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Article

Business Development Company Financing

Todd N. Bundrant, Ann Richardson Knox, Jonathan R. Rosaluk and Michael P. Gaffney [1]

Business development companies ("BDCs")[2] have become popular with various groups of investors in the period following the global financial crisis due to the access a BDC provides to an investment class with potential for higher returns than other types of investments. Such popularity has correspondingly increased the interest of BDCs in leverage, in order to provide liquidity, leverage their portfolios and satisfy the growing appetite of their investors. Accordingly, BDCs have become higher profile borrowers, and this article will provide a brief introduction to BDCs while exploring common collateral structures used in connection with credit facilities for BDCs.

Business Development Companies

In an effort to facilitate access to capital by developing or financially strained companies, Congress created BDCs in the hope of stimulating lending to and investment in companies that often had difficulty securing capital from traditional lending sources such as banks. BDCs were created in 1980 through the Small Business Incentive Act to be investment companies regulated under the Investment Company Act of 1940, as amended ("ICA"), with limited purposes, operating limitations and parameters dictated by statute, as further described below.[3]

In order for an investment vehicle to qualify as a BDC under the ICA and under the Internal Revenue Code, as amended ("IRC"), an entity must satisfy the following requirements:[4]

First, under the ICA, a BDC, by definition, must be operated for the purpose of making investments in certain securities specified in the ICA, and, with some exceptions, must make available "significant managerial assistance" with respect to the issuers of those securities (*e.g.*, providing significant guidance and counsel concerning the management, operations or business objectives of the company). Second, under the ICA, a BDC may not acquire certain types of assets unless, at the time of acquisition, at least 70% of the value of its total assets are comprised of certain eligible assets. Third, the IRC places caps on the amount that any one investment may comprise of the overall BDC portfolio (*e.g.*, the securities of any one issuer may constitute no more than 25% of the total portfolio value) in order to achieve asset diversification.[5] Fourth, under the ICA, a BDC must have an asset coverage ratio of at least 200%, which is equivalent to a maximum leverage ratio (total debt to total equity) of 1:1.[6] Fifth, under the ICA, BDCs are subject to certain prohibitions and restrictions on transactions with "affiliated persons" (a term that the ICA defines broadly) and various other requirements governing the management and operation of the BDC. Finally, a BDC must distribute at least 90% of its investment company taxable income to investors in order to maintain pass-through tax status under the IRC.[7]

One appeal of BDCs to investors is that BDCs may provide exposure, through a liquid investment, to private, often illiquid, investments that are normally only accessible to high net worth or otherwise sophisticated investors. Typically, private equity investments are attractive to investors because they have potential to result in higher returns than other closed-end funds such as a high-yield bond fund. Because there are fewer lenders and investors in the market that BDCs target, higher returns are frequently possible.

The indebtedness that a BDC may incur pursuant to a BDC credit facility will most likely be used to expand its investment portfolio in the form of loans or additional equity investments in assets. Such indebtedness must be structured and secured in a manner that will achieve appropriate leverage for such BDC while ensuring that such BDC will be able to comply with the various BDC regulatory requirements and the stated investment objectives, policies and restrictions of such BDC.

Lending to Business Development Companies

While a BDC is a unique entity that is distinguishable from other types of borrowers in both form and function, loans to BDCs from a commercial perspective are largely comparable to fund financings to private equity funds. The most easily recognizable characteristic that a BDC credit facility may have with other fund financings is found in the collateral package that is used to secure the indebtedness and the methods used for calculating the borrowing base.

SUBSCRIPTION-BACKED CREDIT FACILITY SIMILARITIES

The vintage of the BDC may be a determining factor in the type of collateral structure that is used to secure the credit facility. When a BDC initially begins to attract investors and acquire its investment portfolio, it may be a private entity (a model successfully employed by many REITs). Such an entity is typically marketed to an existing investor base by large private equity firms, whereby its shares are not listed on an exchange and its shares are sold through a private placement offering.[8]

In general, the capital structure of a BDC that is a private entity may closely resemble that of a private investment fund with an ongoing capital commitment (*i.e.*, equity commitment) by each of its investors. This commitment to make additional contributions of capital to the BDC at future dates, coupled with the fact that the investment portfolio is either nonexistent or too recently acquired to provide a reliable credit profile, will likely result in a lender structuring the transaction in a manner similar to a subscription-backed credit facility with a private investment fund (a "Subscription Facility"). A Subscription Facility, also known as a "capital call facility," secures the obligations owing to the lender thereunder by pledging the unfunded capital commitments of the limited partners in the private investment fund and the corresponding obligation to make capital contributions when called by the private investment fund's general partner. In the case of a BDC credit facility, the lender may similarly choose to secure the obligations owing thereunder by taking a pledge of the unfunded capital commitments of the investors and the corresponding obligation to make capital contributions in accordance with the relevant organizational documents for such BDC and the BDC's interest therein. The borrowing base in respect of such a facility will also be determined in large part by the composition of the investor pool and an advance rate will be derived from various investor-specific factors, including the credit profile of individual investors. The diligence conducted by a lender with respect to the collateral in such a facility, therefore, will likely be focused on the obligation (or, alternatively, any defenses related thereto) of each investor to fund its respective unfunded capital commitment and on the capacity of such investor to make payments in respect thereof. If a BDC has a credit facility similar to a Subscription Facility and such BDC were to convert from a private entity into a publicly traded entity, the occurrence of such an event would require a material amendment to its constituent documents and would trigger a requirement to repay the credit facility.

For a BDC that has a more mature portfolio of assets or a different organizational structure, however, a lender may be able to structure the credit facility by relying on the portfolio of assets held by the BDC as opposed to the investors in the BDC.

NET-ASSET-VALUE CREDIT FACILITY SIMILARITIES

BDCs may initially begin with a non-traded or private structure as discussed above and then convert to an exchange listed entity or have a more traditional initial public offering. In either instance, such BDC will become a publicly traded company, and like most other publicly traded companies, investors will only be required to make a one-time up-front investment with no obligation to contribute further capital to the company. If a BDC is similarly structured (*i.e.*, with no ongoing capital commitment by its investors), lenders will be unable to secure the obligations under a BDC credit facility by taking a pledge of future capital to be contributed by the existing investors. As a result, the BDC will likely seek a credit facility that would, instead, be secured by all or a portion of its underlying investment portfolio. The collateral pledged by the BDC may consist of deposit or securities accounts, instruments such as promissory notes documenting loans made by the BDC to a portfolio company, or the equity shares held by the BDC in a portfolio company and various rights relating thereto. Using the underlying portfolio to secure the obligations under a BDC credit facility is similar to the collateral package employed by lenders in connection with a net-asset-value credit facility with a private investment fund ("NAV Facility").[9]

The underlying portfolio investments can be used not only to secure the indebtedness under a BDC credit facility but can also be used to determine the borrowing base and amount of leverage available to a BDC thereunder. Similar to the type of borrowing base calculations that may be used in a NAV Facility, lenders will be concerned with the composition of the BDC's portfolio and, as a result, will set forth requirements with respect to diversification of the portfolio, investment strategy and liquidity. Common borrowing base considerations may include limitations on the value attributable to any one portfolio investment or type of investment (*e.g.*, second-lien loans or common equity shares), minimum number of investments and nonperforming assets. Similar to a NAV Facility, the lender may also include covenants and mandatory prepayment events tied to performance of the underlying portfolio, which, unlike the borrowing base, may or may not be strictly related to the net asset value of the underlying portfolio. In a BDC credit facility structured around the portfolio of investments, the diligence conducted by a lender will likely be focused primarily on the historical performance of each portfolio asset and any issues related to the pledge and foreclosure upon any of the pledged portfolio assets.

Conclusion

When properly executed, a BDC credit facility can provide the maximum amount of leverage for such BDC while at the same time providing the lender with acceptable collateral and borrowing base protections. Experienced legal counsel can advise both BDCs and lenders on any potential obstacles in respect of the proposed collateral package, and each BDC will have special considerations that need to be analyzed when considering the appropriate type of credit facility collateral and borrowing base package. For instance, (i) an investor's obligation to make future capital contributions to a BDC and (ii) a BDC's investment in an underlying portfolio investment (structured either as a loan thereto or an equity stake therein) may be subject to restrictions on the pledge of such collateral to a lender under a BDC credit facility, and any appropriate consents or other mitigation in respect thereof should be obtained or addressed prior to such pledge. The growing popularity of BDCs and the unique characteristics of such an entity in its capacity as a borrower will present challenges that can be navigated with the assistance of legal counsel and result in growth opportunities for both BDCs and lenders.

Endnotes

[1] Todd Bundrant is a partner in Mayer Brown's Banking & Finance practice. Ann Richardson Knox is a partner in the Banking & Finance practice at Mayer Brown and oversees the Fund Finance team in the New York office. Jon Rosaluk is an associate in Mayer Brown's Chicago office and a member of the Banking & Finance practice. Michael Gaffney is a Banking & Finance associate in Mayer Brown's Charlotte office.

[2] A "business development company" is defined in Section 2(a)(48) of the ICA.

[3] BDCs endeavor to structure and operate as regulated investment companies under the IRC in order to qualify for pass-through tax treatment.

[4] Provisions related to BDCs are set forth in ICA Sections 54-65, including related definitions in Section 2(a) and certain corresponding SEC rules.

[5] IRC § 851(b)(3)(B)(ii). The IRC offers some relief from the diversification requirements for BDCs that have been identified by the SEC as principally engaged in providing funding to other corporations that are principally engaged in the development or exploitation of inventions and technological improvements that have not been previously available. IRC § 851(e)(1).

[6] Note that if a BDC wants to issue debt (*e.g.*, debentures), such BDC must have an asset coverage percentage of at least 200% immediately after such debt is issued. The existence of other indebtedness, such as debentures or notes, may reduce the amount of indebtedness that may be incurred under a BDC credit facility in order to comply with this asset coverage requirement.

[7] IRC § 852(a)(1)(A).

[8] Some BDCs, particularly at their inception, might structure themselves to operate (i) without registration under the ICA, in reliance on relevant exceptions from the ICA's definition of investment company (*e.g.*, Section 3(c)(1) or Section 3(c)(7)); (ii) without registering their securities under the 1933 Act; and (iii) without regulation under the 1934 Act. Following registration and election under the ICA, BDCs may take various forms (*e.g.*, exchange listed, non-exchange listed but publicly offered, and privately offered).

[9] For a detailed update on current trends and developments in the subscription-backed credit facility, net-asset-value credit facility and general fund finance markets, please see Mayer Brown's *Fund Finance Market Review Fall 2016*.