

## **NAV Financings and “Bankruptcy Unlikely” Special Purpose Vehicles**

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This article examines structuring tools to help demystify, simplify and harmonize the documentation and structures supporting Net Asset Value financings (“NAVs”). For the purposes of this article, NAV refers to a senior ranking credit facility provided to a private equity or similar fund or asset manager which is supported by a diversified portfolio of assets<sup>1</sup> and their related cash flows, and sized based on the net asset value of such portfolio.

A few of the most attractive use cases for NAVs are:

- Providing liquidity to a mature fund when a subscription facility is not available because capital commitments are fully drawn but the obligation to fund costs, expenses or dividends remains ongoing.
- Bridging the gap at a crucial time for follow-on investments when returns from underlying investments have not been realized but exit timing is sub-optimal.
- Providing liquidity to make new or follow-on investments, finance dividends, make equity cures, offer competitive “cash” bids and boost returns for portfolio investments.
- Providing funding to redeem exiting investors in the fund or to buy out minority stakes from investors.

Similarly, lenders are increasingly interested in NAV exposure because of the relatively low loan to value ratios, inherent diversity and the opportunity to get additional exposure and connectivity with the asset managers to whom they are already providing capital for downstream portfolio investments.

The COVID-19 pandemic served as a catalyst for moving NAVs from a niche and exotic capital raising tool into the mainstream. These facilities allowed asset managers to leverage the strength of their existing portfolios, providing relief for limited liquidity and covenant breaches arising under their portfolio-level financings. In the same period, the intense competition in the credit markets encouraged lenders (both bank and non-bank) to diversify their offerings, and many lenders who were previously portfolio-level or subscription facility lenders branched into NAV solutions to provide stretch and bridge capital to borrowers while benefitting from the additional interest, asset coverage and diversity for their loans.

Despite all the benefits, many potential NAVs fail to pass the term sheet and diligence stage as lenders grapple with the downstream and upstream impacts of a collateral base that is subject to competing claims and limitations on pledges and transfers. There is no one-size-fits-all solution that has been broadly adopted by the market, and generally there are two extremes: one, inexpensive and buttoned up, and the other, expensive and equity-like. In some more onerous structures, extensive consents are required from (i) the fund’s general partner as a result of transferring the underlying limited partnership interests to the NAV borrower and/or a pledge of the collateral assets to the lender and (ii) the portfolio investment parties due to restrictions contained in the downstream investment documents, debt documents or both.

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<sup>1</sup> Portfolio assets may include equity holdings, credit extensions or real estate, for example.

As this burgeoning market begins to mature, we believe there is a middle ground available through careful structuring and planning. Our proposal is to couple a “bankruptcy unlikely” double holding company structure with hardwired cooperation provisions and certain tweaks to fund and downstream investment documents. In our view, this “Modern” NAV approach will greatly help to reduce friction costs, increase certainty of closing and facilitate a simpler and more user-friendly structure.

Our proposed NAV structure borrows from well understood features of the securitization market, pares those features down to the essentials for these structures, and combines them with tweaks at the fund and portfolio investment level to help limit required consents and increase access to a broader range of capital sources. The “bankruptcy unlikely” structure is designed to reduce the risk (i) of a defensive bankruptcy filing by the borrower and (ii) that a bankruptcy court would substantively consolidate the borrower into the bankruptcy estate of an affiliated entity, which in either case could adversely impact the NAV collateral.

In the charts and illustrations below, we will cover some of the key features and diligence considerations central to NAVs. However, we acknowledge this is not a universal solution for all investments and recommend funds and their advisors plan for NAVs from inception similar to the way funds now plan for subscription facilities.

The following sections will cover:

- Diligence and Planning;
- Structure and Key Features of the “Modern” NAV; and
- Overview of “Bankruptcy Unlikely” Special Purpose Vehicles (“SPV”).

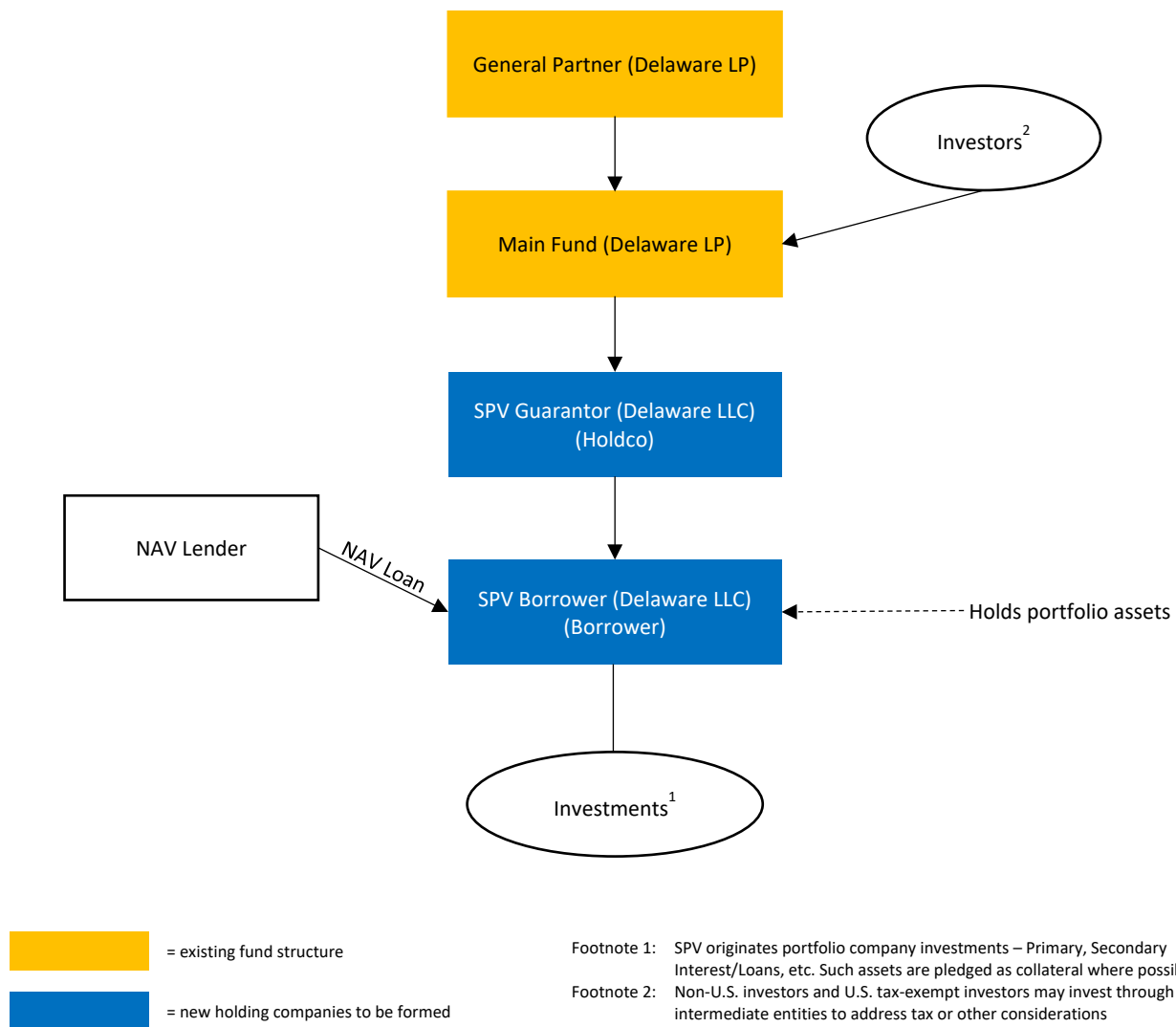
| I. Diligence and Planning for NAVs  |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                       |
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| Current Diligence & Consent Process | <p><b>Key Diligence Tasks</b></p> <p>Prior to undertaking any NAV loan, the borrowers and the lenders must review certain existing documentation of the fund/investor, including, without limitation, (a) the structure chart for the fund and its investments, (b) the fund’s organizational documents and any subscription financing documents and (c) the fund’s debt and equity portfolio investment documentation, to confirm (i) whether consent rights are triggered by the borrowing of debt, guarantees and/or transfer of the underlying equity interests or a pledge of the other control rights or fund assets as collateral to the lender and (ii) if such transactions will trigger a change of control or require additional consent in order for the lender to step in to such collateral (including rights and interests in equity holdings and control rights of the fund) at the time of enforcement of the lender’s security interest. In non-control investments, there are additional questions about the ability to make distributions, force a sale of assets and obtain information and periodic reporting about the assets and whether the terms of the financing arrangements would breach the fund’s existing confidentiality agreements in respect of its portfolio investments.</p> <p><b>Key Hurdles</b></p> <p>A few of the most common issues include:</p> <ul style="list-style-type: none"> <li>• The fund documents may specifically permit subscription financing, but not NAVs or other financings. The review of whether NAVs are permitted may be very fact specific and the treatment of such investment in the waterfalls in the fund’s investment documentation may be unclear such that the outcome may be driven by the use of proceeds rather than the drafting of the investment documents themselves.</li> <li>• Existing financing arrangements at the fund and portfolio levels may contain negative pledges, collateral packages or change of control provisions which will require consent both for the initial pledge to the NAV lender of the applicable collateral and for the subsequent transfers on enforcement. Even if a pledge of the borrower’s assets (e.g. the equity interests held by the borrower or its parent) are permitted under the fund documents and downstream debt documents, the enforcement of such pledges could have broad consequences including the triggering of a change of control, a key man event, a termination of the investment period and an acceleration of the portfolio-level debt.</li> <li>• Internal restructurings, share pledges and moving capital from the fund to its portfolio investments in the form of debt or preferred equity may trigger tax or other regulatory consequences or require consents of LPs, LPACs, lenders or in the case of non-wholly owned or non-control investments, other equity holders.</li> </ul> |

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|                                                                                | <ul style="list-style-type: none"> <li>• The existing downstream investment documents may only permit investments to be made in the form of common equity which limits the ability of the NAV lender to have control in a downstream restructuring or influence its administration.</li> <li>• Non-control investments may also have the additional challenge of the inability to obtain reporting, force distributions or sales and minority discounts on sales or partial sales of assets.</li> <li>• Obtaining required consents and reporting can be time consuming and uncertain and might allow the other stakeholders (including lenders, investors and counterparties) to reopen documents or require other economics and/or more onerous terms in exchange for granting the required consents. In addition, counterparties downstream generally oppose broad transfer and step-in provisions and, even if consents are obtained, they will be narrowly tailored and potentially require a re-underwrite and consent for any new counterparty at the time of transfer.</li> <li>• There is also a general concern in NAVs that the fund could file a defensive bankruptcy prior to obtaining any required consents, and the borrower may be consolidated into the bankruptcy estate of the fund, causing the NAV lender and its interests to be exposed to broader credit risks than anticipated. For example, depending on how the subscription financing documents are drafted, there is a risk that a NAV lender could become subordinated to a subscription lender with an overly-broad, and earlier-in-time, collateral grant.</li> <li>• On case-by-case basis, tax and regulatory consequences (for example, UBTI) of the financings to the fund and moving assets in a new holding company or pledging shares in such assets.</li> </ul> |
| <b>Recommendations for New Funds and Investments to Facilitate Future NAVs</b> | <ul style="list-style-type: none"> <li>• Ensure that internal reorganizations (including adding in new pass-through holding companies for portfolio investments) are permitted without consent. For example, relevant documentation should permit the structure contemplated in the next section.</li> <li>• Ensure that debt, guarantee and lien incurrence provisions permit the incurrence of fund-level debt (and/or debt at the level of a subsidiary of a fund) secured by portfolio investments and the returns on such investments (not just the capital calls of limited partners).</li> <li>• Ensure that the treatment of loan proceeds is contemplated and addressed appropriately in the investor waterfalls.</li> <li>• Ensure that a pledge of downstream assets and a transfer in the context of a financing (and exercise of step-in rights) does not require consent of the investors or the downstream lenders.</li> </ul>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                            |

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|  | <ul style="list-style-type: none"> <li>• Ensure that subscription financings have narrow collateral grants that are limited to the right to call capital and the proceeds thereof and do not contain broad negative pledge provisions with respect to fund assets, investments and recoveries which do not support the subscription facility's borrowing base.</li> <li>• Tailor downstream investment and debt documents to permit investments in the form of debt and preferred equity and to allow for the pledge of such investments and related rights to receivables without the consent of the portfolio investment parties.</li> </ul> |
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| <b>II. Structure and Key Features of “Modern” NAVs</b>           |
| Sample “Bankruptcy Unlikely” Double Holding Company Illustration |

## Sample Modern NAV Structure



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| <p><b>Bankruptcy Unlikely Double Holding Companies</b></p>  | <ul style="list-style-type: none"> <li>• Two SPVs are formed below the fund, each with independent directors. The guarantor/holding company (“<b>Holdco</b>”) will be a wholly-owned subsidiary of the fund and Holdco’s wholly-owned subsidiary will be the NAV borrower (“<b>Borrower</b>”). The Borrower will own the underlying portfolio investments included in the borrowing base.</li> <li>• This structure is similar to the structure commonly used for securitizations and real estate financings. Rating agencies are accustomed to seeing a similar double holding company structure with independent directors at each level. We believe such familiarity will: (i) facilitate NAVs getting rated which will help with lower pricing (either from attracting lower cost financing sources such as banks and insurance companies lending directly or participating in such financing through back-leverage or other exposure to NAV deals), (ii) allow lenders to more clearly ring-fence the assets and liabilities that they are underwriting and (iii) allow time for the lender and Borrower to work out a troubled pool of assets with lower risk of a bankruptcy filing.</li> </ul>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                |
| <p><b>Guarantees/Collateral Package/Negative Pledge</b></p> | <ul style="list-style-type: none"> <li>• <b>Guarantees:</b> Guarantees to be provided by Holdco and any interim holding companies above the portfolio company investment level.</li> <li>• <b>Base Collateral:</b> The most basic secured modern NAV will include a pledge of (i) a loan proceeds and other returns on portfolio investments and (ii) the deposit and securities accounts into which the distributions are made and proceeds of the underlying fund interests are paid. In addition to UCC filings, accounts will be held with the lender or perfected via control agreements with the depositary bank or securities intermediary.</li> <li>• <b>Equity Pledges:</b> In addition, where possible, a pledge of the equity interests held by Holdco in the Borrower, and by the Borrower and its subsidiaries in lower-level investment holding companies, may be included in the collateral package. However, where such pledge is not possible because of the need for third-party consents, costs (including local counsel costs), change of control, and/or tax and regulatory issues, a negative pledge over such equity interests may be utilized. This can be documented by either using a negative pledge in the credit agreement itself or taking the additional step of having such non-loan party subsidiaries execute negative pledge agreements.</li> </ul> <p>Even if the formal pledge of equity interests is not possible, careful structuring downstream may permit a lender to have rights in a downstream bankruptcy or restructuring. We would recommend lenders require, where possible, that further downstream investments of NAV proceeds are structured as intercompany debt, equity commitment letters or preferred equity (ideally with voting rights). Doing so has the benefit of potentially allowing the NAV lender to have (i) a pledge of the intercompany note or equity commitment letter governing the downstream investment without triggering change of control and restrictions on equity pledges and transfers, (ii) voting</p> |

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|                                             | rights in a downstream bankruptcy and (iii) a mechanism to step in and continue funding downstream limited partnership commitments.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     |
| <b>Asset Specific NAV Revaluation Tests</b> | <ul style="list-style-type: none"> <li>• <b>Financial Covenant Testing:</b> The net asset value of the portfolio assets should be tested both as a periodic maintenance test and as an incurrence test. Changes in diversity and concentration should also be taken into account on a periodic and event-driven basis.</li> <li>• <b>There Should Be Two Levels of Financial Covenant Testing:</b> One level triggers an immediate event of default and a lower level triggers the enhanced cooperation period described below.</li> <li>• <b>Covenant Calculation and Testing Should Be Carefully Tailored and Dynamic:</b> The credit agreement should be tailored to the specific asset classes and flexible enough to handle a change in circumstance. If there is a change to the risk profile of the portfolio asset (for example, concentration limits rise or fall or there is a key man event downstream in a secondaries deal), both lender and borrower will benefit from the asset being revalued rather than excluded from the borrowing base in full. The credit agreement should clearly provide for testing and revaluation procedures (including third party valuation rights in select circumstances). Select examples include: <ul style="list-style-type: none"> <li>○ Depending on the collateral, bankruptcy events should allow for third party reevaluation not an automatic reduction to zero, which is frequently the case.</li> <li>○ Partial realization of the underlying fund assets or a down-round should trigger reevaluation of the asset as a whole rather than simply decreasing such asset's value by a corresponding amount.</li> </ul> </li> </ul> <p>Larger, higher quality and more diverse pools of assets may contain more passive testing requirements.</p> |
| <b>Enhanced Cooperation Period</b>          | <ul style="list-style-type: none"> <li>• Generally, the Borrower should have flexibility to reinvest and manage its portfolio investments. In the absence of a default and subject to pro forma covenant compliance, the Borrower should have the authority to sell portfolio assets and reinvest into new assets that will contribute to the borrowing base with limited lender consent rights. However, during a default, there should be greater lender involvement and more limited reinvestment rights without lender consent. As a general matter, during the enhanced cooperation period, proceeds from equity raises, asset sales and returns on investments should be applied to repay the debt. In addition, there should be more stringent requirements regarding the appropriate consideration for such events and requirements regarding receiving cash proceeds and cash sweeps into the lender-controlled accounts.</li> </ul>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                           |

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|  | <ul style="list-style-type: none"> <li>• Consensual foreclosure/enhanced cooperation should be hardwired into the NAV documentation to ensure cooperation and a pathway to cure a default and/or realize value or exit the facility without triggering a key man event under the fund’s investment documents or a change of control at the portfolio investment level. Key features include: <ul style="list-style-type: none"> <li>○ <b>Cash sweeps/cash trapping to pay down loans during a default.</b> The Borrower should be required to use cash from equity raises, distributions, asset sales and other returns on capital to repay debt. The agreement should require cash sweeps and distributions into lender controlled accounts.</li> <li>○ <b>While the lender will maintain the flexibility to accelerate the loans, there should be a hardwired cooperation period and steps plan built into the credit agreement.</b> The credit agreement should contain a process for involving a third-party valuation agent, an investment banker and a sale plan. It is important that the Borrower/fund drive the sale process and decision-making, but that the lender maintains control through the ability to determine satisfaction with the milestones through objective valuation and process metrics. This portion of the agreement should be carefully discussed at the term sheet and negotiation stage and the enhanced cooperation plan should be flexible enough to allow the parties to take into account changes in the plan when consummating asset sales, negotiating a refinancing or otherwise securing alternative capital.</li> <li>○ <b>Cooperation of the Fund/Investment Advisor/General Partner Should Be Hardwired.</b> Even if the fund, investment advisor and general partner are not generally parties to the credit agreement, they should acknowledge the agreements and be bound by the cooperation and sale provisions of the agreements to ensure that the parties work collectively towards an appropriate solution. Consider, where appropriate, the inclusion of bad acts provisions to encourage such cooperation and to maintain the “bankruptcy unlikely structure”.</li> </ul> </li> </ul> |
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| III. Overview of “Bankruptcy Unlikely” SPVs |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                |
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| Single Member Delaware LLC                  | <ul style="list-style-type: none"> <li>• If the Borrower and Holdco are structured as corporations, their management will not be able to disclaim fiduciary duties. In contrast, the Delaware Limited Liability Company Act explicitly permits the members of a limited liability company to include provisions in its organizational documents which restrict or eliminate fiduciary duties.<sup>2</sup> This is one of the most attractive features of a Delaware limited liability company structure.</li> <li>• Delaware law is unique in the broad discretion it gives in structuring a company, particularly by permitting the elimination of fiduciary duties that directors, managers or members owe to the company.</li> <li>• The elimination of fiduciary duties does not permit elimination of the implied contractual covenants of good faith and fair dealing, but does generally limit the liability to which the sponsor’s nominated directors will be exposed. This Delaware structure may not be available in all cases but, where achievable, can be very attractive.<sup>3</sup></li> <li>• Investment documents (both at the fund level and the portfolio level) need to be reviewed on a deal-by-deal basis to determine whether consent will be required in order to form a new Delaware SPV and for such SPV to hold equity and other interests currently held by the fund.</li> </ul> |
| Independent Director                        | <ul style="list-style-type: none"> <li>• It is standard practice in the securitization market to utilize an independent director, hired from a nationally recognized service provider, who may consider only the interests of the Borrower or Holdco, as applicable, including their respective creditors, when voting on a bankruptcy filing. If imported into NAVs, the practice should be enforceable assuming the applicable provisions in the operating agreements for the SPVs are properly drafted.</li> <li>• The blocking vote of an independent director, while helpful in ensuring bankruptcy remoteness, is not an absolute bar, as a complete prohibition will not be enforceable.<sup>4</sup></li> <li>• A director who receives a substantial benefit from supporting a transaction cannot be objectively viewed as disinterested or independent and, for this</li> </ul>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                       |

<sup>2</sup> 6 Del. C. §18-1101(c): To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement, the member’s or manager’s or other person’s duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement; provided, that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing.

<sup>3</sup> 6 Del. C. §18-1101(e): A limited liability company agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a member, manager or other person to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement; provided, that a limited liability company agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.

<sup>4</sup> See *In re Pace Industries, LLC*, Transcript of Hearing, Case No. 20-10927 (MFW) (Bankr. D. Del. May 5, 2020)) where the bankruptcy court in Delaware explained that persons have a constitutional right to avail themselves of a right to file a bankruptcy, to negotiate with their creditors and other stakeholders.

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|                               | reason, it is customary to hire a director from a nationally recognized provider to act as an independent director. <sup>5</sup>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                          |
| <b>Separateness Covenants</b> | <ul style="list-style-type: none"> <li>• Separateness covenants should be included in both the loan documentation and the SPV organizational documents.</li> <li>• Restrictions on activities and the observance of corporate formalities will reduce the possibility that the entity's assets will be consolidated with the bankruptcy estate of an affiliate.</li> <li>• Such restrictions may, with respect to such SPV: <ul style="list-style-type: none"> <li>○ restrict its purpose and powers;</li> <li>○ limit its ability to incur additional indebtedness or pledge its assets without the consent of all directors (including independent directors), other than ordinary course debt expressly permitted by the terms of the loan documents and related to its ownership and operation of the pledged equity interests and other encumbered assets;</li> <li>○ impose restrictions on intercompany transactions;</li> <li>○ require the maintenance of separate books, records, bank accounts and financial statements (other than consolidated financial statements that note the separateness of the entity's assets);</li> <li>○ restrict commingling of assets;</li> <li>○ restrict merger, consolidation, dissolution and any amendment to the provisions in its organizational documents related to its separateness without unanimous consent of all directors, including the independent director;</li> <li>○ require the entity to pay its own liabilities out of its own funds and not guarantee or hold out its assets as available to satisfy the obligations of others; and</li> <li>○ require unanimous consent of all directors, including an independent director, to file bankruptcy.</li> </ul> </li> </ul> |

<sup>5</sup> See *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1992) where the Supreme Court of Delaware determined a director is only independent when its "decision is based entirely on the corporate merits of the transaction and is not influenced by personal or extraneous considerations".

Sidley boasts a broad and deep cross-disciplinary team working at the forefront of fund finance structuring and transactions, inclusive of subscription facilities, NAV facilities, preferred equity issuances, management fee facilities, GP/principal financings, hybrid facilities, warehouse financings, repurchase agreements, variable funding note facilities, medium term note programs, back leverage, prime broker and intermediary liquidity, collateralized fund obligations, and private equity-backed notes. We have experience in every major fund type, across all asset classes and fund strategies. Our expertise is not limited to our vast finance skills, as we take a holistic approach to fund finance in the broader context of the fund's life cycle and capital structure, taking into consideration and bringing to bear our expertise in fund formation, regulatory matters, ERISA and tax considerations, and structural integration with arrangements both upstream and downstream in the fund capital structure. Our clients include participants in all sectors of the fund finance market including hedge funds, real estate funds, private equity funds, investment funds, private credit funds, mutual funds, asset managers, fund sponsors, managers, advisors and principals, prime brokers and broker-dealers, national and regional commercial banks, non-bank lenders, insurance companies, derivatives counterparties, custodians, rating agencies, and investors. A select list of our fund finance partners includes:



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