



Fund Finance 2020

Fourth Edition

Contributing Editor:
Michael C. Mascia

glg global legal group



CONTENTS

Preface	Michael C. Mascia, <i>Cadwalader, Wickersham & Taft LLP</i>	
Introduction	Jeff Johnston, <i>Fund Finance Association</i>	
General chapters	<i>Hybrid and asset-backed fund finance facilities</i>	
	Leon Stephenson, <i>Reed Smith LLP</i>	1
	<i>Subscription line lending: Due diligence by the numbers</i>	
	Bryan G. Petkanics, Anthony Pirraglia & John J. Oberdorf III, <i>Loeb & Loeb LLP</i>	14
	<i>Derivatives at fund level</i>	
	Peter Hughes, Vanessa Kalijnikoff Battaglia & Joseph Wren, <i>Travers Smith LLP</i>	25
	<i>Do subscription facilities purr – or do they roar?</i>	
	Jan Sysel, Jons Lehmann & Kathryn Cecil, <i>Fried, Frank, Harris, Shriver & Jacobson LLP</i>	37
	<i>Financing funds of one: A borrower’s field guide</i>	
	Mary Touchstone & Ashley Belton, <i>Simpson Thacher & Bartlett LLP</i>	47
	<i>Investor views of fund subscription lines</i>	
	Patricia Lynch & Patricia Teixeira, <i>Ropes & Gray LLP</i>	56
	<i>Enforcement: Analysis of lender remedies under U.S. law in subscription-secured credit facilities</i>	
	Ellen Gibson McGinnis, Erin England & Richard D. Anigian, <i>Haynes and Boone, LLP</i>	63
	<i>The secondaries market: The rise of GP-led and preferred equity solutions</i>	
	Samantha Hutchinson & Amrita Maini, <i>Cadwalader, Wickersham & Taft LLP</i> Ian Wiese, <i>Investec Bank plc</i>	85
	<i>1940 Act issues in fund finance transactions</i>	
	Marc Ponchione, <i>Allen & Overy LLP</i>	91
	<i>Considerations in providing NAV facilities to individuals</i>	
	Meyer C. Dworkin & Christopher W. Holt, <i>Davis Polk & Wardwell LLP</i>	99
	<i>The state of play on overcall limitations in the U.S.</i>	
	Michael C. Mascia & Wesley A. Misson, <i>Cadwalader, Wickersham & Taft LLP</i>	106
	<i>Comparing the European, U.S. and Asian fund finance markets</i>	
	Emma Russell & Emily Fuller, <i>Haynes and Boone, LLP</i>	113
	<i>Umbrella facilities: Pros and cons for a sponsor</i>	
	Richard Fletcher, Sarah Ward & John Donnelly, <i>Macfarlanes LLP</i>	123
	<i>Side letters: Pitfalls and perils for a financing</i>	
	Thomas Smith, Margaret O’Neill & John W. Rife III, <i>Debevoise & Plimpton LLP</i>	132
	<i>What next for regulation of fund finance as the EU plans CMU “2.0”?</i>	
	Michael Huertas, <i>Dentons Europe LLP</i>	142
	<i>Fund finance lending: A practical checklist</i>	
	James Heinicke, David Nelson & Daniel Richards, <i>Ogier</i>	157
	<i>Assessing lender risk in fund finance markets</i>	
	Robin Smith, Alistair Russell & Emma German, <i>Carey Olsen Jersey LLP</i>	169
	<i>Fund finance meets securitisation</i>	
	Nicola Wherity & Jessica Littlewood, <i>Clifford Chance LLP</i>	181

<i>Room for market growth: Second liens and shared liens in subscription credit facilities</i>	
Mark C. Dempsey, Anastasia N. Kaup & Ann Richardson Knox, <i>Mayer Brown LLP</i>	189
<i>Regulatory registrations, filings and officer appointments to Cayman Islands funds: The questions for lenders</i>	
Derek Stenson & Michael O'Connor, <i>Conyers</i>	196
<i>Understanding true leverage at the fund level: A European market and sector approach</i>	
Michel Jimenez Lunz & Iulia Gay, <i>SJL Jimenez Lunz</i>	203
<i>Fund finance in Ireland and Luxembourg: A comparative analysis</i>	
Jad Nader, <i>NautaDutilh Avocats Luxembourg</i> & Phil Cody, <i>Arthur Cox</i>	211
<i>The fund finance market in Asia</i>	
James Webb, <i>Carey Olsen</i> , Daniel Lindsey, <i>Goodwin</i> , Emma Wang, <i>East West Bank</i>	222
<i>Fund finance facilities: A cradle-to-grave timeline</i>	
Bronwen Jones, Winston Penhall & Kevin-Paul Deveau, <i>Reed Smith LLP</i>	231

Country chapters

Australia	Tom Highnam, Rita Pang & Luke Leybourne, <i>Allens</i>	241
Belgium	Nora Wouters & Mathieu Raedts, <i>Dentons Europe LLP</i>	255
Bermuda	Matthew Ebbs-Brewer & Sarita Ebbin, <i>Appleby</i>	265
Canada	Michael Henriques, Michael Davies & Alexandra North, <i>Dentons Canada LLP</i>	273
Cayman Islands	Simon Raftopoulos & Anna-Lise Wisdom, <i>Appleby</i>	280
England & Wales	Samantha Hutchinson, Jeremy Cross & Nathan Parker, <i>Cadwalader, Wickersham & Taft LLP</i>	288
France	Philippe Max, Guillaume Panuel & Meryll Aloro, <i>Dentons Europe, AARPI</i>	296
Guernsey	Jeremy Berchem & Nicole Sorbie, <i>Appleby (Guernsey) LLP</i>	304
Hong Kong	Fiona Cumming, Patrick Wong & Stephanie Rowland, <i>Allen & Overy</i>	312
Ireland	Kevin Lynch, Kevin Murphy & David O'Shea, <i>Arthur Cox</i>	322
Italy	Alessandro Fosco Fagotto, Edoardo Galeotti & Valerio Lemma, <i>Dentons Europe Studio Legale Tributario</i>	337
Jersey	James Gaudin & Paul Worsnop, <i>Appleby</i>	344
Luxembourg	Vassiliyan Zanev, Marc Meyers & Antoine Fortier Grethen, <i>Loyens & Loeff Luxembourg S.à r.l.</i>	349
Mauritius	Malcolm Moller, <i>Appleby</i>	360
Netherlands	Gianluca Kreuze, Sabine Schoute & Michaël Maters, <i>Loyens & Loeff N.V.</i>	369
Scotland	Hamish Patrick, Rod MacLeod & Andrew Kinnes, <i>Shepherd and Wedderburn LLP</i>	377
Singapore	Jean Woo, Cara Stevens & Shen Mei Bolton, <i>Ashurst</i>	383
Spain	Jabier Badiola Bergara & Luis Máiz, <i>Dentons Europe Abogados, S.L. Unipersonal</i>	390
USA	Jan Sysel, Ariel Zell & Flora Go, <i>Fried, Frank, Harris, Shriver & Jacobson LLP</i>	398

Considerations in providing NAV facilities to individuals

Meyer C. Dworkin & Christopher W. Holt
Davis Polk & Wardwell LLP

Background

Credit facilities available to private equity funds follow one of two general forms: “Subscription Facilities” and “NAV Facilities”.

Subscription Facilities – also referred to as “subscription line” or “capital call” facilities – are a common structure for many newly-formed funds with significant unfunded capital commitments. The fund’s obligations under a Subscription Facility are secured by all of the fund’s rights with respect to the capital commitments of its investors; most fundamentally, the ability to call capital from such investors and the proceeds of such capital calls. Availability under these facilities is subject to a borrowing base, calculated as an agreed advance rate against the unfunded capital commitments of certain highly-rated (or otherwise creditworthy) “included” investors. Subscription Facilities have become an increasingly important tool for funds early in their life-cycle, providing funds flexibility and speed in making investments by having the lender “bridge” the period between the date of an (initial) investment and the date on which the fund calls and receives capital from its investors as long-term capital.

Subscription Facilities are, however, unavailable as a source of financing to many funds, either because the fund’s organisational documents do not permit (or, in certain cases, do not permit critical structural aspects of) such facilities, or the fund has already invested a significant portion of its capital (and/or its “investment period” has ended), leaving it with insufficient unfunded commitments against which to borrow (and/or significant restrictions on calling any such capital). In these cases, private equity funds have generally turned to “NAV Facilities” – also known as “asset backed” or “net asset value” facilities – to meet their ongoing financing needs.

NAV Facilities, in contrast to Subscription Facilities, are backed by the fund’s investment portfolio. In the most common structures provided to “fund-of-funds”, these investments are primarily equity interests in hedge funds and private equity funds, typically purchased in the secondary market. Availability under NAV Facilities is similarly subject to a borrowing base, but here calculated using the net asset value of qualifying fund interests satisfying specific eligibility and investment criteria, and adjusted for customary concentration limits. If at any time, the ratio of (x) outstanding loans to (y) the borrowing base exceeds a specified threshold, the borrower will be required to prepay loans (or take other agreed actions) to restore compliance with the agreed maximum ratio.

An interesting market development over the past few years has been the expansion of NAV Facility borrowers to include high net-worth individuals and family offices with significant hedge fund and private equity fund investment portfolios.¹ These borrowers utilise the proceeds of such NAV Facilities to either make general distributions to the ultimate owner of the investments or finance other, unrelated investments, in each case without liquidating – and thereby retaining the future upside to – the underlying investment portfolio.

In this chapter, we examine the typical structure of, and collateral securing, such NAV Facilities provided to individuals. And, importantly, we focus on issues to consider – and potential solutions – when providing such NAV Facilities.

Structure and collateral: NAV Facilities

As noted above, NAV Facilities “look down” to the underlying investment portfolio as the credit support for the financing. In a typical NAV Facility for an individual, the individual establishes one or more special purpose vehicles (“SPVs”) to obtain the financing and hold the underlying fund interests included in the borrowing base. Where structured with a single SPV, the SPV will act as the borrower of the NAV Facility and provide a pledge of all assets of the SPV (other than the underlying fund interests) to the lender to secure its obligations under the NAV Facility. In turn, the individual will pledge 100% of the equity interests of the NAV Facility borrower (the “Equity Interest Collateral”).²

This pledge of the Equity Interest Collateral provides NAV Facility financing sources, upon the occurrence of an event of default, with the right to exercise secured creditor remedies with respect to the equity interests of the SPV. This includes the right to foreclose upon or sell such equity interests in accordance with the uniform commercial code (“UCC”) or other applicable law and/or manage an orderly disposition of the underlying portfolio investments via a power of attorney typically granted under the NAV Facility documentation. To perfect the collateral grant, UCC financing statements are filed against both the controlling individual and SPV borrower, and the parties enter into control agreements in favour of the lender with respect to all applicable deposit or securities accounts.³

Issues to consider in NAV Facilities provided to individuals or family offices

Evidence of ownership of portfolio investments

A fundamental structural element of NAV Facilities is that the borrower owns the underlying portfolio investments included in the borrowing base. Unlike liquid equity or debt securities credited to a securities or brokerage account, there is no simple mechanism for lenders to verify such ownership. As such, as a condition precedent to funding any NAV Facility, lenders will require satisfactory evidence of the borrower’s ownership of the portfolio investments.

In NAV Facilities provided to private equity funds, such evidence often takes the form of an accountants’ certification provided in connection with the most recent audited/reviewed financial statements of the borrower. This approach is not feasible in many NAV Facilities provided to individuals, however, as individuals often prepare a single consolidated tax return; they do not prepare financial statements – and, thus, their accountants do not conduct any such audit – solely at the borrower level.

To address this gap and give lenders comfort as to the borrower’s ownership of the underlying portfolio, individuals should, at a minimum, be required to provide lenders with recent periodic account statements from the underlying portfolio investment sponsor

naming the borrower as the limited partner (or other applicable equityholder) and stating the current capital account balance of the investment.

In addition, especially with respect to large investments to be included in the borrowing base, lenders may require that the individual obtain written confirmation from the general partner (or similar managing entity) of the underlying portfolio investments as to the borrower's ownership (and capital account balance) as of the closing date. Such communication may be a formal certification, or as informal as a response by such general partner to an email or other written communication from the borrower, copying the lender, requesting confirmation of the borrower's current capital account balance with respect to the relevant investment.

Finally, where the individual has retained a third-party advisor, administrator or similar custodian to manage the portfolio, lenders may also seek a written certification, confirmation and/or recent capital account balance statements from such third party.

A related concern of lenders in NAV Facilities is ensuring that the portfolio investments remain owned by the borrower – and thus appropriately included in the borrowing base – throughout the life of the financing. While private equity funds may be able to provide satisfactory evidence of such ownership through periodic accountant certifications together with ongoing financial reporting, as noted above, this may not be feasible for individuals. In such cases, lenders may require the individual to instruct underlying general partners (or similar entities) to include the lender as an “interested party” on all account statements, activity reports and other correspondence with respect to the applicable portfolio investments, ensuring that lenders receive both periodic confirmations as well as real-time updates as to any changes in the portfolio investment.

NAV-specific representations, covenants and events of default

As is typical in most financings, borrowers under NAV Facilities are required to periodically make representations and warranties and continuously comply with affirmative and negative covenants, the breach of which results in the occurrence of event of default under the NAV Facility and provides lenders with the right to exercise secured creditor remedies.

In addition to customary representations and covenants as to the borrower's organisation and activities, NAV Facilities include portfolio investment-specific provisions, including representations as to: (x) the borrower's ownership of the portfolio investments included in the borrowing base; and (y) the portfolio investment documentation not prohibiting the individual's pledge of equity interests in the borrower or limiting the lender's right to foreclose on such equity interests or exercise other creditor remedies (collectively, the “NAV-Specific Representations”).

In addition, in order to ensure the integrity of the structure, NAV Facilities will contain negative covenants prohibiting the borrower from: (x) incurring liens on the portfolio investments; (y) making distributions or dividends of the portfolio investments to the individual; and (z) selling or otherwise disposing of any portfolio investment, in each case subject to limited exceptions (collectively, the “NAV-Specific Covenants”).

In contrast to NAV Facilities provided to private equity funds – in which lenders often rely upon an extended course of financial dealings with the sponsor and the practical reality that “repeat-player” sponsors would suffer significant reputational risk and exclusion from the financing market as a result of an intentional breach of NAV Facilities – a lender to an individual will often not be able to rely on such a time-tested relationship. In particular, an individual viewing the NAV Facility as a one-time event may not ascribe the same value to its reputational risk in those markets.

There are a few potential mechanisms for borrowers to address this concern. First, the individual (or, in the case of a family office, additional individuals, trusts or other estate planning entities) may provide a personal guarantee of the NAV Facility. As individuals typically view NAV Facilities as “limited recourse” financings, in which lenders have claims solely against the borrower and its portfolio investments (but not the individual and its other assets), they are reluctant to provide full and unconditional guarantees of the NAV Facility.

Rather, such guarantees are most typically structured as contingent, “bad boy”, guarantees under which the individual is liable for all obligations under the NAV Facility upon (or, in certain cases, an indemnification of the lender’s actual costs and losses arising from) the occurrence of certain specified “trigger” events, including one or more of: (i) a voluntary or involuntary bankruptcy or insolvency event with respect to the borrower; (ii) any breach of the NAV-Specific Representations or NAV-Specific Covenants; (iii) any breach of any other representation or covenant to the extent such breach impairs (in a material adverse respect) the lender’s security interest in the collateral or ability to be repaid; and/or (iv) any gross negligence, bad faith, wilful misconduct, intentional misrepresentation or omission of a material fact.

A second more proscriptive, but effective, approach is to require the individual to appoint an independent director, manager or administrator for the borrower. Such independent third party would be responsible for monitoring any non-ordinary course activities of the borrower, and its consent would be required under the borrower’s organisational documents to sell, distribute or otherwise transfer any underlying portfolio investment, incur liens on the portfolio investments or engage in any similar transaction that may impact the lender’s collateral and rights or remedies under the NAV Facility, including by seeking protection against the lender through a voluntary bankruptcy filing. Under such structure, any sale distribution, transfer, lien or similar transaction effected by individual/borrower without the consent of such third party would be *ultra vires* and, thus, an unenforceable violation of the borrower’s organisational documents.

Individual ownership of portfolio investments

In addition to the primary items noted above, a number of specific issues arise as a result of the (ultimate) ownership of the portfolio investments by an individual. First, lenders under NAV Facilities to individuals may have well-established banking or other relationships with the individual. Thus, notwithstanding the intended “limited recourse” nature of such financings, lenders should consider including a “key man” provision that, upon the death or incapacity of the individual, permits the lender to either accelerate the loans and exercise its creditor remedies or unilaterally adjust the NAV Facility to address the impact of such death or incapacity.

A further, related issue arises where the individual provides a personal guarantee of the NAV Facility (whether full or “bad boy”). While the guarantee itself may be drafted to make clear that it is intended to be binding on the estate of a deceased guarantor,⁴ creditors of a deceased individual may be required to follow jurisdiction-specific steps to enforce their claims against the fiduciary of a decedent’s estate.⁵ In some cases, it may also be the case that no such fiduciary will be appointed because, for example, all of the individual’s assets have been transferred during lifetime to a revocable trust that becomes irrevocable at death. Accordingly, lenders may wish to familiarise themselves with the guarantor’s estate plan and to, once again, consider including a “key man” provision triggered by the death of the guarantor or the failure of an acceptable successor to expressly assume the related guarantee obligation within some reasonable period of time following the death of the guarantor.

Finally, lenders should be aware of the potential implications of a personal bankruptcy filing by an individual.⁶ In certain instances, bankruptcy courts may extend the “automatic stay” protection applicable to the individual (as debtor) to non-debtor entities owned and controlled by the individual on the premise that claims against assets owned by the individual debtor (even through a separate and distinct entity) are in effect claims against that individual.⁷ Even where such stay is so extended, and absent substantive consolidation of the borrower with the individual, the lender’s claim against the SPV borrower should still be structurally senior to any claims of creditors directly against the individual.

Taken together, while a lender may be subject to delay in exercising its rights and remedies in the case of a personal bankruptcy of the individual, the lender should ultimately be able to realise against the collateral held and pledged by the borrower entity on a senior basis to the extent the lender’s security interest in the collateral has been perfected on a first priority basis.

Conclusion

As individuals increasingly explore the potential options for financing their hedge fund and private equity fund portfolios, we expect that an increasing number of individuals and other non-fund borrowers will seek to use NAV Facilities for a growing range of purposes, and with increasingly varied collateral and structural considerations. To ensure that lenders are appropriately protected in providing NAV Facilities to individuals, we expect to see further developments in structural and documentary protections to address this growth and evolution in the complexity of such financings.

* * *

Endnotes

1. For purposes of this article, we refer solely to investment portfolios held by high-net-worth individuals, although the specific organisational structure will differ in each case, based largely on the estate planning of such high net-worth individual, and often include both trusts and other corporate entities.
2. In contrast, in a “double-SPV” structure, a “holdings” SPV is established to hold the equity interests of the borrower, and most typically provides a “downstream” guarantee of the borrower’s obligations under the NAV Facility, securing such guarantee with a pledge of both such equity interests, as well as the deposit and securities accounts into which distributions on and proceeds of the underlying portfolio investments are paid.
3. Where the portfolio investments underlying a NAV Facility are equity interests in hedge funds – rather than private equity funds – lenders will often require that interests be credited to a securities account, thereby creating a “securities entitlement” in favour of the borrower/customer which borrowers, in turn, pledge to lenders and perfect under the UCC upon entry into control agreements. Importantly, under this structure, upon an event of default, the lenders’ remedies include directing the applicable securities intermediary to redeem the underlying hedge fund interests, pursuant to the terms of the underlying fund documentation.
4. One straightforward method to do so is to expressly provide in the relevant instrument that the guarantee is binding on both successors and assigns of the individual as well as on “the heirs and legal and personal representatives” of the individual.

5. After the death an individual, a court of competent jurisdiction (e.g., where the individual was domiciled at death) may appoint a fiduciary (e.g., executor, administrator, personal representative, etc.) responsible for the payment of the decedent's debts and other obligations as part of the settlement of the decedent's estate. Some jurisdictions may require creditors of a deceased individual to file proofs of claim with the relevant fiduciary within a specified period, or have special statutes of limitation applicable to claims against the decedent's estate intended to facilitate the efficient settlement of estates. Special rules may also apply to contingent claims.
6. We note that for purposes of this article we have assumed a U.S. bankruptcy and estate administration regime. In NAV Facilities provided to non-U.S. domiciled borrowers or guarantors, appropriate precautions and advice should be sought.
7. Factors that courts will look to in substantively consolidating the borrower entity with the controlling individual include whether customary corporate separateness formalities were complied with by the borrower and the individual and creditors were aware of their separateness or, in contrast, whether the individual simply treated the borrower as its "alter ego".

**Meyer C. Dworkin****Tel: +1 212 450 4382 / Email: meyer.dworkin@davispolk.com**

Mr. Dworkin is a partner in Davis Polk's Corporate Department, practising in the Finance Group. He advises lenders and borrowers on a variety of finance transactions, including acquisition financings, asset-based financings, debtor-in-possession financings, bankruptcy exit financings and structured financings. In addition, Mr. Dworkin regularly represents hedge funds and corporations in negotiating prime brokerage agreements, ISDA and BMA-standard agreements and other trading and financing documentation and other complex structured financial products.

**Christopher W. Holt****Tel: +1 212 450 3079 / Email: christopher.holt@davispolk.com**

Mr. Holt is an associate in Davis Polk's Corporate Department, practising in the Finance Group. He advises financial institutions and borrowers on a variety of secured and unsecured corporate finance transactions, including acquisition financings, asset-based financings and fund financings.

Davis Polk & Wardwell LLP

450 Lexington Avenue, New York, NY 10017, USA

Tel: +1 212 450 4000 / Fax: +1 212 701 5800 / URL: www.davispolk.com

www.globallegalinsights.com

Other titles in the **Global Legal Insights** series include:

- **AI, Machine Learning & Big Data**
- **Banking Regulation**
- **Blockchain & Cryptocurrency Regulation**
- **Bribery & Corruption**
- **Cartels**
- **Corporate Tax**
- **Employment & Labour Law**
- **Energy**
- **Fintech**
- **Initial Public Offerings**
- **International Arbitration**
- **Litigation & Dispute Resolution**
- **Merger Control**
- **Mergers & Acquisitions**
- **Pricing & Reimbursement**



Strategic partner