Upstream and Affiliate Guaranties in NAV Loans

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Guaranties are a common feature in fund finance transactions. Particularly in NAV loans, upstream and affiliate (or "sideways") guaranties are used. Below we discuss some of the context for the use of these types of guaranties, as well as some of the issues that lenders should consider in relying on them.

Upstream Guaranties

It is not uncommon in NAV loan transactions for the borrower to hold the underwritten assets for the financing (*i.e.*, the fund's portfolio of investments) through one or more controlled subsidiary holding vehicles (each, a "HoldCo"). Lenders may take a pledge of the management and economic interests in the HoldCos (rather than the underlying investments). In order to get as close to the underlying investments as possible (without taking a pledge), lenders may require that a HoldCo issue a guaranty directly to the lenders (or the administrative agent, on behalf of the lenders), guaranteeing the borrower's obligations under the NAV loan facility. This "upstream" guaranty provides the lenders a direct claim against the HoldCo for amounts due under the loan, mitigating some of the risk of structural subordination to potential creditors (expected or unexpected) at the level of the HoldCo.[1]

Affiliate Guaranties

It is also common in NAV loan facilities for the borrower's portfolio of investments to be held by multiple subsidiaries and/or affiliates of the borrower. Each such subsidiary or affiliate may be designated as a guarantor for repayment of the loan. As a result, such entities end up guaranteeing the obligations of their affiliates. The purpose of these affiliate guaranties is the same as the upstream guaranties discussed above – namely, to provide the lenders with a more direct enforcement claim in a default scenario.

Use of Such Guaranties

Motivations for the use of such upstream and affiliate guaranties may include:

- a lender's desire to underwrite a broader portfolio of investments, mitigating concentration risk to the portfolio of a single holding entity;
- a lender's desire to ensure that it is not subordinate to creditors that may arise at the level of the entity that directly owns the investment; or
- a borrower's desire to obtain a higher loan-to-value ratio than the lenders would otherwise provide based on the investments alone.

While upstream and affiliate guaranties can help to address these issues, they may raise nuanced legal issues that should be discussed with counsel in light of the relevant facts and circumstances.

Enforceability Considerations

Guaranties constitute the assumption of the liabilities of another entity and are contingent claims against the guarantor. Under certain insolvency laws, guaranties may be subject to challenge, and payments under guaranties may be subject to avoidance. Upstream or affiliate guaranties may be subject to heightened scrutiny and challenge in a bankruptcy or distress scenario. Below are a few potential issues lenders should bear in mind with respect to upstream and affiliate guaranties.

1. Constructively Fraudulent Transfer Avoidance. Under Bankruptcy Code section 548 and certain state laws, (a) transfers of property (including grants of security interests or liens), or (b) obligations assumed (such as incurring a loan or guaranty obligation) may be avoided as constructively fraudulent if BOTH of the following requirements are satisfied:[2]

- (i) the transferor/guarantor does not receive reasonably equivalent value; AND
- (ii) the transferor/guarantor is insolvent or undercapitalized or rendered insolvent, undercapitalized or unable to pay its debts because of the transfer or the assumed liability.

A guaranty by a parent of the obligations of a wholly owned and solvent subsidiary, a so-called downstream guaranty, is generally regarded as providing the parent with reasonably equivalent value through an enhancement of the value of its equity ownership of the subsidiary.

Upstream and affiliate guaranties require more scrutiny than guaranties by a borrower parent to determine whether any potential enforceability issues are present.

a. Reasonably Equivalent Value. The determination of value is not formulaic or mechanical, but rather generally determined by the substance of the transaction. Value or benefits from a transfer may be direct (*e.g.*, receipt of loan proceeds) or indirect. But if indirect, they must be "fairly concrete."

In each of the above scenarios, we are assuming that the upstream or affiliate guarantor would not use the proceeds of any loans and, consequently, would not be added to the loan facility as a borrower. However, other indirect but tangible benefits or value to the guarantor should be identified, *e.g.*, favorable loan terms or amendments, use of the NAV facility proceeds that may indirectly but materially benefit the guarantor, maintenance of the entire fund group of entities that benefits the guarantor, etc.

b. Financial Condition of Guarantor. The financial condition of the transferor/guarantor is evaluated at the time of the incurrence of the guaranty. The evaluation is made from the debtor/guarantor – in what condition was the guarantor left after giving effect to the transfer or assumption of the obligation. Diligence regarding a guarantor's financial condition may demonstrate that such guarantor is sufficiently creditworthy to undertake the guaranty and remain solvent and able to conduct its respective businesses. Representations from the guarantor may be sought to confirm its financial condition.

c. Potential Mitigants. In addition to performing diligence with respect to the above points, lenders and their counsel will often include contractual provisions to mitigate the possibility that a guaranty may be found to constitute a fraudulent transfer. Savings clauses, limited recourse guaranties, and net worth guaranties are all tools that can be used to address the issues noted above. The scope and appropriateness of such provisions is beyond the scope of this article and should be discussed with external deal and restructuring counsel.

2. Preference Challenge. Under Bankruptcy Code section 547, a transfer made by a debtor to a creditor, on account of an antecedent debt, that is made while the debtor was insolvent and within 90 days before the bankruptcy case has been commenced may be subject to avoidance as a preferential transfer. Certain defenses may apply to a potential preferential transfer, including the simultaneous exchange of "new value" by the creditor. However, note that any pre-bankruptcy transfers of value, like payments under a guaranty, may be subject to scrutiny and potential challenge by the guarantor/debtor or a bankruptcy trustee.

Guaranties can be an important element in structuring NAV loan transactions to achieve the terms desired by the parties and to provide necessary protections for the lenders, but consideration needs to be given to the legal issues, such as the ones mentioned here, that their inclusion can present.

[1] Lenders will typically also require the HoldCo to pledge its accounts to which proceeds of the underlying investments are paid, allowing lenders to foreclose on such cash at the HoldCo level, without the need for such cash to first be distributed up to the borrower.

[2] Note that the precise language of certain state fraudulent transfer laws may differ, but conceptually, most state statutes require a showing of (i) insufficient or unreasonably small consideration in exchange for the transfer or liability

incurred, and (ii) the transferor/debtor being insolvent at the time of the transfer, or becoming insolvent or subject to financial distress as a result of the transfer.

Sustainable Finance: Maintaining Integrity

May 19, 2023

By **Katie McShane**
Special Counsel | Fund Finance

The LSTA and LMA hosted their Joint New York Conference yesterday. One of the panels focused on "Sustainable Finance: Maintaining Integrity" and featured an impressive line-up of industry leaders in this space, including Cadwalader's Sukhvir Basran, a partner in our London office and co-head of our ESG practice. The other panelists included Gemma Lawrence-Pardew, Head of Sustainability, Director – Legal, at LMA; Robert Lewis, partner at Sidley Austin LLP; and Tess Virmani, DGC & EVP – Public Policy, Head of ESG at LSTA.

The panelists were involved in the recent LMA/LSTA drafting guidance for sustainability-linked loans (SLL), and various updates to the SLL principles and guidance. (We recently hosted a London breakfast discussion with the LMA and LSTA with the aim of "Unlocking Sustainability-Linked Loans." Click **here** to listen to the discussion. Click **here** to read a detailed summary.)

The panelists provided an overview of the model language and discussed some of the key differences between the LMA and LSTA drafting guidance. They noted that while both follow the same principles, the drafting is different since they are suited to different markets.

The discussion also centered around what was in the various updates to the SLL principles and what decisions were made in developing the SLL guidance, as well as frequently asked questions that the panelists have received since the release of the guidance. A common thread through these discussions was the importance of maintaining the integrity of this product. Some of the differences between the U.S. and European markets were also discussed.

Of course, it's impossible to have a discussion about SLLs and not mention greenwashing. One of the panelists provided an interesting overview of litigation in this space, which was remarkably different in the U.S. compared to Europe or Australia. Most notably, the plaintiff success rates for greenwashing suits in the U.S. have been found to be much lower than in Europe and Australia.

The panelists have each been at the forefront of growth in the SLL market, and this panel was therefore able to provide a fantastic overview of the SLL market as it currently stands.

This will continue to be a hot topic, and I will have the opportunity to join Sukhvir for a July 18 Strafford Webinar. Please mark your calendars; more details will follow.

What We're Reading

May 19, 2023

Institutional investment allocations, sponsor consolidation, bank-private equity origination partnerships, NAV volume − plenty of long-term themes in this week's private market news. Here's what we're reading.

- NAV transactions totaled an estimated $21 billion in 2022 even as broader loan market origination struggled, according to Rede Partners' recent ***NAV Financing Market Report***. An overwhelming majority of lenders report seeing more inbound NAV opportunities in 2022 than in 2021 even as loan margins widened.
- Calpers is going into an extensive portfolio review next month with an appetite to increase its allocation to private equity from $52 billion currently. See the *Financial Times'* "**Calpers signals 'appetite' to increase bets on private equity**."
- Falling interest rates and expanding liquidity over the past decade obscured just how much beta has contributed to investment performance. That dynamic is changing, and future institutional asset allocation practices will develop to better separate out beta in core equity and fixed income allocations with a greater share of allocations in the future going to equity and fixed income alternatives, such as private credit, asset-based financing and hybrid equity, according to views published in an ***Apollo Investor Presentation*** in mid-May. In the private market, wealth management channels are expected to be a key driver of AUM growth for Apollo.
- Strategic M&A among private sponsors faces many obstacles ranging from culture fit and integration to valuing and financing an acquisition. Not surprisingly, tie-ups have historically been relatively rare compared to the number of sponsors in existence. In 2021, strategic transactions perked up and consolidation will likely increase further from here, according to Bain & Co.'s ***Is Strategic M&A Finally Catching On in Private Capital?*** Aside from the compelling reasons for consolidation cited in the Bain report − AUM growth and the benefits derived from scale − we think middle market sponsors may find access to fund finance more challenging in the year ahead, which could add another reason to consider making a deal.
- Blackstone is open to partnering with regional banks as a participant in loan originations, according to the *Financial Times'* "**Blackstone in talks with US regional banks over lending partnerships**." Discussions with banks are reportedly focused on partnerships using the existing infrastructure at banks to originate loans that are ultimately channeled to insurance company balance sheets.

FFA Asia-Pacific Fund Finance Market Update

May 19, 2023

The FFA APAC Executive Committee will host an Asia-Pacific Fund Finance Market Update on June 13, with fund finance experts providing the latest market updates and discussing trends and APAC fund finance market predictions. This Zoom program will take place at 1:00 pm HKT and SGT / 3:00 pm AEST. Register **here**.

The program will be moderated by Mourant partner Danielle Roman and will include the following speakers: James Abbott, Partner, Corrs Chambers Westgarth; Paul Aherne, Partner, Walkers; Fi Dinh, Managing Director | Head of Fund Finance APAC, MUFG Investor Services; Tom Kirby, Managing Director | Head of Fund Finance, Bank of China; Angela Lai, Head of APAC and Valuations, Research Insights, Preqin; Soumitro Mukerji, Partner, Mayer Brown LLP; Niamh Targett, Director, ANZ; Albert Tan, Partner | Co-Head of Fund Finance, Haynes & Boone; Jean Woo, Office Managing Partner, Singapore, Ashurst; and Frank Wu, Senior Vice President, Institutional Investors, DBS Bank.

Fund Finance Tidbits – On the Move

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Congratulations to Matt Finn, who has been recently promoted to Director in the Global Fund Banking group in the New York office of Silicon Valley Bank. Matt joined Silicon Valley Bank in 2015 and has extensive banking experience in subscription finance, working closely with onshore and offshore sponsors.

Congratulations to Matt Doyle, who has recently joined Apple Bank in New York as Vice President − Subscription Finance. Matt was previously in Silicon Valley Bank’s New York office, focusing on subscription fund banking.

Jeff Nagle Named Head of Corporate and Commercial Finance

May 19, 2023

Our colleague Jeff Nagle, who has appeared in *Fund Finance Friday* on a number of occasions with his insightful observations on LIBOR transition, has been named Cadwalader's head of Corporate and Commercial Finance.

In this new role, Jeff will continue to oversee a team of attorneys based in Charlotte and New York that handles a wide variety of lending transactions to corporate and commercial borrowers, including a market-leading practice in syndicated commodities finance deals.

Jeff represents clients in a wide variety of financing transactions. His principal practice focuses on leveraged finance and other syndicated bank loan transactions, NAV financings, the financing of financial assets, distressed debt trading, asset-based lending, commodities financings, energy project financings and rescue financing, workouts, debtor-in-possession financings and exit financings. Jeff's clients include many of the world's leading domestic and foreign commercial banks, investment banks and other financial institutions, including hedge funds. Jeff is also one of our leaders on innovation and emerging technologies impacting financing transactions, including blockchain technology.

In addition, Jeff was recently elected to a four-year term as a Regent of the American College of Commercial Finance Lawyers, an invitation-only professional organization dedicated to promoting the field of commercial finance law.