT. Register **here**.

FFA Announces '2021 FFA Industry Awards' Honorees

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After much deliberation, the Fund Finance Association committee is thrilled to announce the recipients of the 2021 FFA Industry Awards. Please click **here** to read about the 2021 winners of the “Diversity in Fund Finance Award,” the “2020 Annual Contribution to the Industry Awards,” the “Julian Black Lifetime Contribution to the Industry Award,” the “Dee Dee Sklar Women in Fund Finance Award” and the “NextGen Member of the Year Award.” Congratulations to all of the outstanding honorees and nominees.

Walkers Video Spotlights Cayman's Popularity as PE Funds Destination

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Walkers has published a video, "WalkersGo: Cayman is King for Private Equity," that reviews some of the key reasons that have established the Cayman Islands as a premier jurisdiction for PE funds formation.

Even with the introduction of new laws in various jurisdictions that are aimed at facilitating fund formation, the video asserts that the Cayman Islands is the most popular destination for PE funds for both historical reasons and more recent practical and market-friendly updates to its laws.

The WalkersGo video is available **here**.

Fund Finance Hiring

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Fund Finance Hiring

Wells Fargo is looking to add an Associate to its Subscription Finance team, resident in New York, Charlotte or Los Angeles. For more on the position and how to apply, click **here**.

Cadwalader is looking to hire an experienced finance associate (3-4 years PQE) in its Fund Finance group in the London office. The candidate should have experience working as borrower or lender-side counsel on fund financing transactions or be a general finance lawyer keen to specialize in this field. The applicant should be a self-starting, highly motivated individual who enjoys working in a busy team environment. For more information or to suggest candidates, please contact Cadwalader's **London recruitment team**.