

CADWALDER

Feeling (In)Secure: Security Interests in NAV Facilities

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The fund finance market has experienced serious growth over the last few years. Fund borrowers are seeking more liquidity than ever in terms of the number of funds taking advantage of credit facilities as well as the sheer size of the facilities themselves. We have seen rapid growth in subscription line financings as well as a great deal of interest in other types of financings that allow funds to access liquidity – in particular, NAV loans (*i.e.*, loans that are underwritten by lenders based on the fund borrower's investment portfolio).

NAV is hot and getting hotter. Everyone wants to talk about it, and many of our bank clients who have traditionally offered subscription lines to their fund clients are exploring the possibility of also offering a NAV financing product. With so many new and potential entrants into the NAV market, we have found there is both a lot of excitement about this product and some confusion. Most of the confusion that we see relates to the collateral package (or, sometimes, what the collateral package may lack), and what better forum to clear that up than here in *Fund Finance Friday*?

First, the basics. As most readers here know, subscription line facilities are credit facilities provided by a lender to a fund that are secured by the right to call and receive capital contributions from the fund's investors and the bank account into which those proceeds are deposited. The important thing here is that (at least in the U.S. market) a subscription facility is almost always a *secured transaction*. In a secured transaction, a security interest arises when, in exchange for a loan, the borrower (or another entity in the deal) agrees pursuant to a security agreement or another collateral document to provide certain assets (*i.e.*, the collateral) as security to ensure repayment of the loan obligations and that the lender (also known as the secured party) has the right to exercise certain remedies with respect to the collateral, if the borrower defaults on the loan.

In a subline, there may be multiple security agreements (from different pledgors and/or covering different types of collateral) or, on the opposite end of the spectrum, in some instances, the security agreement may be contained in the credit agreement itself (known as a loan and security agreement).

As a quick primer on security interests in the United States, Article 9 of the Uniform Commercial Code governs security interests in personal property (which term includes capital call rights and bank accounts). The UCC has been adopted in every state (though it does differ to varying degrees from state to state) and, among other things, it provides the “rules of the road” for granting security in that it dictates how security interests are taken and perfected. When a security interest is perfected, it means that the secured party has priority to the collateral over any other third-party creditors that themselves do not have a perfected security interest in the collateral (and also, as noted below, has important bankruptcy implications with respect to the secured party's rights to the collateral vis-à-vis the bankruptcy trustee in an insolvency proceeding). In a subline, we perfect the security interest in the capital call rights pursuant to the filing of a UCC financing statement, and the security interest in the bank account is perfected by the execution and delivery of a control agreement among the depository bank, the lender, and the account holder (*i.e.*, the party granting the security interest in the bank account).

A collateral package has multiple benefits to a lender. First, it gives the lender something of value that it can look to in order to satisfy the obligations under a credit agreement if the borrower fails to pay or otherwise defaults on the loan. A security interest is also important in the context of a bankruptcy where secured creditors have superior rights to unsecured creditors and the bankruptcy trustee. Under the U.S. Bankruptcy Code, a secured creditor is more likely to recover the amount owed than an unsecured creditor, depending on the value of the collateral. In a bankruptcy case, a secured creditor's claim is secured to the extent of the value of its collateral. This gives some assurance to the secured party that, in the context of a bankruptcy of the applicable pledgor of the collateral, the secured party will have a right to the value of its collateral, rather than having the status of an unsecured creditor. Unsecured creditors have no collateral to liquidate to generate proceeds to repay the loan. Proceeds of the borrower's assets will be used first to repay creditors having a security interest over those assets, with any residual proceeds thereof being generally available to satisfy obligations to unsecured creditors. In a bankruptcy, lenders with unsecured claims will be paid *pari passu* with all other unsecured creditors of the fund.

While there are “many flavors” of NAV and, quite frankly, there is probably more diversity in the types of structures and approaches to NAV deals than in subscription facilities, we have seen robust interest from new entrants into the NAV

market that are looking to offer a NAV product where the collateral package is limited to a bank account into which proceeds of the fund's investments are deposited. For this type of product, while the lenders are still underwriting the loan based on the market risk of the fund's investments, in general, the investments themselves are NOT part of the collateral package. Instead, lenders get comfort from what's commonly called a "negative pledge" with respect to these assets.

We do note that the negative pledge facilities described above are separate and distinct from conventional NAV facilities where there is an actual pledge of assets or a pledge of the equity in the entity that owns the assets. This collateral may consist of, for example, portfolio company interests of a private equity fund or portfolio fund assets of a secondaries fund or the underlying loan portfolio of a direct lending fund.

The term "negative pledge" seems to be what causes a lot of confusion for people with respect to these facilities. Rather than there being a grant or pledge of collateral, a negative pledge is actually a "shorthand" reference for a negative covenant in the credit agreement that prohibits the fund from pledging these assets to anyone. The terms of the credit agreement will provide that if the borrower violates this negative covenant, it is an event of default under the credit agreement and gives the lender the right to exercise default remedies under the terms of the credit agreement. Here is an example of such a provision:

Negative Pledge. The Borrower and each Guarantor shall not, and shall not permit any Intermediate Holding Company to, directly or indirectly, create, incur, assume or suffer to exist any Lien on its property or assets (including the Collateral) other than Permitted Liens.

In conclusion, while a NAV deal of this nature is indeed a secured transaction in the most basic sense – there is a grant of security over bank accounts – the risk assets that the lenders are underwriting are neither directly or indirectly pledged (as compared to a subscription facility and other types of NAV loans – not discussed here – where the risk assets themselves are pledged directly or indirectly). The negative pledge is intended to provide the lenders with comfort that, in the event of a default, the borrower will ultimately have sufficient unencumbered assets to repay the loan. However, for these types of facilities, lenders take performance risk to the borrower. If the borrower violates the terms of the negative pledge, although the lenders will have certain remedies under the loan documents with respect to the borrower, to the extent the borrower has provided other third-party creditors with a security interest in its investments (in contravention of the negative pledge), the lenders may be left looking only to the remaining proceeds of the fund's investments after the claims of these secured third-party creditors have been repaid. Additionally, the lender's secured claims in any bankruptcy proceedings with respect to the fund may be limited to the pledged bank account and the funds held therein at the time of bankruptcy (which may be immaterial). Otherwise, the remainder of lenders' bankruptcy claims to the extent insufficiently covered by the bank accounts will be unsecured.

These "negative pledge" NAV facilities are typically entered into with sponsors where lenders are comfortable taking performance risk with respect to the fund complying with the terms of the negative pledge. Lenders accept this performance risk of the assets given, among other things, the low likelihood of a bankruptcy and competing creditor claims, which is why many of these facilities are underwritten for top-tier sponsors. These facilities also commonly feature very low loan-to-value covenants/very high asset coverage ratios.

The Rise of Private Credit in Leveraged Lending: A Preview for Fund Finance?

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Private credit funds are making their presence felt in the leveraged loan market. Recent transactions illustrate the scale direct lenders have achieved, enabling these managers to compete head-to-head with banks. Earlier in the month, a private lender group provided a \$2.5 billion unitranche facility that facilitated Vista Equity Partners' acquisition of Avalara Inc., the latest in a string of large-cap loan transactions that have been done away from banks.

Private credit lending groups bypass the broad loan syndication process used by banks and are therefore able to execute faster with greater pricing certainty. The concentration of financial firepower among a smaller group of institutions affords them greater leverage to negotiate improved terms of the credit documentation than would be the case in a typical bank-arranged syndication. Transaction size also clearly no longer poses the barrier to entry it once did.

Banks are countering by allocating balance sheet to hold loans and by raising in-house direct-lending funds. These moves are intended to provide more streamlined closings and remove syndication price flex. A large inventory of committed unsold loans and significant anticipated writedowns, however, are holding banks back from being more competitive. A Reuters [article](#) this week cites estimates that U.S. and European banks may post losses of \$5-10 billion on leveraged loans in coming quarters.

Private credit AUM totaled \$1.21 trillion in late 2021, according to Preqin data, and may more than double to reach \$2.69 trillion by 2026. A loss of market share in the leveraged loan market may cost banks a significant amount of fee income, but also means the loss of an important connection point for advisory, trading, and other revenues from financial sponsors.

From a fund finance perspective, the unfolding story in the broader loan market illustrates the growing significance of non-bank lenders. We see a few implications for the fund finance market:

- Private credit funds will become a more significant source of capital to the fund finance market in coming years. In the U.S., the advance has been slow but is likely to accelerate.
- Growth in AUM, significant underwriting resources, larger fund sizes, a running clock on deployment windows, and a branching out in strategies are all in-place trends likely to support more private credit lending in fund finance.
- This growth is likely to show up mostly in NAV lending where loan margins align better with private credit cost of capital.
- Banks will continue to play an important role in the market for subscription lines where their ability to bridge liquidity needs cannot be matched by funds primarily due to differences in cost of capital.
- Bank regulation, which often proves to be [pro-cyclical](#), also seems on course to continue driving capital formation towards less regulated institutions.
- In fund finance, the relationship with these funds is more likely to be collaborative. Leveraged loan market speed-to-execution and pricing dynamics don't carry over into fund finance and should allow for mixed lending groups.
- Finally, banks may become more sensitive to extending subscription financing to funds that then directly compete with them for lending business and could instead become strategic in selecting funds with which to partner.

LSTA Borrower ESG Diligence Questionnaire Now in Excel

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The LSTA published an Excel version of its ESG borrower due diligence questionnaire, the latest step in an asset manager ESG diligence initiative that started in June 2021 as a joint project of the Loan Market Association (LMA), the Loan Syndications and Trading Association (LSTA) and the European Leveraged Finance Association (ELFA). The questionnaire is intended to streamline the due diligence process and to generate readily comparable data. The questionnaire and further information can be found [here](#).

FFA University 1.0 and 2.0

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The Fund Finance Association is thrilled to announce the expansion of FFA University, which now includes two fund finance courses. FFA University 1.0 will be the traditional program, designed for those relatively new to fund finance or seeking a refresher, and will be held virtually on September 21. FFA University 2.0 is a more advanced, in-person program for those seeking greater depth and networking opportunities. Class 2.0 will take place on October 6 in New York City in Cadwalader's New York office, with a reception to follow. To register and learn more about both opportunities, please click [here](#).

WFF Europe: 'Back to School' Panel Discussion

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Working with Cayman, Guernsey, Ireland, Jersey or Luxembourg funds? WFF brings you “Back to School: Offshore Structures and Fund Financing ‘101’”, a panel discussion scheduled for Wednesday, September 21. The panel will be moderated by Kate Downey (European Committee Co-chair, WFF/Partner – Corporate, Fried Frank LLP) and will include speakers Julia Keppe (Group Partner – Banking & Finance, Walkers (Jersey) LLP), Patrick Ormond (Partner – Banking & Finance, Walkers (London)), Andrew Traynor (Partner – Co-Head of Finance & Capital Markets, Walkers Ireland LLP), Alex Wickens (Senior Counsel – Banking & Finance, Walkers (Guernsey) LLP) and Miao Wang (Counsel – Funds & Asset Management, Allen & Overy (Luxembourg)). The panelists will discuss local counsel perspectives on common issues and queries around security, due diligence and structuring. Further info and registration available [here](#).

Perspective on Private Market Valuations from Adams Street

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Jeff Diehl, Managing Partner of Adams Street, penned a special report in *Financier Worldwide*, providing a timely perspective on the link between public and private market valuations. Three notable observations: (1) private fund holdings skew towards high-growth companies with potential for multiple expansion, making the sample set not directly comparable to general public market indices; (2) private funds can use multiple approaches to valuation and may attach less weight to public comps when markets dislocate; and (3) private market supply-and-demand dynamics may drive divergences in valuation relative to public markets. All three points illustrate why NAV loan collateral valuations may be less volatile than broader public market indicators. The full write-up, *The Impact of Public Market Dislocations on Private Markets*, is available [here](#).