

CADWALDER

## Assessing ‘Bad Acts’ Risk in NAV Facilities (Part 1 of 2)

May 20, 2022 | Issue No. 176



By **Brian Foster**  
Partner | Fund Finance



By **Patrick Calves**  
Partner | Fund Finance

One aspect of NAV loans that lenders often focus on is the risk of “bad acts” by a borrower with respect to the investments that underpin the loans. For our purposes, NAV loans are loans to alternative investment entities (*e.g.*, private equity funds, secondaries funds, hedge funds, funds of hedge funds, pension funds and family office vehicles) that are underwritten, either on a secured or unsecured basis, by the value of the entity’s investments. When entering into NAV loans, lenders assess the investments owned by the borrowers at closing and then continue to monitor such investments after closing for compliance with financial covenants and other loan requirements. Unlike other types of securities financings (think prime brokerage, securities lending and repo, or typical bank margin loans), where a lender or a third-party custodian on behalf of the lender holds or controls the securities on which the loans are underwritten, the underwritten assets in NAV loans are typically owned and controlled by the borrower, either directly or through one or more subsidiary holding vehicles. Further, even in secured loan facilities, the investments themselves often are not pledged to the lenders directly by the borrower. Instead, the investments are typically owned by subsidiary holding vehicles the equity interests of which are pledged to the lenders as collateral for the loan (*i.e.*, an “indirect pledge” of the investments). See a previous discussion of some of the issues associated with indirect pledge structures [here](#). As a result, the borrowers (directly or indirectly) typically maintain complete control over the assets that the lenders are underwriting.

On top of the “market risk” inherent in NAV loans (*i.e.*, the risk that the value of the borrower’s investments will decline), because a borrower typically remains in control of its investments, such structures involve a degree of “bad acts” risk. For our purposes, “bad acts” refer to actions by the borrower that cause or result in the investments ceasing to be owned by the borrower, or becoming subject to the claims of other creditors, in each case in contravention of the terms of the NAV loan. In this article, we briefly discuss factors that lenders analyze in evaluating the risk in NAV loans of the potential for these bad acts by borrowers. These factors broadly include (i) the profile of the borrower; (ii) the scope of the lenders’ relationships with the borrower; and (iii) the nature of the investment portfolio on which the loan is underwritten.

**Profile of the borrower.** One of the key factors that lenders consider in evaluating bad act risks with respect to NAV loans is the market profile of the borrower, or more specifically, the borrower’s sponsor. Lenders may evaluate factors such as:

- **Frequency of use of financing:** Certain sponsors are serial users of financing such that the use of financing is an integral part of the sponsor’s business model. An example would be a secondaries sponsor that consistently employs financing to acquire portfolios of private equity interests in the secondaries market. Lenders may take comfort from the fact that such a sponsor has a verifiable track record of responsible use of NAV loan financing. Further, lenders may view the sponsor’s continued need for financing to operate its business as an effective incentive to avoid defaults under the sponsor’s existing financings, particularly as a result of bad acts.
- **Breadth of the sponsor’s “brand”:** Certain sponsors have brands that expand well beyond the fund involved in the particular financing. Such sponsors may be affiliated with larger financial institutions, or may have extensive asset management platforms encompassing a broad range of investment strategies, products and asset classes. Lenders may take comfort in the resources such platforms have dedicated to monitoring and compliance, and may perceive sponsors on such platforms to be more averse to the type of negative publicity and reputational harm to the sponsor’s overall brand that would be associated with any bad acts.
- **Sources of equity capital:** Lenders often take comfort from a sponsor’s management of a significant amount of external money. External capital (and particularly institutional capital) can act as a check on certain types of behavior. Lenders may be concerned that investment entities with captive sources of capital (such as family offices, by way of example), may evaluate potential consequences of a financing default solely in the context of a specific

transaction and lender relationship, whereas sponsors beholden to large and sophisticated external investors may be forced to account for broader consequences (e.g., the need to raise additional capital for future fund launches).

Relationship between the lenders and the borrower. Another key factor that lenders consider in evaluating bad act risks with respect to NAV loans is the lender's overall relationship with any given borrower or sponsor. Financings are often entered into with alternative investment entities in the context of a much broader relationship between the lenders and the sponsors of such entities. NAV loans are not always viewed as profitable on a standalone basis. Instead, they are often a part of a package of services offered by the lenders to broaden or deepen engagement among the sponsor, the lenders and their respective affiliates. Where a sponsor has extensive touch points with a lender and its affiliates, comfort may be taken that a financing transaction with such sponsor is less prone to bad acts given the extent of a lender's familiarity with a sponsor and its principals and the sponsor's reliance on the other services provided by the lender.

Characteristics of the investment portfolio. Finally, lenders may also consider the impact of the characteristics of a borrower's investment portfolio on the risk of any bad acts. While the characteristics of a borrower's investment portfolio might not make the likelihood of bad acts more or less likely, as with market risk, a concentrated portfolio raises the stakes to lenders in the event of any impairment of the portfolio, including any bad acts. As a result, the consequence of a bad act with respect to a single investment in a well-diversified portfolio is likely to have less dire consequences for a lender.

Notwithstanding the inherent risk of "bad acts" in certain NAV loan structures as discussed above, there are still various tools that lenders can employ to mitigate these risks (some more onerous for borrowers than others). We will discuss those tools and how they act to mitigate the bad acts risk on another Friday.

## WFF Inaugural 'Reader's Series' – This Tuesday

May 20, 2022 | Issue No. 176



This Tuesday, May 24, Women in Fund Finance will launch a new “Reader’s Series” that will feature members of the fund finance community who are avid readers of non-fiction, with an emphasis on topics concerning both social and economic impacts.

The inaugural event will discuss the award-winning book, *Dopesick: Dealers, Doctors and the Drug Company that Addicted America* by journalist Beth Macy, who is a prolific writer on the opioid crisis. Also discussed will be award-winning *Empire of Pain* by Patrick Radden Keefe, a staff writer for *The New Yorker* and a *New York Times* best-selling author. The discussion will be led by Walt Jackson of Onex Credit, Mike Henry of U.S. Bank, and Cadwalader’s Leah Edelboim. Click [here](#) to register **in-person** or [here](#) for **virtual** attendance.

## FFA NextGen Event in London

May 20, 2022 | Issue No. 176

The Fund Finance Association's NextGen network announced a May 25th event focused on team construction and personality types, followed by a networking reception. For more information or to register, click [here](#).

## **Wildgen Publishes Fund Finance Security Guide**

**May 20, 2022 | Issue No. 176**

Offshore law firm Wildgen this week published a multi-jurisdiction fund finance security guide, with contributions from many of the leading fund finance law firms. The U.S. chapter was co-authored by Cadwalader's Wes Misson, Brian Foster and Patrick Calves and is available [here](#).

## OakNorth Bank Article in The Drawdown

May 20, 2022 | Issue No. 176

*The Drawdown* this week published a guest contribution by Mohith Sondhi of OakNorth Bank covering his forecasts for how macro market volatility will impact fund finance. The subscription-required article is accessible [here](#).

## WFF US: Fireside Chat with Bloomberg's Mary Schapiro

May 20, 2022 | Issue No. 176



Come join WFF's fireside chat on June 1 with Mary Schapiro to learn how the financial sector is taking up arms in the battle against climate change. To register, click [here](#).

## **Investec Thought Leadership Piece on HoldCo Financing**

**May 20, 2022 | Issue No. 176**

Investec recently published a thought leadership piece on how sponsors can structure additional leverage above the portfolio-company level when a portfolio company is unable to optimize leverage levels directly. To access the piece, click [here](#).

## **Fitch Ratings Report on Private Equity CFOs**

**May 20, 2022 | Issue No. 176**

Fitch Ratings released a report this week on private equity collateralized fund obligations and their positive credit performance over the past six months. In the report, Fitch noted that some tranche rating upgrades are occurring as a result of deleveraging. The report is premium content and requires a subscription, but is accessible [here](#).

## Cadwalader Welcomes New FF Team Members

May 20, 2022 | Issue No. 176



Charles Hambling



Tanner Lusk



Liza Branyon



Johnna Brooks

We are very pleased to welcome several new team members to our Fund Finance group and our firm. We look forward to their contributions as part of our growing practice.

Joining the firm recently are:

- **Charles Hambling** (Associate, London)
- **Tanner Lusk** (Associate, Washington, D.C.)
- **Liza Branyon** (Staff Attorney, Charlotte)
- **Johnna Brooks** (Staff Attorney, New York)

## On the Move – Fund Finance Tidbits

May 20, 2022 | Issue No. 176

On the Move

Wells Fargo is looking to hire a Vice President in either New York or Charlotte for its Subscription Finance Group. For more info, please visit [here](#) or contact [matthias.jahnke@wellsfargo.com](mailto:matthias.jahnke@wellsfargo.com).

Hark Capital is looking for an Associate to join its team in New York. Hark is an NAV-based lender that has raised three dedicated funds. The Associate qualifications include 2-3 years of corporate or investment banking experience, ideally in fund finance or leveraged finance. If you are interested, please reach out to [Sara Casey](#).