

Fund Finance Friday



Hurdling Into the Borrowing Base

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As was briefly touched upon in a prior Fund Finance Friday article “[Borrowing Base/Coverage Ratio Approaches in Subscription Finance Facilities](#),” a subscription facility which uses the borrowing base approach looks at each investor’s commitment to fund and the administrative agent and/or lenders deciding the level of credit that will be given to such commitment for those investors (the “[Borrowing Base](#)”). In certain instances there may be investors that are initially excluded from the Borrowing Base (“[Excluded Investors](#)”) due to certain side letter provisions (i.e., cease funding rights or sovereign immunity), lack of creditworthiness or other legal issues, whereby the lender is concerned about including such investor’s capital commitment in the Borrowing Base and its ability to ultimately be able to call capital on such investor.

As the borrowers will want to include as many investors as possible in the Borrowing Base to maximize their borrowing capabilities, one compromise has been to include certain Excluded Investors in the Borrowing Base (the “[Hurdle Investors](#)”) once such investor has funded a certain portion of its commitment (typically in the 40%-50% range) (the “[Hurdle Condition](#)”). In some instances, lenders may also include additional Hurdle Conditions for any Hurdle Investors, such as fund investments maintaining a certain level of percentage of cost to fair market value ratio in order to add additional protections for including these Hurdle Investors in the Borrowing Base.

By allowing an Excluded Investor to be treated as a Hurdle Investor upon satisfying the Hurdle Condition, this allows for a potentially greater Borrowing Base. Upon satisfaction of the Hurdle Condition by the Excluded Investor, such investor is then typically treated as either (i) a designated investor during such time and would typically then be included in the Borrowing Base at such advance rate (typically 65%), or (ii) can be treated separately at its own advance rate. Additionally, the Hurdle Investors may also receive the benefit of a higher concentration limit (i.e., the preset limits of such Hurdle Investors unfunded capital commitments as a percentage of the aggregate investor base unfunded capital commitments included in the Borrower Base) so long as the Hurdle Conditions are satisfied, thereby allowing for a greater amount of such Hurdle Investors unfunded capital commitments to potentially be included in the Borrowing Base.

Lenders become comfortable with such Hurdle Investor concept based upon the fact that once these investors have funded a significant portion of their capital commitments, it is less likely such investors would walk away from funding additional capital commitments due to the punitive nature of a typical limited partnership agreement for a defaulting limited partner (i.e., the investor’s interests could be sold and such investor will no longer be an investor in the fund, the investor could forfeit distributions, etc.) as the investor will have sufficient “skin in the game” and will likely continue funding their capital contributions.

It is important to note that lenders will typically want to make sure that these investors are only Hurdle Investors at such times as the Hurdle Condition is satisfied. What this means is that lenders will want to consider if recallable distributions should be taken into account when determining if the required commitment amounts have been funded in order to satisfy the Hurdle Condition. This is to avoid instances where the investor has initially satisfied the Hurdle Condition but subsequently receives a recallable distribution, which results in the investor’s funded commitments no longer satisfying the Hurdle Condition, and thus could negate the protection of the investor having sufficient “skin in the game” for lender’s to treat such investor as a Hurdle Investor. If recallable distributions are not taken into account, it

could be interpreted that such investor will be a Hurdle Investor on an ongoing basis upon the initial satisfaction of Hurdle Condition.

When the facility includes syndicate lenders, such lenders will want to confirm if there are any approval rights to the inclusion of such Hurdle Investors. Certain credit agreements will only require the funding threshold noted above to be met, while others may also require: (i) approval by the administrative agent for Hurdle Investors; (ii) a pre-approved list of investors as negotiated by the administrative agent and the borrowers; or (iii) approval by all lenders or lenders holding a certain pro rata share of the lender commitments (typically approval by lenders holding above 50% of the lender commitments in the aggregate). The syndicate lenders will also want to determine whether the definition for amending either the Hurdle Condition or Hurdle Investor will require approval by: (i) all lenders; (ii) lenders holding a certain percentage of aggregate commitments; or (iii) only the administrative agent. The syndicate lenders will also want to confirm that the credit agreement requires the borrowers to provide compliance certificates confirming whether such Hurdle Conditions have been satisfied or not, the intervals at which such compliance certificates should be provided, and that any such compliance certificate will require the borrowers to provide their calculations demonstrating satisfaction of such Hurdle Conditions.

This is a very broad overview on the concept on how Hurdle Investors and Hurdle Conditions work in connection with the Borrowing Base. There are numerous variations on the requirements lenders might impose for satisfaction of Hurdle Conditions and the above is not intended to be an exhaustive list. As always, if there are any issues or questions that arise in connection with Hurdle Investors or any other concepts discussed herein, we here at CWT are always happy to assist in providing any such guidance.