CADWALADER

FUND FINANCE FRIDAY

Finding the FUNd in Pre-Funding

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In this week's *Fund Finance Friday*, we will discuss the mechanics around an investor's right to pre-fund all or a portion of its capital commitment ("Pre-Funding Investor"). In a subscription-based lending facility, a lender will lend against the unfunded capital commitments of a fund's diverse investor pool composed of private equity funds, high-net-worth individuals, governmental entities and more. Some investors, such as tax-sensitive and governmental entities, may not want to participate in a subscription credit facility due to tax and other regulatory implications (*e.g.*, a capital contribution linked to a financing may cause a tax-exempt investor to realize UBTI). As a result, we are seeing more mechanisms in limited partnership agreements and side letters giving Pre-Funding Investors, in respect of fund debt, the right to pre-fund the pro rata portion of their capital contributions prior to the incurrence of debt by the fund and a drawdown notice being delivered to the other investors in connection to the repayment of fund debt.

The capital commitments of a Pre-Funding Investor are usually excluded from borrowing base eligibility because these commitments are typically not considered to be "callable" under a subscription credit facility. While pre-funding mechanics provide fund borrowers more flexibility to accept otherwise creditworthy investors, there is a risk that borrowing availability under a subscription credit facility may be reduced and, in some cases, significantly limited if there is a large concentration of Pre-Funding Investors that might be excluded from the borrowing base. As a result, we have recently seen fund documentation include more lender-friendly provisions that could make the Pre-Funding Investor's capital commitments eligible for borrowing base inclusion in a subscription credit facility. In response, lenders are being asked to lend against the Pre-Funding Investor's capital commitments and include these commitments as part of the underwriting and credit approval process of the loan.

The first step in considering whether a lender should include a Pre-Funding Investor's capital commitments in the borrowing base must begin with a careful review of the principal fund formation documents. We tend to see many of the Pre-Funding Investor provisions in the fund's limited partnership agreement, but these provisions may also be found in the subscription agreements and side letters. A common pre-funding debt formulation includes some variation of the general partner providing written notice to the Pre-Funding Investor of the proposed financing. This notice is usually delivered to the Pre-Funding Investor on or prior to the date on which the general partner intends to cause the fund to incur indebtedness in order to finance a portfolio investment or some other partnership purpose. The notice should specify the amount of capital that otherwise would have been called from such Pre-Funding Partner if the fund had issued a capital call to the limited partners instead of financing the investment. The Pre-Funding Investor will be required, or given the opportunity to, pre-fund its pro rata portion of such financing before a drawdown notice is issued to the other investors (a "Pre-Funded Capital Contribution"). The applicable fund documentation should clearly specify that a Pre-Funded Capital Contribution shall not be treated as a capital contribution or reduce the uncalled capital commitment of the Pre-Funding Investor until such times as the Pre-Funded Capital Contribution is either (i) repaid by the fund in tandem with the repayment of the indebtedness that gave rise to the Pre-Funding Capital Contribution or (ii) used to make a capital contribution pursuant to a subsequent capital call, in which case, the Pre-Funded Capital Contribution shall reduce, on a dollar-for-dollar basis, the amount otherwise required to be contributed by the Pre-Funding Investor. Additionally, as a result of any pre-funding, the general partner typically has broad discretion to make adjustments to the allocations and distributions among the investors to ensure that any interest expense incurred in connection to a borrowing is not attributable to any Pre-Funding Investors. We also tend to see that Pre-Funding Investors have the right to revoke their status as a Pre-Funding Investor by delivering written notice to the general partner. While the foregoing pre-funding mechanisms are some of the more typical provisions that we frequently come across in partnership documents, we have seen less detailed provisions that make it more challenging to have a clear understanding of the status of the Pre-Funding Investor's capital commitments and reliance thereof for inclusion in the borrowing base.

Even with fund formation documents that clearly set forth Pre-Funding Investor provisions intended to accommodate a potential credit facility, we have seen lenders continue to designate the capital commitments of the Pre-Funding Investor as excluded from the borrowing base. By doing so, the lender is mitigating against the potential risk that the Pre-Funding Capital Contribution could be construed as having already been called or no longer available to repay to the outstanding loan obligations. With a diversified limited partner base, the exclusion may not make much of a difference in the borrowing base calculation. However, if the borrowing base is not as broad or has high concentrations in a few limited partners, excluding the Pre-Funding Investor from the borrowing base could significantly reduce availability to the fund. If excluding the Pre-Funding Investor from the borrowing base is not feasible, there are other provisions that can be included in the lender's credit agreement to help mitigate against lending on a Pre-Funding Investor's capital commitment.

One frequently documented approach is to condition the inclusion of the uncalled capital commitments of the Pre-Funding Investor in the calculation of the borrowing base until such time as the occurrence of one or more exclusion events. Namely, an exclusion event would be triggered when the fund borrower, as a condition precedent to borrowing, notifies the lender that a Pre-Funding Investor has elected to pre-fund its pro rata portion of a credit extension prior to delivery of the formal drawdown notice to the other investors for the repayment of such credit extension. Upon the occurrence of the exclusion event, only the portion of the Pre-Funding Investor's unfunded capital commitment, which such Pre-Funding Investor has elected to contribute in advance as a Pre-Funding Capital Contribution, would be excluded from the borrowing base. This approach provides additional capacity in the borrowing base for the fund to include the unfunded capital commitments of a Pre-Funding Investor while at the same time providing the lender with additional protections that the borrowing base will not include any Pre-Funded Capital Contribution. This approach should be evaluated on a case-by-case basis, and the credit documentation should include enhanced notice and reporting requirements and should take into account the fact that an investor may not remain a Pre-Funding Investor throughout the tenor of a subscription facility. In addition to advance notice prior to a request for borrowing and ongoing reporting requirements, we have seen lenders require that each Pre-Funding Investor wire all Pre-Funded Capital Contributions to a segregated deposit account maintained by the fund borrower with the lender and specifically include this account in the collateral description in the security documents. The additional requirement of maintaining a segregated account provides additional protections and safeguards against including the Pre-Funding Investor in the borrowing base, and ensures that the lender's lien will include all the Pre-Funded Capital Contributions funded into the segregated deposit account.

As the fund finance market continues to expand and broaden with new funds entering the space each year, we should expect to see more innovative and varied structures from fund borrowers and their investors. This innovation may present lenders with new opportunities to explore alternative lending approaches and tailor-made credit facilities to support their fund clients' credit needs.