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A fund borrower's guide to NAV and Hybrid Facilities:

Considerations for a "bankable" partnership agreement for fund-level leverage beyond the sub line

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Introduction

Over the past 15 years, fund sponsors (with the assistance of experienced fund finance counsel) have improved the form of their fund limited partnership agreements ("**LPAs**") to provide the flexibility necessary to enter into subscription credit facilities backed by the uncalled capital commitments of the fund's investors ("**Subscription Facilities**"). These LPA improvements include express language as to (i) the authority to incur debt, whether on a several, joint and several, guaranteed or cross-collateralised basis, (ii) the ability to pledge the fund's assets to secure such obligations, (iii) investor acknowledgments to fund capital contributions without defence, offset or counterclaim, and (iv) third-party beneficiary rights for lenders as to the foregoing provisions. These improvements help make the LPAs "bankable" and facilitate the streamlined execution of Subscription Facilities, often without the need to deliver investor consent letters, which can be expensive, burdensome and time-consuming.

A Subscription Facility is an essential tool in a fund's toolbox. Such a facility is often put in place soon after the initial investor closing, increased in size as additional investor commitments are added, supplemented with additional borrowers based on the fund's ongoing investment needs, and extended past the initial maturity date to support the fund through its investment period and beyond. An inherent limitation of a Subscription Facility, however, is the aggregate amount of uncalled capital commitments, which declines over time as capital is called and deployed to make investments.

Over the last several years, funds have sought additional liquidity in the form of (i) supplementing their Subscription Facilities by adding collateral relating to the investment value of the fund ("**Hybrid Facilities**"), or (ii) entering into new credit facilities backed by the net asset value of their investment portfolios ("**NAV Facilities**"). With a combination of Subscription Facilities, Hybrid Facilities and/or NAV Facilities, a fund can meet its financing needs from its inception (when uncalled capital is high and asset values are low), through its investment period (as uncalled capital declines and asset values increase), and after the end of its investment period (to support existing investments and return capital to investors when uncalled capital may be low). Historically, a NAV Facility was most commonly put in place later in a fund's life as a replacement for a Subscription Facility. However, recently, funds are showing interest in NAV Facilities earlier in their life cycles, when there is still a large pool of uncalled capital and the Subscription Facility is in active use.

Increased interest in NAV Facilities and Hybrid Facilities extends across fund strategies and types, including secondaries funds, infrastructure funds, open-ended funds and buy-out funds. While these funds often have fulsome provisions in their LPAs relating to Subscription Facilities, fund sponsors and their counsel may wish to evaluate their LPAs and

related investor disclosures with a view toward ensuring that there is sufficient flexibility to enter into other financing arrangements (including NAV Facilities and Hybrid Facilities) that may be in the best interest of the fund and its investors. To this end, fund sponsors may consider updating their LPAs to include terms that will streamline the execution and implementation of NAV Facilities and Hybrid Facilities.

It is important to note that any analysis of a fund's LPA cannot be done in a vacuum. It is a fact-specific inquiry that is based on the totality of the circumstances, including the fund structure, the fund strategy and the nature of investments, the fund's desired debt capacity, investor expectations as to the use of leverage, investor sensitivities to fund-level debt (whether tax, ERISA or otherwise), and disclosures by the fund to its investors (including in the fund's private placement memorandum). There is no "one-size-fits-all" approach. Rather, the terms of a fund's LPA will reflect the negotiated arrangement between the fund and its investors as to permitted indebtedness.

This chapter aims to provide fund borrowers and their counsel with guideposts for reviewing and negotiating LPA provisions, all with the goal of maximising the fund's flexibility to incur and secure debt to support its investments and other activities throughout its life cycle.

NAV Facility basics: Comparisons and contrasts to Subscription Facilities

The primary distinction between a NAV Facility and a Subscription Facility is the nature of the assets that form the basis of the collateral and the borrowing base (or the amount of debt that the fund can incur). At the most basic level, a Subscription Facility "looks upward" to the investors' uncalled capital commitments and a NAV Facility "looks downward" to the fund's investment portfolio.

The borrowing base under a Subscription Facility is equal to the product of one or more advance rates, multiplied by the uncalled capital commitments of the investors. Investors may be divided into groups that receive varying advance rates, depending on their credit quality. Further, certain investors may be subject to concentration limits or hurdle conditions, while others may be excluded entirely from the borrowing base. In contrast, the borrowing base under many NAV Facilities is equal to the product of one or more advance rates, multiplied by the net asset value of the fund's investments. Investments may be divided into groups that receive different advance rates – these may be based on the jurisdiction or credit rating of the investments, or whether they are public or private investments. Similar to a Subscription Facility, certain types of investments may be subject to concentration limits or excluded entirely from the borrowing base. While there are obvious parallels between these two types of facilities, the calculations determining the amount of debt that a fund can incur are fundamentally different.

The collateral under a Subscription Facility typically comprises (i) the uncalled capital commitments of the fund's investors, (ii) the right of the fund and its general partner to issue capital calls to the fund's investors, (iii) the right of the fund to receive capital contributions from such investors, and (iv) the accounts into which the capital contributions are deposited. The scope of Subscription Facility collateral has become relatively standardised, although there may be complications based on the structure of the fund and the investors' capital commitments. In contrast, there is greater variation in the collateral provided under a NAV Facility, which can be tailored to suit a fund's particular circumstances and financing needs. This variation is largely driven by (a) the structure of the fund and how its investments are held (whether directly or through one or more holding companies), (b) the need of the

particular fund to maintain other debt arrangements, whether at the fund or asset level, (c) the position of the NAV Facility borrower within the overall fund structure (whether at the fund level or at one or more special purpose vehicles), and (d) the commercial understanding between the lender and the fund sponsor.

Collateral and partnership agreement pledging provisions

The scope of the collateral package is a gating item when negotiating a NAV or Hybrid Facility. The most robust collateral package requested by lenders might include a lien on each borrower's (i) rights to receive proceeds and distributions in respect of its investments, (ii) accounts into which such amounts are deposited, and/or (iii) equity interests in its underlying investment vehicles. This type of package will require fund sponsors and their counsel to review the fund documents to confirm that they include appropriate authorisations, as well as the underlying investment documents to determine whether they include any applicable restrictions.

Juxtaposed against these arrangements are more borrower-friendly "collateral-lite" facilities, where the collateral comprises the bank accounts into which distributions and other proceeds are deposited. This pledge is then coupled with a covenant by the borrowers to deposit distributions and other proceeds into such accounts. In these cases, lenders may seek additional protection by requiring a negative pledge on certain assets (including equity interests) held by the borrowers. The benefits of these facilities from a fund sponsor perspective are:

- they are more cost-effective from a legal perspective to put in place in light of the narrower scope of security documentation;
- there is no ongoing collateral management, particularly as investments are purchased and sold during the life of the fund; and
- this approach may avoid potential legal, regulatory and contractual complications (as discussed further below).

As a threshold matter, a fund should determine whether its LPA and other fund documents permit the pledge of the required collateral. For a fund sponsor looking for maximum flexibility, the pledging provisions of the LPA will permit the fund to grant a security interest in each of (i) its investments (whether its entire portfolio or a subset thereof), (ii) any distributions or proceeds related to its investments (including the fund's rights to receive such amounts), and (iii) the bank accounts into which such amounts are deposited. Additionally, if the NAV or Hybrid Facility will be used to finance a single investment or a subset of investments, a fund sponsor should discuss with its funds and tax counsel, as well as accountants, to determine whether collateral relating to the non-financed investments may be used to support those borrowings.

Diligence considerations relating to NAV Facility collateral packages

Aside from analysing the fund documents in connection with a proposed collateral package, fund borrowers and their counsel then have to address any restrictions contained in asset-level documents, including relevant financing and acquisition agreements and governing documents. For example, an agreement with respect to an investment may prohibit any transfer or pledge (whether it be direct or indirect) of the fund's equity interest therein. These considerations are not only relevant in cases where the fund is pledging its equity interests in investments; they may also be applicable in cases where the fund agrees to (i) a negative pledge on such equity interests, or (ii) a pledge of (or negative pledge on) its

economic rights in respect of such equity interests. Therefore, in most cases, there will necessarily be a certain amount of diligence to be completed with respect to the underlying documentation governing the investments.

This analysis will be largely dependent on the fund structure, including at what level within the structure the NAV Facility borrowings will be incurred (whether at the fund level or at one or more entities that sit below the fund). A fund sponsor may wish to position the debt below the fund for a number of reasons. If the fund already has a Subscription Facility in place, some NAV Facility lenders prefer that debt be incurred below the fund so that the Subscription Facility lenders are structurally subordinated to the NAV Facility. If this structuring is not envisioned when the fund is first established or the Subscription Facility is first entered into, a fund sponsor may try to "retro-fit" newly formed aggregators or special purpose vehicles into the existing fund structure. However, doing so could create additional complications, such as triggering third-party consent requirements or necessitating regulatory filings.

Below are some diligence questions to consider:

- Do any deal-level counterparties or the organisational documents with respect to the investment require notice and/or consents in order for the fund to pledge its direct or indirect equity interest in such investment? For example, are there transfer or change of control provisions that would be breached upon any foreclosure on the fund's equity interest in a default scenario? Or, if broadly worded, could a transfer or change of control provision be inadvertently triggered by the fund granting a lien or agreeing to a negative pledge on its equity interest or its rights to receive distributions in respect thereof?
- To the extent the collateral includes investments consisting of public securities, or the NAV Facility lenders request a negative pledge with respect to such investments, are there any securities law or other regulatory considerations (such as Regulation U) that need to be discussed with the fund's counsel?
- Are any notices required to, or consents required from, regulators in connection with the direct or indirect pledge of the fund's equity interest in any investment or right to receive proceeds therefrom? What is the process and timing necessary for such notices or consents?
- Are there any local law issues relating to the jurisdiction of the pledged investments?

Analysing these provisions may require coordinating with various local counsel, regulatory specialists and deal-level counsel who are most familiar with the fund's investments. As such, the diligence process may be cumbersome and expensive, particularly if (i) a large number of investments will be pledged, or (ii) the collateral package (including any negative pledge) is broad in scope. One of the key benefits to a "collateral-lite" facility (where the collateral comprises solely the bank accounts into which distribution and other investment proceeds are deposited) is the reduction of potential legal, regulatory and contractual issues.

Liability of borrowers

Negotiations regarding the extent of the collateral package will be influenced by the allocation of liability among the borrowers. As a condition to providing a single borrowing base calculated by reference to the net asset value of the fund's entire investment portfolio, NAV Facility lenders may require the borrowers (including any main fund, parallel fund or alternative investment vehicle ("**AIV**")) to provide credit support for each other's obligations. Such credit support may be in the form of joint and several liability, guarantees or cross-collateralisation. The level at which the NAV Facility debt is incurred (whether at

or below the fund level) may inform a fund's analysis as to its preferred approach, but each of the below considerations may still apply. In any case, a fund may want to maximise its optionality by permitting each such arrangement in its fund documents in order to obtain the best possible financing terms.

Before diving into the merits and drawbacks of each approach, it is important to understand why the liability structuring for NAV Facilities differs from that of Subscription Facilities. Unlike NAV Facilities, many Subscription Facilities are carefully crafted to avoid any credit support being provided by a main fund for the benefit of any of its AIVs, or *vice versa*, whether in the form of joint and several liability, guarantees or cross-collateralisation. These entities all have access to the Subscription Facility collateral, as they each have the ability to call capital from the same pool of investors that subscribed to the main fund. Therefore, there is no compelling reason to have any credit support (let alone joint and several liability) provided among these entities in connection with a Subscription Facility. From a funds and tax perspective, avoiding linkage between a main fund and its related AIVs is ideal. AIVs may be set up to accommodate the preferences of investors with different tax profiles and objectives. Having an AIV provide credit support to its related main fund (or *vice versa*) may increase the risk that the separateness of these vehicles will not be respected for U.S. tax purposes. As a result, many Subscription Facilities are set up so that each AIV secures only its own obligations and not the obligations of its related main fund or other related AIVs. Similarly, the main fund secures its own obligations and not those of its related AIVs.

While AIVs have access to the same pool of investor commitments as their related main fund, these entities typically make different investments. Therefore, any collateral provided by a main fund and its related AIVs in connection with a NAV or Hybrid Facility may not be shared among such entities in the same manner as the shared pool of uncalled capital commitments that secure a Subscription Facility. As a result, NAV and Hybrid Facility lenders may expect some type of credit support to be provided for the benefit of all borrowers, including as between a main fund and its AIVs.

NAV and Hybrid Facility lenders may insist on the borrowers being jointly and severally liable for, or providing guarantees of, all obligations under the facility. With this approach, each borrower is liable for the full amount of loans outstanding under the facility, regardless of which borrower incurred the loans. During an event of default, the lender (or, in the case of a syndicated facility, the agent) can demand repayment of any loan from any or all of the borrowers and exercise remedies against any of the pledged collateral. However, there are some potential pitfalls with this approach. First, it may negatively impact the U.S. tax analysis, as described above. Further, some borrowers may have significantly less asset value than other borrowers, and that disparity could render a small borrower immediately insolvent (or in violation of applicable debt limits in its organisational documents) upon the incurrence of a loan by a larger borrower. Savings language that limits the liability of each borrower to the maximum that may be incurred without rendering such borrower insolvent (or in violation of its LPA) can mitigate this result.

Fund sponsors tend to prefer cross-collateralisation in their fund-level debt arrangements over both joint and several liability and guarantees, mainly as a result of the authorisations included in the fund documents, the investors' expectations and tax considerations. Each borrower may cross-collateralise each other borrower's obligations by granting a lien on its collateral to secure its own obligations as well as the obligations of each other borrower. With this approach, even though borrowings by the main fund, any parallel fund and any AIV are on a several basis, the obligations of each borrower are secured by the combined

collateral. As it relates to the obligations owed by any borrower, lenders will have full recourse against the combined collateral (subject to any applicable savings limits); however, they will not otherwise have recourse to any other assets of the borrowers, except in the case of the borrower that initially incurred the loan.

Regardless of which approach is agreed upon, a fund sponsor may explore options with their fund, fund finance and tax counsel to help mitigate any fund- or tax-related concerns without disadvantaging lenders. For example, the borrowers may enter into a contribution and reimbursement agreement to ensure that each borrower is ultimately only liable for its applicable share of the facility obligations. In any case, funds and tax counsel should be consulted to determine whether the liability structure works under the fund documents or affects the U.S. tax analysis described above.

Impact of LPA debt limitations on NAV and Hybrid Facilities

When reviewing a fund's organisational documents, in addition to any collateral- or liability-related issues, attention should be given to any provisions governing incurrence of indebtedness. Of course, a fund's LPA has to permit the incurrence of debt, and many LPAs undoubtedly allow the incurrence of Subscription Facility debt. However, in the case of a NAV or Hybrid Facility, it is critical to analyse how the LPA limits the fund's ability to incur debt and whether any investor side letters further restrict a fund's debt capacity.

Some common issues that arise in connection with fund-level debt limits are as follows:

- As a fund calls and deploys capital, the amount of its uncalled capital reduces over time. Any debt limit that prohibits debt in excess of uncalled capital may inadvertently limit (or even prohibit) a NAV Facility or Hybrid Facility or any other indebtedness later in the life of the fund.
- Any debt limit tied to asset value (but which excludes uncalled capital) may inadvertently limit the ability of a fund to incur any indebtedness early in its life before it has made many investments.
- If a debt limit solely relates to (or excludes) debt incurred under a Subscription Facility, the fund will have to determine whether a Hybrid Facility (which is secured by typical Subscription Facility collateral, in addition to other collateral) should be similarly limited or excluded.
- Are there any side letters that place further restrictions (whether on amount, use of proceeds or tenor) on the fund's ability to incur debt?
- Does the calculation of uncalled capital require a reserve for, or reduction of, any outstanding debt and, if so, does that impact any of the agreed debt limits in the LPA?
- Is there sufficient disclosure to investors regarding how debt is calculated and reported, and the possible risks of leverage generally?
- Do the debt limitations in the fund-level LPA apply to debt incurred by any entities that sit below the fund in the structure (i.e., holding companies or other special purpose vehicles through which the fund makes its investments)?

Fund document limitations on use of NAV and Hybrid Facility loan proceeds

In terms of potential uses of loan proceeds, NAV and Hybrid Facilities may enable a fund sponsor to further leverage its investments, refinance asset-level debt, fund follow-on investments and accelerate distributions to investors in advance of exiting investments. Given this wide range of possible uses of proceeds, a fund should give thought to its expected use of such facilities when drafting its LPA and negotiating its other fund documents.

To the extent the fund would like to borrow to make distributions to investors, query whether it is permitted to do so under its LPA and side letters. Note that, regardless of whether such authorisations are included in the fund documents, some lenders may not be comfortable lending for the purpose of making distributions or may have internal policies restricting such use of proceeds.

Additionally, funds should consider any tenor limitations included in LPAs with respect to borrowings. For example, if Subscription Facility debt is intended only to bridge capital calls (and not for any longer-term purposes), shorter tenor limitations may not present any issues. However, in the case of a NAV or Hybrid Facility, longer-term leverage may be in the best interest of the fund. NAV Facility loans are intended to be repaid with investment proceeds, the timing of which are not fully within the fund's control. Likewise, Hybrid Facility loans may be repaid with investment proceeds. Therefore, to preserve optionality, a fund should consider incorporating flexibility in its fund documents to allow NAV and Hybrid Facility borrowings to be outstanding for longer durations.

Conclusion

NAV and Hybrid Facilities are bespoke in nature and need to be individually tailored to reflect a fund's structure, investment portfolio, investor expectations and liquidity needs. Given the increasing importance of these financing arrangements in providing liquidity to funds, a fund sponsor and its counsel should review the fund LPA in advance of any such financing (and ideally in advance of the execution of the LPA and other fund documentation) to ensure that it maximises flexibility for the fund's financing objectives and is "bankable" for any anticipated credit facility structure. Specifically, the fund sponsor and its counsel will want to consider the following in their LPA and fund documentation review:

- Collateral that will be permitted to secure the facility.
- Liability structure of the borrowers under the facility.
- Debt limitations that may impact borrowing capacity.
- Use of loan proceeds provisions that may affect expected facility usage.

The foregoing is also a helpful list of items to bear in mind in any LPA and other fund document discussions with investors regarding the fund's anticipated use of leverage to support its investments and other activities. Front-loading this LPA analysis will help the fund streamline execution of its credit facilities and achieve best-of-market terms for the financing structure selected.

* * *

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