

Investor Pre-Funding Rights in Subscription Credit Facilities

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I. Introduction

As the market for subscription-backed credit facilities, also known as "capital call" or "capital commitment" facilities ("Subscription Facilities"), continues to mature, we have seen co-mingled private investment funds (each, a "Fund") seek higher advance rates and inclusion of a wider pool of investors in the borrowing base. As such, banks and other credit institutions (each, a "Lender") extending credit to a Fund under a Subscription Facility must carefully determine the eligibility criteria regulating which uncalled capital commitments of investors in the Fund will be included (or excluded) from the borrowing base.² One increasingly negotiated point in recent Subscription Facilities is whether to include in the borrowing base the unfunded commitments of investors that have the right to pre-fund their allocable share of borrowings. This article provides an overview of the nature of such borrowing pre-funding rights, the reasons why investors request such rights and some of the ways in which Lenders and Funds have addressed such rights in Subscription Facilities.

II. Borrowing Pre-Funding Rights, Generally

An investor's right to "pre-fund" its capital contribution (such investor, a "Pre-Funding Investor") is typically set forth in an investor's

side letter, but may also appear in the Fund's partnership or other operating agreement. Generally, a pre-funding right provides the investor with the option to fund its pro rata capital contribution to the Fund at a point in time (e.g., at the time of or within a short period following the incurrence of debt by the Fund), before a capital call notice is generally delivered to the investors to repay a debt obligation of the Fund.³

An investor's pre-funding right is often limited to circumstances in which the Fund intends to borrow money. In such circumstances, the Fund's general partner will typically agree to provide an investor with timely notice of the Fund's intention to borrow, and allow such investor the opportunity to pre-fund its allocable share of any such borrowing. The investor may have the right to elect to pre-fund (or not pre-fund) a capital contribution on a loan-by-loan basis.⁴ Alternatively, the general partner may have the right to elect to treat an investor as a Pre-Funding Investor and call capital from such investor in lieu of borrowings being made on behalf of such investor (though other formulations are also seen). The Fund may expressly acknowledge in the partnership agreement or side letter that the amounts pre-funded by such investor will be treated as a capital contribution made by such investor as of a specified date. The general partner may also have broad authority to make adjustments to the provisions of the

partnership agreement to accommodate the pre-funding of capital contributions.

III. Purpose of Pre-Funding Rights

There are a number of reasons why investors may seek, and sponsors may agree to, a pre-funding right.

One reason is to avoid potential adverse tax consequences. Tax exempt investors, sensitive to unrelated business taxable income ("UBTI"), may seek such provisions to avoid recognizing unrelated debt-financed income ("DFI"), which is treated as UBTI for federal income tax purposes. Specifically, a portion of such investors' gross income derived from or on account of "debt-financed property" is treated as gross income from an unrelated trade or business, which, after certain deductions, is taxable to such investors in the same manner as UBTI.⁵

Investors in limited partnerships generally recognize their share of the limited partnership's income and deductions,⁶ and the tax character of such income and deductions is determined as if such income or deductions were realized by the investor directly.⁷ Absent certain exceptions, debt incurred by a Fund could cause its investments to be debt-financed property for UBTI-sensitive tax exempt investors.⁸ Accordingly, if a tax exempt investor's share of partnership income is derived from debt-financed property, then a portion of such income may be DFI.⁹ Pre-funding or opt-out rights are intended to prevent the allocation of Fund-level debt to the applicable tax exempt investor so as to prevent recognition of DFI.

Another reason for pre-funding or opt-out rights is that some investors, such as certain governmental entities or endowment plans, may have provisions set forth in their constituent documents, side letters or investment policies that restrict or prohibit the use of their capital commitments as credit support to secure the debt obligations of the

Fund. We have also seen a variation on such a restriction in side letters specifying that an investor is not obligated to honor a capital call made by a Lender (which typically results in outright exclusion from the borrowing base in our experience).

In addition to addressing tax, regulatory and policy considerations, Pre-Funding Investors may also receive economic benefit on account of pre-funding contributions. To the extent an investor pre-funds a capital contribution in lieu of a borrowing and the Fund agrees to treat such contribution as being made prior to the time the capital contributions of the other investors are required, there is a benefit to such Pre-Funding Investor with respect to calculating the preferred return.¹⁰ The investor also may be spared what would otherwise be its pro rata share of the cost of borrowing. As such, any adjustment made to accommodate a Pre-Funding Investor will be highly negotiated between such Pre-Funding Investor and the Fund, although it is also not uncommon for a Pre-Funding Investor to be treated the same way as the non-Pre-Funding Investor for purposes of preferred return calculations and distributions. Additionally, under the Fund's partnership agreement or the applicable side letter, a Pre-Funding Investor usually does not bear any share of the cost or expense incurred by the Fund in connection with a borrowing with respect to which it pre-funded.

IV. Addressing Borrowing Pre-Funding Rights in Subscription Facilities

There are a number of ways Pre-Funding Investors may be addressed in the borrowing base of a Subscription Credit Facility. Historically, Lenders often excluded the capital commitment of Pre-Funding Investors from the calculation of the borrowing base altogether. More recently, we have seen a trend towards Lenders giving borrowing base credit to the capital

commitment of Pre-Funding Investors subject to certain parameters.

One approach is to include the Pre-Funding Investor in the borrowing base until such time as it funds its allocable share of the applicable loan within the time period agreed upon in the Fund's partnership agreement or such investor's side letter (as applicable), and require a dollar-for-dollar repayment of the borrowings under the Subscription Facility to which the pre-funding election relates as the Pre-Funding Investors capital contributions are received (regardless of whether a mandatory prepayment would otherwise be triggered under the Subscription Facility).¹¹ This prepayment mechanism addresses the fact that the Pre-Funding Investor will not be making a capital contribution at the time capital would be called from the investors generally to repay the borrowing, but permits the Fund to borrow against the Pre-Funding Investor's unfunded capital commitment prior to and during the period between when the Fund draws on the line and the point in time that the Pre-Funding Investor makes its related capital contribution under the Fund's partnership agreement or the applicable side letter (or fails to make such capital contribution and is deemed an excluded investor). A Subscription Facility with these features will typically include enhanced notice requirements whereby the Fund is obligated to alert the Lender if any investor elects to pre-fund or opt-out of borrowings, so the mandatory prepayments and exclusion event may be monitored.

Another way to address a Pre-Funding Investor is to include such investor's unfunded capital commitment in the borrowing base, but then adjust the borrowing base calculation to subtract out the amount of capital contributions that the Pre-Funding Investor elects to pre-fund. This amount is generally calculated as the result of (a) the Pre-Funding Investor's pro rata share (based on unfunded

capital commitments) of all outstanding borrowings minus (b) the Pre-Funding Investor's pro rata share (based on unfunded capital commitments) of all borrowings for which such investor has declined to pre-fund in writing. In order for the Fund to receive credit in the borrowing base for the portions of the Pre-Funding Investor's allocation of borrowings that it has declined to pre-fund, the Lender typically requires receipt of written evidence of such election. The Lender may also require that the Fund deliver to each Pre-Funding Investor a notification giving such Pre-Funding Investor the opportunity to pre-fund its portion of the borrowing. With this approach, a Lender may also require more robust ongoing borrowing base reporting, and with each request for borrowing, a detailed listing of which Pre-Funding Investors have elected, declined, or not responded to a request to verify their plans to pre-fund any given borrowing so that the borrowing base and resulting line availability may be properly calculated.¹²

In addition to considering the borrowing base impacts of a Pre-Funding Investor, the Fund's partnership agreement will need to be reviewed to determine how the pre-funding rights and mechanics work generally, and how any overall provisions may impact the analysis. An overall provision in a Fund's constituent documents provides the Fund with the right to call capital from non-defaulting (or non-excused) investors to make up for shortfalls resulting from the failure (or excuse) of investors to fund capital contributions. Limitations (or ambiguity resulting from silence) on such overall rights may restrict the ability of a Fund or a Lender to call capital from Pre-Funding Investors to make up any shortfall resulting from the default (or excuse) of other investors. This issue can be heightened if the Pre-Funding Investor also has the right to opt-out of capital calls to repay borrowings.

V. Conclusion

As the fund finance market continues to evolve, Lenders and Funds continue to explore new and innovative ways to include a wider pool of investors in the borrowing base. Subject to certain parameters, more Lenders are now willing to consider inclusion of the

unfunded capital commitments of Pre-Funding Investors in the calculation of the borrowing base. Care should be taken, however, in reviewing and understanding the applicable provisions of a Fund's constituent documents and side letters when considering such an approach.

Endnotes

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² See "Subscription Credit Facilities: A Comparison of Differing Borrowing Base Structures."

³ In lieu of a pre-funding right, certain investors may have a right to "opt-out" of borrowings pursuant to a side letter provision or the Fund's partnership agreement. Such an opt-out right will customarily provide that the applicable investor will not be required to fund capital contributions to repay Fund-level indebtedness, and as such, the unfunded capital commitment of such investor is typically excluded from the borrowing base in Subscription Facilities.

⁴ The partnership agreement of some Funds may hardwire an investor's obligation to pre-fund each borrowing, and as such, the investor does not make an election to pre-fund (thus resulting in a more streamlined approach under a Subscription Facility).

⁵ Sec. 514(a)(1) of the Internal Revenue Code of 1986, as amended (the "Code"). The applicable portion is equal to the average "acquisition indebtedness" with respect to the debt-financed property over the average amount of the investor's adjusted basis in such property during the applicable tax period.

⁶ Sec. 702 of the Code; Treas. Reg. § 1.702-1(a).

⁷ Sec. 702(b) of the Code; Treas. Reg. § 1.702-1(b).

⁸ For example, property is not debt-financed property if the applicable "acquisition indebtedness" is repaid more than 12 months before its disposition. Sec. 514(c)(1); Treas. Reg. § 1.514(b)-1(a).

⁹ Sec. 512(c)(1) of the Code.

¹⁰ There are a number of variations in the market with respect to treatment of the timing of a Pre-Funding

Investor's contribution, including deeming the contribution as being made as of a specified date (e.g., 90 or 120 days after the borrowing occurred), regardless of when such investor's contribution is actually pre-funded.

¹¹ The Subscription Facility Documents will typically provide for a specific investor exclusion event that is triggered upon a Pre-Funding Investor's failure to fund.

¹² A variation of this approach would be to include an investor (subject to typical inclusion and exclusion criteria) and adjusting the borrowing base to reduce availability to the extent that such investor has given notice of its intention to pre-fund a borrowing.

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