Valuation Challenge in NAV Facilities

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In this article we look at the lender's right to challenge a sponsor's valuation of their investments in the context of a NAV-backed financing. This right to challenge is a relatively recent development in these transactions, which has come in and out of vogue depending on the general state of the market, with a notable rise at the beginning of the pandemic due to concerns over the accuracy of valuations in the near term.

All the same, as NAV facilities become more and more prevalent in the market, we are seeing something approaching a settled market position when it comes to the triggers, exercise and consequences of a lender's right to challenge valuations. Below is a summary of the most commonly negotiated aspects.

For context, this article speaks primarily to European bank-led NAV facilities lent against one or more direct private equity investments. Other asset classes will work quite differently – in particular, private credit, which typically follows the well-established norms of the ABL space, or secondaries, where there may be less scope to challenge a valuation owing to the underlying reporting not being produced by the borrower but by the investee sponsor.

- **Triggers to challenge**. The facility agreement will typically include various provisions that flow from the level of the LTV ratio, such as margin ratchets, cash sweep percentages and drawstops, as well as financial covenants. The trigger to a challenge right that we see most often is based on the lenders, following delivery of the relevant reporting, taking the view that the reported LTV is incorrect to the extent that a different margin or cash sweep percentage would apply, or there would be a drawstop or a financial covenant breach. Alternatively, there may be a hardwired percentage by which the lender must believe that the value has been overstated.
- **Who can challenge**. In a syndicated facility, individual lenders may have the right to challenge a valuation or it may be a majority lender decision, and this will vary from deal-to-deal.
- **When a challenge can be made**. There will typically be a set period following delivery of the relevant reporting for the lender to challenge a valuation, which will clearly be a point of focus for a sponsor not wanting to have a potential revaluation hanging over them for an extended period of time. There may be a consultation period before any third-party valuer is appointed, during which the lenders and sponsor will conduct good-faith discussions to agree a valuation between themselves for a set period of time, and if a resolution cannot be reached, then the process becomes more formal. Timeframes vary but tend to be a matter of a few weeks from delivery of the initial reporting to appointment of a third-party valuation agent, during which time distributions may be restricted. There may also be a set period during which the valuation must be completed. The time allowed to make the challenge and appoint the third-party valuer is important – too short a time can leave the lenders with an unworkable mechanic that practically times them out of being able to make the challenge in accordance with the challenge mechanic requirements.
- **Regularity of challenge**. There will usually be a limit on how often a lender can challenge a valuation, typically starting from once per quarter with overall annual limits. However, these limits may be disapplied where a challenge is deemed successful (please see below) or a default is continuing.
- **Appointment of valuation agent**. The agent appointed will most often need to be from a pre-agreed list of names, or by agreement between the sponsor and lenders. Where agreement between the sponsor and lenders is required this needs to be factored into the timing for making the appointment to avoid a situation where the sponsor can frustrate the use of the mechanic through its failure to agree the valuer in a timely fashion.
- **Valuation scope and methodology**. This goes to the heart of what a revaluation is intended to achieve. While a lender will want the valuation agent's scope to be as broad as possible, sponsors will prefer to limit it to a review of the sponsor's application of its own valuation methodology as set out in the relevant reporting and not the underlying data or choice of methodology. In any event, the sponsor will need to agree to provide all access necessary for the agent to carry out their agreed scope. Which investments are included will also be a point for discussion – should the review be only in respect of the investment(s) that the lender thought overstated in the report or in the entire portfolio? It may be that a critical mass threshold is agreed, whereby an initial challenge is only in respect of the relevant investment(s), but repeated concerns or successful challenges allow the lender to open up the entire portfolio.
- **Successful challenge**. What constitutes a successful challenge will be a matter of negotiation, and is often pegged to the initial trigger, *i.e.*, success may mean that the revaluation determines that a higher margin or cash sweep threshold should apply or there is a drawstop or a financial covenant breach (a “Facility-Based Event”), and/or that the relevant investment(s) is marked down by a set percentage on the reported value.

- **Consequences**. Where success is determined by reference to a Facility-Based Event, the third-party valuation will be used to re-calculate the LTV ratio, which will then automatically be applied to set the margin, cash sweep percentage, etc., until the next report. Alternatively, where success means demonstrating a set percentage reduction on the reported value, it may be that it is only by hitting that percentage reduction that the LTV is re-calculated – for example, where the success threshold is set at a 10% reduction but the revaluation only results in a 5% reduction, the entire reported valuation continues to be used for LTV purposes (not the 95% determined by the valuer). This can result in a perverse position where it is shown that a different ratchet should apply but because the variation does not meet the required percentage variation, both the existing valuation and ratchet stand and the challenge is considered to have failed. The greater the required percentage variation the greater the risk of such an outcome. Another material consequence of a valuation being deemed successful is the allocation of the costs of the valuation between borrower and lender.

We Talk Banking & Finance Podcast: Client and Counsel Dynamic

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Cadwalader Finance associate Carla Pilcher joins the ***We Talk Banking & Finance*** Podcast with Walkers' Banking & Finance group partner, Julia Keppe, and Julia Mandich, assistant general counsel at Barings, to discuss the dynamic between a client and counsel, instructing counsel and local counsel, and how all sides can better understand the motivating factors and build stronger relationships.

Listen **now**.

The Forgotten LPA Amendment

August 18, 2023

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A fund is a living, breathing organism that aims to achieve much more than being a vessel for a subscription credit facility. The limited partnership agreement ("LPA") of the fund may have to be amended, restated, supplemented or otherwise modified from time to time to: address changes in the regulatory environment or legal requirements; respond to requests from limited partners; reflect changes in the fund's investment strategy; clarify ambiguities in the LPA; allow for the sale or transfer of the fund's assets; optimize tax efficiency for the fund and its investors; or change carried interest or management fees. Whatever the reason for the amendment, syndicated credit agreements typically contain a covenant that requires the borrower to notify the administrative agent of an amendment so that the administrative agent may determine whether or not such an amendment is material and therefore requires lender consent. This article focuses on common covenant language – there may be some nuances and deviations from the typical process outlined below.

For a fund (and its counsel), the first step after an LPA amendment is drafted is to notify the administrative agent of the proposed amendment and request that the administrative agent determine whether or not the proposed amendment is a "material amendment." Although we are focusing on LPAs here, the covenant is generally broader and provides that no credit party shall alter, amend, modify, terminate, waive or change any provision of its constituent documents (which includes the LPA), any subscription agreement or any existing side letter without notice to the administrative agent.

Typically, a proposed amendment will be a "material amendment" if it (a) affects the debt limitations in the LPA or under the credit agreement; (b) affects the credit party's or investor's debts, duties, obligations, and liabilities, or the rights, titles, security interests, liens, powers and privileges relating to capital calls, capital contributions, capital commitments, uncalled capital commitments or any other collateral; (c) suspends, reduces or terminates any investor's unfunded capital commitments or obligation to fund capital calls; or (d) otherwise has a material adverse effect on the rights, titles, first priority security interests and liens, and powers and privileges of any of the lenders. The consent of the lenders and the administrative agent is usually required within specific time periods if the proposed amendment is a "material amendment." Certain types of amendments may be expressly deemed not to be material under the credit agreement, and the consent of the administrative agent or the lenders may not be required. Such non-material amendments are usually limited to admission of new investors to the fund and to reflecting transfers of interests permitted by the credit agreement. However, written notice to the administrative agent of any such amendment is still generally required.

The credit agreement covenant may not be at the front of the minds of borrowers when a proposed amendment is considered that doesn't directly relate to the credit facility. Consequently, an amendment may be implemented without notice to the administrative agent. In such instance, the fund would be well advised to keep in mind Cadwalader partner Tim Hicks' article, ***Been There, Gonna Do That***, and note the distinction between a waiver and consent, which is aptly and succinctly summarized therein as "*a waiver is for the depravities already committed and a consent is when you need forgiveness for what you are about to do,*" and ask the administrative agent (and, if needed, the lenders) for a waiver.

Whether a waiver is granted, of course, will hinge on the materiality, from the lender's perspective, of the LPA amendment, and a borrower should be ready to see potential responsive revisions to the credit agreement. This brings the discussion full circle: The established process for obtaining lender consent prior to a material LPA amendment not only avoids surprises to the lender but can also spare the borrower from being caught off guard by unanticipated consequences for the credit facility.

Cadwalader Climbs in Syndicated Loan Rankings

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Despite the global syndicated loan market being down 18% for the first half of the year, Cadwalader has surged to the 12th position among all U.S. syndicated loan legal advisors. This impressive climb showcases the continued advancement of the firm's global lending platform beyond fund finance, moving up from an unranked position last year. The firm strategically bolstered its capabilities by welcoming a market-leading leveraged finance and private credit group in February. This new addition amplified the firm's strengths and widened its influence in special situations and leveraged finance, across both the U.S. and Europe. The full rankings are available **here**.

Women in Fund Finance Fall Event

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Register now!

Cadwalader is proud to sponsor the second annual Charlotte Women in Fund Finance fall forum and networking event. Join us in the Queen City for an exciting and timely panel discussion followed by a networking reception. Additional details to come. You can register **here**.

All members of the fund finance community are welcome!