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Fund Finance: Overview

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A Practice Note giving an overview of the growing practice of fund finance. It includes a description of the most common types of credit facilities and a review of the features that make fund finance facilities both attractive and challenging from the perspectives of borrowers and lenders.

Investment funds (funds) are investment vehicles formed by investment managers. The term "fund" is used broadly here to include hedge funds, funds of funds, private equity funds, venture capital funds, private credit funds, real estate investment trusts (REITs), special situations funds, regulated investment companies (RICs), business development companies (BDCs), and any of their respective management companies, investment managers, or advisers.

The funds use capital provided to them by investors for their investments, with the investors hoping to earn a high rate of return on their capital. For more information on private equity funds and fund formation, see Practice Note, Private Equity Fund Formation.

The funds often obtain third-party financing from lenders to improve their liquidity and to avoid missed investment opportunities. Lenders have historically been banks, but a growing portion of financing is being provided by private credit, direct lending, and other funds. The products offered are collectively known as fund finance.

These products give access to liquidity to serve various purposes over the life of a fund, whether to allow a fund to make investments before calling capital from its investors, to return capital to its investors before a traditional liquidity event, or otherwise. These loans provide flexibility to a fund and have become a valued operational tool for them.

This Note is an overview of the growing practice of fund finance, including a description of the most common types of credit facilities and a review of the features that make fund finance facilities both attractive and challenging from the perspectives of borrowers and lenders.

Fund Structures

Funds are usually structured as limited partnerships (which, in the US, are most typically organized in Delaware) and include:

- A general partner (GP) who manages the activities of the fund.
- Various limited partners (investors), commonly consisting of high net-worth individuals, financial institutions, life insurance companies, pension funds, endowments, and foundations.

A fund may be formed as a limited liability company (LLC) as an alternative to a partnership. The fund is customarily operated by a management entity that may also serve as the GP of the partnership (or manager or managing member of the LLC, as applicable). The rights and duties of the manager may be set out in a separate management agreement and include rights to payment for services and reimbursement of expenses.

The investors commit to invest a specific amount of money (capital) in the fund (capital commitment), which the fund uses to make investments in accordance with the terms of the fund's governing document. These investments often are in the form of equity ownership of entities known as portfolio companies.

If the fund is a limited partnership, the fund's governing document is a limited partnership agreement (LPA). The LPA sets out the rights and obligations of the investors relating to the fund. Each investor executes and delivers a subscription agreement, which is a short agreement between the investor and the fund containing the investor's agreement to contribute a stated amount of capital during the term of the fund.

To the extent an investor negotiates terms different from other investors, these are set out in a side letter, also between the investor and the fund. Typical subject matter for a side letter includes rights to assign the investor's position, retention of a right to sovereign immunity, an excuse from compliance with the LPA under expressly stated situations or agreements for most-favored-nation treatment.

The fund has a finite life, usually ten years, and the LPA typically requires that investments be made primarily in the earlier years of the fund's life. After about the fifth year, the fund is only permitted to make follow-on investments, which are related to earlier investments, and may not deploy funds for entirely new investments.

Because neither the fund nor the investors want to have money lying idle, the investors only provide cash to the fund as needed. When the fund's manager decides on a suitable investment, it "calls capital" from the investors. If the fund makes a capital call, the investors must fund their commitments by paying cash (capital contribution) into a specified fund account within a predetermined period of time set out in the LPA (for example, ten business days).

Fund Finance

The term "fund finance" is used broadly to describe any type of financing that is put in place at the fund level or within the fund structure (rather than at the asset or investment level of the fund).

The most common types of fund financing are:

- Subscription facilities.
- NAV facilities.
- Hybrid facilities.

For more information on fund finance, including collateral structures, legal due diligence considerations, practical suggestions around enforcing remedies, and bankruptcy risks, see Practice Note, Security Interests: Fund Finance.

This Note does not address:

- Subscription finance in the form of term loans, which are typically provided to funds that invest in real estate development where financing is needed over a longer period of time or where leverage is an integral component of the funds needed for an investment.
- Types of financing that have non-debt components, including preferred equity structures.
- The law of any jurisdiction outside of the US, US federal or state securities laws, the applicable laws of any particular state, tax issues, or Employee Retirement Income Security Act of 1974 (ERISA) issues.

Overview of Subscription Facilities

A subscription facility (also known as a capital call facility) is a line of credit primarily used by closed-end private equity and other investment funds to bridge investments or fees and expenses ahead of capital contributions from investors. It is most often a senior secured revolving line of credit in which the collateral is the fund's uncalled capital commitments from its investors.

This type of facility is typically put in place at or soon after the fund's formation, when the uncalled capital commitments from its investors comprise the most valuable asset of the fund. Typically, there is no security interest in the fund's underlying portfolio assets. Instead, the collateral consists of:

- The fund's and its GP's rights:
  - in and to the uncalled capital commitments of the investors; and
  - to make capital calls and enforce the obligations of the investors to make capital contributions.
- The deposit accounts of the fund into which the capital contributions are made.

The facilities are fully recourse to the fund borrower but not to the GP.

Under a subscription facility, the fund borrows against its uncalled capital commitments, subject to a borrowing base and advance rates based on the creditworthiness of the investors. There may also be:

- Investor concentration limits (see Credit, Structuring, and Diligence Considerations: Subscription Facilities).
- Certain events that exclude a portion or all of an investor's commitment, including, for instance, an investor's downgraded credit rating, decline in total net worth, transfers or defaults on capital commitment obligations, or other impairment of the investor's ability to fund its remaining capital commitments.

Subscription facilities may be committed or uncommitted and are often subject to annual renewal, although the amount available naturally reduces over time, as there is less uncalled capital in the later years of the fund's investment period and life cycle.

Overview of NAV Facilities

A net asset value (NAV) facility is an attractive credit solution later in a fund's life (after all or most of its uncalled capital has been deployed), as it unlocks the value of the assets that the fund has created or acquired.

The borrowing base in a NAV facility is comprised of the fund's underlying portfolio of assets (as opposed to its uncalled capital). The portfolio of assets could include controlling or minority interests in companies or other funds, loans, or real estate.

The value attributed to the borrowing base is determined by reference to the value of "eligible" assets satisfying specific criteria, subject to an advance rate that is based on several factors, including liquidity, diversity, and actual or projected cash flow of the portfolio of assets. The manner and frequency with which the underlying assets are valued over the life of the loan, and by whom, is a highly negotiated and important component of a NAV facility. Lenders typically also want a mechanism to allow them to challenge the valuation and may want the ability to engage a third-party appraiser in certain circumstances.

The structure of a NAV facility depends on:

- The nature of the assets that comprise the NAV facility's borrowing base.
- The intended purpose of the NAV facility.
- The existing fund structure.

A NAV facility is typically a senior ranking credit facility that can be either a term loan or a revolver, usually has a term of one to five years, and can be secured or unsecured.

Where a fund's structure and operating documents permit it, the borrower and the guarantor of a NAV facility are often newly formed "special purpose vehicles" (SPVs) that sit under the fund and above the portfolio investment, helping to insulate the assets supporting the NAV facility from subscription facility creditors or other fund-level debt and liabilities.

Where secured, the collateral package of a NAV facility may vary greatly from one facility to the next depending on several factors, including regulatory considerations, constraints in the operating documents of the fund and the underlying assets, and constraints in the debt documents to which the underlying assets are subject or party. Subject to those constraints and considerations, the elements of the collateral package of a NAV facility may include some or all of the following:

- A pledge of the equity of the borrower or holding vehicles that own the portfolio investments, or both.
- To the extent that the underlying investments are portfolio companies, a pledge of the equity in those portfolio companies.
- To the extent that the underlying investments are loans, a pledge of those loans.
- A pledge over:
  - the account into which distributions from the investments are deposited; and
  - if the portfolio investments are securities held in a securities account, the securities account.

  The accounts may be blocked or springing (that is, the borrower has access to the account until an event of default occurs and a lender delivers a "notice of exclusive control") depending on negotiated terms and the account structure and usage.
- Assignment of contractual rights to allow lenders to direct the sale and disposition of the portfolio investments after a default.

Where there are barriers to obtaining all or most of these collateral protections and lenders are otherwise comfortable (after a full assessment of the broader structure, including the number, quality, diversity, liquidity, performance and expected cash flows of the assets, the contemplated loan-to-value ratio, and the anticipated pricing), lenders may agree to a much more limited set of "collateral-lite" protections comprised primarily of a lien in:

- The distributions from the underlying investments arising from an agreed set of events.
- The account into which these distributions are deposited, coupled with cash sweep mechanisms from that account, triggered on the occurrence of certain events under the facility.

This arrangement is also often paired with a negative pledge on the underlying assets in which the lender is not taking a security interest as an additional protection. Where it is not possible to take a lien on certain assets at closing, a lender may require that the assets created or acquired after closing are structured and held in such a way that they may be pledged. Under these circumstances, a negative pledge that not only prohibits granting a lien in the assets to others, but also bars entering into any agreements that prohibit the lender from taking a lien in such assets, may be appropriate.

For more information on considerations around a NAV facility's collateral package, see Credit, Structuring, and Diligence Considerations: NAV Facilities.

Overview of Hybrid Facilities

Hybrid facilities combine features of both subscription facilities and NAV facilities, including:

- A borrowing base and maximum facility amount that look to and are based on both the uncalled capital commitments of investors in the fund and the NAV of the assets or investments held by the fund. Depending on the facility, this could take the form of a single combined borrowing base or facility amount or separate tranches for each of the subscription and NAV pieces (including separate groups of lenders for each tranche).
- A collateral pool that includes both:
  - capital call rights, capital contributions, and the deposit accounts into which capital contributions are made; and
  - the underlying investments of the fund, where and to the extent possible (see Overview of NAV Facilities), and deposit accounts into which distribution and liquidation proceeds from investments are deposited.

Depending on the facility and whether there are separate tranches and lender groups as noted above, the capital commitments and related collateral accounts might primarily secure the subscription piece, and underlying investments and related collateral accounts primarily secure the NAV piece, with an intercreditor agreement put in place to govern the rights of the respective lender groups to the collateral.

Eligibility and inclusion criteria, concentration limits, and default and prepayment triggers are set in reference to, and reporting is required with respect to, both the investors and the underlying investments of the fund.

Fund Finance Considerations

The decision by a fund as to whether and when to pursue financing, and a lender's decision to provide it, can be influenced by a variety of factors, including:

- The fund's investment strategy, value, type, and liquidity and the diversity of its assets.
- Pricing.
- The credit quality of the fund's investors and their appetite for, or expectations of, leverage.
- The projected life cycle of the fund and where the fund currently sits in that life cycle.
- Whether there is debt or credit support elsewhere in the fund structure.
- Regulatory considerations.
- Market conditions.

Several of these considerations for each of the three common types of fund financings are described in more detail below.

Considerations for Subscription Facilities

Subscription facilities have generally become an expected feature put in place at a fund's inception. For funds, the primary benefit of subscription facilities is liquidity accessibility and management. Subscription facilities effectively convert uncalled capital commitments into immediately available liquidity, enabling a fund to make investments or meet expenses without having to call capital or sell portfolio assets. Under a subscription facility, fund borrowers may be able to access cash within one or two business days, whereas calling capital in accordance with a fund's governing documents typically requires giving investors at least ten to fifteen business days' notice to make capital contributions.

The speed and certainty of advances under a subscription facility allow a fund to capitalize on immediate investment opportunities that the fund may otherwise have missed if the capital had not been readily available, particularly in strong M&A environments where investment opportunities are more frequent and funds need to be able to act quickly.

In that connection, subscription facilities also allow fund managers to:

- Smooth out capital call schedules and alleviate the administrative burden on funds and investors by reducing the frequency of capital calls.
- Avoid making capital calls for investments that may not ultimately be consummated.
- Harmonize early capital calls with subsequent calls to better align the calculation of internal rates of return across investor groups during slower fundraising cycles in which a fund may have to pursue multiple closes.

Another benefit of subscription facilities in a favorable interest rate environment can be the ability to increase internal rates of return. By drawing on the subscription line rather than calling capital, fund managers use leverage to shorten the investment period, which can result in higher yields.

Lower interest rates (as compared to NAV facilities and other financing options) and less restrictive covenants are other attractive features of subscription facilities from a fund's perspective. For instance, covenants often align with many of the limitations and conditions in the fund's organizational documents, including reporting requirements and regulatory compliance. Lenders also typically do not require any financial covenants other than limitations on debt that align with any limitations already required by the fund's organizational documents.

Lenders like subscription facilities because the investors' capital commitments are considered highly secure and enforceable unencumbered collateral. The senior secured collateral comes from creditworthy sources, including sovereign funds, insurance funds, pension funds, family offices, and high net-worth individuals. Lenders are lending against that credit quality rather than the credit quality of the (typically) newly formed fund. Lenders also take comfort in conservative advance rates and a low risk of collateral enforcement issues. The collateral is more liquid than collateral typically given for operating company loans or NAV facilities.

The subscription lending space also garners interest and new entrants because of the low barriers to entry and rare instances of default resulting in enforcement actions. Most lenders are generally familiar with the collateral (that is, the types of investors and the creditworthiness of the investors whose capital commitments constitute the borrowing base). Furthermore, they do not need expertise in a fund's industry to understand the collateral and the risks involved in an investment when making the loan and enforcing remedies.

Subscription facilities are most useful in the early stages of a fund's life when the fund does not have any meaningful assets or investments to use as collateral for other financing, and all or substantially all of the fund's capital commitments remain uncalled. As the investment period continues and uncalled capital commitments reduce over time, the availability under the subscription facility is also reduced as the borrowing base and collateral is reduced. This is when a NAV or hybrid facility becomes more attractive.

The spring 2023 disruption among financial institution lenders with heavy concentrations in subscription facilities, taken together with a higher interest rate environment and regulatory pressures constraining lenders' balance sheet capacity for these loans, have combined to render these facilities less plentiful, more expensive, and subject to more stringent terms. This has altered the value proposition of these facilities for both funds and lenders, causing all parties to be more thoughtful and deliberative in pursuing and sizing them rather than reflexively putting in place the largest possible lines at each fund formation.

Considerations for NAV Facilities

A NAV facility becomes a viable financing option later in a fund's life. While the value of a subscription facility is significantly diminished or no longer available because capital commitments are close to being fully drawn, those capital call proceeds will have been deployed in investments. Once a critical mass of cash-flowing investments is reached, they may become a viable pool to support a loan. A NAV facility allows a fund to capitalize on the inherent diversity of its underlying assets to secure financing terms, even if a specific asset is in distress or a particular sector is impaired. Compelling features of NAV facilities from a lender's perspective include relatively low loan to value ratios, relatively higher pricing and, as with subscription facilities, the opportunity to connect and develop long term relationships with asset managers that can lead to exposure in other lines of business.

Typical uses for NAV facilities include:

- **Working capital liquidity**. They can be used to cover a fund's ongoing working capital, pay certain costs and expenses or make carry investments and distributions or dividends to equity holders.
- **Asset-level investments**. They can be used to make new or follow-on investments, make equity cures, offer competitive "cash" bids, boost returns of portfolio investments, increase investments in existing positions or eliminate asset-level financing.
- **Capital returns to investors**. They can be used to bridge the gap at a crucial time for follow-on investments when returns from underlying investments have not been realized but exit timing is not optimal, provide funding to redeem exiting investors in the fund, buy out minority stakes from investors, or seed an anchor investor's initial investment in a subsequent fund.

While NAV financings have long been a settled form of financing for hedge funds, funds of funds, mutual funds, and private credit funds, they are becoming increasingly popular for private equity funds as well. This rise can be attributed to a confluence of circumstances. Many of the elements that have caused some disruption in the subscription line market are contributing factors. Those elements, combined with the following conditions, are causing what might have formerly seemed a prohibitively expensive alternative to be more viable in a constrained environment:

- A slowdown in M&A activity, causing sponsors to seek ways to hold assets for longer.
- Headwinds in fundraising, causing a need to find liquidity from other sources.
- Tightening of credit markets more generally, limiting other financing options.
- Higher interest rates across the board.

Lenders and potential lenders have met the market, as alternative lenders seek attractive opportunities to deploy cash, traditional financial institution lenders seek opportunities to diversify away from pure subscription line plays, and insurance company investors seek opportunities to deploy capital while mitigating their risk-based capital treatment.

Considerations for Hybrid Facilities

Like subscription and NAV facilities, hybrid facilities may be used by funds for both general liquidity needs and the ability to manage internal rates of return, as well as to smooth and increase the predictability of the capital call and investment processes. Hybrid facilities can be particularly useful to funds that:

- Are well into the investment period, so that a facility supported solely by capital call rights would have limited availability.
- Have limited or lower quality investors, so that adding recourse to the underlying assets of the fund would allow for greater borrowing power than a stand-alone subscription facility.
- Have few or lower quality underlying investments, so that adding recourse to capital commitments of the fund would allow for greater borrowing power than a stand-alone NAV facility.
- Invest in assets that are expected to have cash flows early on (for example, loan interest paid to private credit funds), which they would like to leverage alongside a subscription line early in the fund's life cycle.

From a lender's perspective, a hybrid facility can present an opportunity to lock itself in as the primary lender to a fund, diversify its credit risk or exposure to the fund, while broadening and deepening the collateral pool by looking both up to investors and down to the fund's underlying assets, and capture higher pricing than a subscription line alone.

Depending on a lender's credit requirements or potential issues or complexities in a fund's investor base or investment pool, a hybrid facility might also be the only structure by which a lender is able to get comfortable extending credit to the fund. Hybrid facilities come in and out of fashion as a viable financing alternative, but find particular favor when market conditions constrain lending capacity and funds find "one-stop" shopping more palatable. They also find favor when funds expect interest rates to rise and are confident that locking in a "blended" rate earlier that may be slightly higher than a rate for a subscription line alone will nonetheless be more cost-effective than waiting to put in place a stand-alone NAV facility at the increased future rate.

Credit, Structuring, and Diligence Considerations

There are several credit, structuring, and diligence considerations that inform the structure and documentation of any fund financing. These concerns will necessarily be the focus of and raised by lenders as they determine the feasibility of a particular financing, assess the associated risks, and address structuring considerations, loan-to-value ratios, and pricing accordingly. It is also prudent for funds that intend to seek financing to anticipate and understand these considerations early, as certain issues might be avoided or mitigated by a careful approach to fund formation and offering documentation, initial investor negotiations, and investment management strategies.

The legal diligence for any fund financing should start with reviewing the fund's organizational structure to determine which entities should be credit parties and pledge collateral to properly outline the structure of the facility and identify the parties to it. Another threshold diligence step common to all types of fund finance is determining a fund's ability to pursue financing under its organizational documents, including subscription agreements, side letters, and the LPA or other operating agreement of the fund and all related entities implicated in the financing.

At minimum, the organizational documents should permit the incurrence of indebtedness, including, to the extent applicable, on a joint and several basis (with cross-collateralization) with parallel funds and alternative investment vehicles, as well as the pledge of collateral.

Parties should also diligence any limitations in the LPA on the amount that may be borrowed, the amount of time an advance may remain outstanding, and the types of assets that may be pledged. Very often, fund organizational documents include robust provisions permitting subscription facilities, but the inclusion of language contemplating other types of indebtedness, including NAV and hybrid facilities, is less common.

A summary of certain other credit, structuring, and diligence considerations in the context of subscription, NAV, and hybrid facilities is below.

Subscription Facilities

The creditworthiness and stability of the investor base are crucial to the underwriting of subscription facilities. Lenders assess the financial strength, commitment history, and diversity of the investors to help determine the risk profile of a potential fund borrower. Lenders may be concerned that a non-diverse investor pool or a concentration of a few investors with large capital commitments can present more risks to the likelihood of repayment than a diversified, evenly concentrated pool of investors.

In the event of highly concentrated commitments, lenders may seek investor letters from the applicable investors for additional comfort. An investor letter is an agreement between the investor and the lender, the goal of which is to provide contractual privity with the investor and eliminate any uncertainty or ambiguity as to the investor's obligation to fund its capital contributions to repay the subscription facility.

From a structuring perspective, lenders will have an expectation that any intervening entities between the borrower fund and the ultimate investors are party to the financing documents to ensure a direct line of recovery to the investors themselves. Depending on regulatory and other considerations, the subscription facility may be structured in any number of ways to achieve this objective including by rendering all the entities direct obligors under the credit documents or putting in place "cascading" pledges (pursuant to which capital call and related rights are collaterally assigned within the fund structure) should there be tax, regulatory, or other bars to direct privity and joint and several liability.

Given that the uncalled capital commitments of the investors are a lender's primary source for repayment under a subscription facility, a lender must conduct sufficient diligence to confirm its ability to access the uncalled capital commitments in an enforcement scenario. In addition to the baseline diligence of the LPA noted above, other elements important to a subscription facility to be identified in the LPA are as follows:

- **Waiver of counterclaims, defenses, and setoffs.** Lenders expect the LPA to explicitly state that the investors agree to fund their capital contributions without setoff, counterclaim, or defense (although the right of the limited partners to bring claims in a separate proceeding against the GP and the fund may be preserved).
- **Third-party beneficiaries.** Lenders also seek to be named as third-party beneficiaries of the LPA and to be carved out from any provision that prohibits third-party beneficiaries.
- **Repayment of indebtedness.** The LPA should not have any restrictions on making capital calls for the purpose of repaying indebtedness, whether during or after the investment period or during any suspension period (for example, after a key person event).
- **Default remedies/overcall.** Lenders will pay close attention to remedies for investors' failures to make capital contributions or comply with the LPA, including reducing the defaulting investor's capital account, transferring or selling the defaulting investor's partnership interest, or charging a default rate. Lenders will also expect to be permitted to call capital from non-defaulting investors to make up the shortfall created by the defaulting investors, without limitations.
- **Excuse/exclusion.** Lenders will review any provisions that permit investors to be excused or excluded from making capital contributions for certain investments. This includes customary excuse and exclusion provisions related to ERISA, bank holding company status, or participations in investments that would violate law, but also provisions that could excuse an investor from making certain other types of investments.
- **Management company.** If the LPA permits the GP to engage a management company, and the management company has been delegated rights of the GP under the LPA (for example, under a management agreement) to call capital and exercise remedies against investors, the

lender may seek to include the management company as a party to the loan documents.

Lenders ideally also want to see language in the LPA that requires the investors to fund their capital contributions to a specific account (which will be pledged as part of the collateral), and includes acknowledgments from investors that:

- The obligations to make capital contributions are legal, valid, binding, and enforceable.
- The lenders are relying on the capital contributions as the primary source of repayment and would not make the loan but for this reliance.
- The capital contributions are a commercial act and not subject to any immunity defense.

To the extent these LPA provisions are not addressed (or are not adequately addressed or are ambiguous), lenders may consider requiring the fund to amend the LPA to address those deficiencies or adjusting the terms of the loan to mitigate any perceived risks. Alternatively, as described above, lenders may consider requiring investors with large capital commitments to execute investor letters that address those issues and reinforce the investor's obligation to fund its capital contributions to repay the subscription facility.

Lenders will also review the fund's subscription agreements. Subscription agreements are generally form agreements entered into by each investor and contain key information about the investor and its commitment. The subscription agreement contains the investor's agreement to its rights and obligations under the LPA, including its obligation to make capital contributions, and should be reviewed to confirm an investor's proper legal name, the amount of its investment, the GP's acceptance of the investor's commitment and amount, and to ensure it does not purport to amend the LPA in a manner that would be adverse to the facility.

Side letters are agreements between the fund and an investor that modify or supplement terms to the LPA with respect to a particular investor. Lenders will review side letters for any terms that could adversely affect their right to the collateral and repayment of the subscription facility, including most-favored-nation provisions, sovereign immunity considerations, negotiated excuse, opt-out, exit, or cease funding rights for particular types of investments or under particular circumstances, and limitations on overcall rights where there are other defaulting investors (see Fund Structures).

NAV Facilities

Credit, structuring, and diligence considerations can be quite different from one NAV facility to the next, given their broad applicability across several fund and asset types (for example, funds of funds, private equity funds, private credit funds) and the diverse array of potential lenders and their unique credit parameters. The bespoke nature of these transactions renders completion of careful diligence early on critically important in order to determine whether a contemplated deal is even viable.

Ideally, at the formation stage, the fund organizational documents will be drafted with as much flexibility for future financings as possible, beyond merely the initial subscription facility phase. As with subscription facilities, lenders will need to diligence the organizational documents of the fund, but they will also need to conduct diligence on any existing debt documents of the fund, as well as on the documents governing the underlying assets, including, in the case of portfolio companies owned by a private equity fund, each portfolio company's organizational documents, together with any credit documents for indebtedness at the portfolio company level, and, in the case of loans made by a private credit fund, the credit documentation evidencing each loan.

In the case of the organizational documents of the fund, this baseline diligence will confirm:

- Whether a NAV facility is contemplated or permitted.
- Whether there are any particular guardrails or limitations in place that would impact the feasibility or structure of a NAV facility (which will need to be assessed together with any existing subscription facility that will remain in place at the time a NAV facility is established).
- The permissions for pledging the underlying assets.

Where financing that would encompass a NAV facility is not expressly permitted, funds and lenders will need to work together to assess whether they are comfortable that the contemplated financing is nonetheless acceptable and the extent to which the fund may need to amend the LPA, obtain limited partner advisory committee consent, update investor disclosures, or otherwise inform investors. The lender will also assess whether the permissions in the organizational documents are sufficient to support the lender's contemplated facility structure and collateral package.

Also at the fund level, lenders will assess any other existing indebtedness, whether subscription facilities or otherwise, to discern whether there are limitations on incurrence of indebtedness or pledge of assets that could hinder the NAV facility or will require consent or intercreditor arrangements with the other creditors.

In reviewing the organizational documents and loan documents for underlying private equity assets, lenders will be focused on whether there are any direct or indirect limitations on pledging (and ultimately transferring) the equity in the entities, including:

- In the underlying portfolio company organizational documents, whether the equity is not permitted to be pledged outright, or the pledge would trigger a change of control.
- In the underlying portfolio company loan documents, whether:
  - the equity is already encumbered in support of the loans;
  - a direct or indirect pledge or transfer will trigger a change of control; or
  - there are negative pledge or similar prohibitions on pledging the equity.

Lenders also need to be cognizant of strong "pick your partner" rules that will be implicated in their ability to actually enforce against the interests even where a pledge may be permitted.

In reviewing the loan documents for underlying private credit assets, lenders will be focused on whether there are any direct or indirect restrictions on the ability to pledge (and ultimately transfer) the loans and the related collateral pledged in support of the loans.

Where there are issues in obtaining clean pledges of underlying assets, lenders will assess the broader structure, including the number, quality, diversity, liquidity, performance, and expected cash flows of the assets, the contemplated loan-to-value ratio, and the anticipated pricing in order to determine whether they can accept a narrower "collateral-lite" package confined, for example, to cash flows generated by certain liquidity events and the account into which the cash flows are deposited, or will instead insist on a more fulsome collateral package by negotiating and obtaining consents to pledge (and ultimately transfer) all or the most significant of the underlying assets.

Given the inherently greater risk in NAV facilities arising from the potential for existing debt both at the fund level and at the underlying asset level, certain lenders typically seek stronger structuring protection through a bankruptcy-remote structure. From a diligence perspective, this introduces the need to transfer the underlying assets into a new SPV structure if the structure is not contemplated and put in place at the fund's inception. The extent of the required bankruptcy-remote features will be yet another variable considered against the features of the underlying assets, pricing, loan-to-value ratio, and the potential collateral package.

Hybrid Facilities

In addition to the various considerations described under Credit, Structuring, and Diligence Considerations: Subscription Facilities and Credit, Structuring, and Diligence Considerations: NAV Facilities, there are a handful of considerations unique to hybrid facilities that have further implications for the credit analysis, enforcement concerns, and diligence review with respect to these facilities. These include:

- The term of the facility and its placement in the fund's life cycle might merit considering whether certain features should fall away or spring into place as more capital is called, the investment period nears its end, or the asset pool grows. Relatedly, if a hybrid facility is put in place in the very early stages of a fund, negotiating and drafting terms around the NAV-based components could be difficult with a relatively limited asset pool.
- Accounting for both investors and fund assets in determining eligibility or inclusion criteria, advance rates, covenants, default and prepayment triggers, and other terms of the credit documentation, as well as obtaining and perfecting a security interest in an expanded pool of collateral, generally results in a more time consuming and expensive facility structuring and documentation process than for a stand-alone subscription or NAV facility.

For more information on security interests and methods of perfection and enforcement of security interests in fund finance, see Practice Note, Security Interests: Fund Finance.

From Vital Tools to Creative Solutions

Fund finance is a dynamic and evolving space with a vast toolkit from which parties draw to tailor financing solutions to their unique needs, from the reliable subscription facilities accepted as an integral element of fund capital structures to the more bespoke NAV facilities developing to meet unique needs in a rapidly changing market environment. Subscription facilities, NAV facilities, and hybrid facilities are among the most common types of fund finance, but they are certainly not the only ones. The continuum of financing solutions for funds are as varied as the funds themselves and range from these to any number of management company and GP financings, preferred equity arrangements, and structured and securitization solutions. Market forces, fund needs, and lender complexion and capacity will continue to spur innovation and change in the space.