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FUND FINANCE FRIDAY

Get To Know Your BDCs

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BDCs (defined below) were introduced to the subscription finance scene a few years back as they rode the growth wave of private debt funds following the financial crisis. Now, they seem ever-so-popular in our market – witness the doubling of the federal statutory leverage limitation applicable to BDCs last March, a sure driver of growth.

A business development company ("BDC") may sound like a toddler mumbling the alphabet, but it has become a serious component of the private debt market today. Some have forecast that the size of the direct lending market will reach $1 trillion by 2020. Of this, according to a March 2019 report on BDCs issued by Deloitte, BDCs have increased in total assets from $23 billion in 2009 to $101 billion through 2018. A remarkable growth rate by something with such a boring name. And now, many top sponsors are taking their horse to the old town road.

BDCs were originally designed to provide investment to "Mom and Pop" shops. Congress passed the Small Business Incentive Act of 1980, which amended the Investment Company Act of 1940 (the "40 Act") to add BDCs as a new category of investment company. Akin to a closed-end investment fund, the recent explosion of growth in the BDC market has been on the private side. However, a BDC can be spun off into a publicly traded fund, much like a mutual or exchange traded fund – providing the "average Joe" with the ability to invest and gain exposure to broadly diversified securities in privately held small and middle market companies without incurring corporate-level tax.

Per the Small Business Credit Availability Act, passed by Congress in March of 2018, BDCs are now permitted to employ leverage at a 2:1 debt-to-equity ratio (previously 1:1 before passage of the legislation). This, and the sponsor-driven private closed-end capital call style mechanics of the recent wave of BDCs, is creating more opportunity for subscription line debt to bridge BDC fund investment into the middle market. Year-to-date, Cadwalader has already closed more sub lines for BDCs than in all of last year, and we have closed 9 total in the last 18 months.

A few things to keep in mind when you structure that next subscription line for a BDC:

- BDCs are typically structured as Delaware limited liability companies and not as partnerships. The nomenclature in the corporate documents will differ quite a bit from what many subscription lenders are accustomed to seeing.
- In many cases, the facility authorizing language and investor acknowledgments will be included in the subscription agreements or the offering memorandum (incorporated by reference in the subscription agreements) as opposed to in the operating agreement or bylaws.
- There will also be no general partner per se as the company will be run by an independent board. The finance documents should be updated accordingly to reflect the fund structure, parties and terminology.
- Shares are often issued by the company in exchange for capital contributions. Lenders should ensure that each shareholder has received adequate consideration in connection with its capital commitment, along with a waiver of share issuance (or authorization to issue) in the case of a lender calling capital in order to avoid a potential problem during an enforcement scenario. Language can often be added to the corporate documents or comfort gained through a more fulsome defense waiver from the investors in favor of the lenders.
- Lenders should understand the timing and ramifications of a public offering, merger or spin off of the fund and how it impacts the investor base and obligation to contribute capital. In most cases, early notification of these liquidity events and an early maturity or default trigger may be needed to ensure adequate time to call capital for repayment.
- The 40 Act representations and warranties, covenants and legal opinions will all differ from the traditional fund, as a BDC will be a registered investment company (“RIC”). Specific covenants regarding compliance with investment policies and negative covenants or default triggers for failing to maintain RIC status and/or comply with the 40 Act should be considered.
- The offering memorandum and other corporate documents may need to be picked up under the negative covenant for material amendments.
- The leverage limitations, in addition to citing any relevant provisions in the corporate documents, should also generally require compliance with the 40 Act requirements.
- Tax distributions will almost certainly be negotiated. RICs are domestic corporations that benefit from a special rule: they can deduct their dividends, and thus are subject to corporate-level tax, only on their undistributed net income and gain. A RIC generally must distribute 90% of its net ordinary income each year to maintain RIC status. Many RICs promise their investors that they will use commercially reasonable efforts to distribute 100% of their net income and gain each year, and will likely negotiate their credit lines accordingly. Understandably, there is friction as lenders do not like, and often cannot accept, investors being paid first during a borrowing base deficiency or event of default type scenario.
- BDC facilities may limit multi-jurisdictional complexity and cost, given somewhat simple fund structures and tax benefits that may alleviate the need for offshore vehicles.
- Subscribers can be in the hundreds, which may add costs via diligence. There are ways, however, to efficiently manage this process, particularly where the cost stresses the deal, while still protecting the bank.