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In The Know

Leveraged Finance Newsletter

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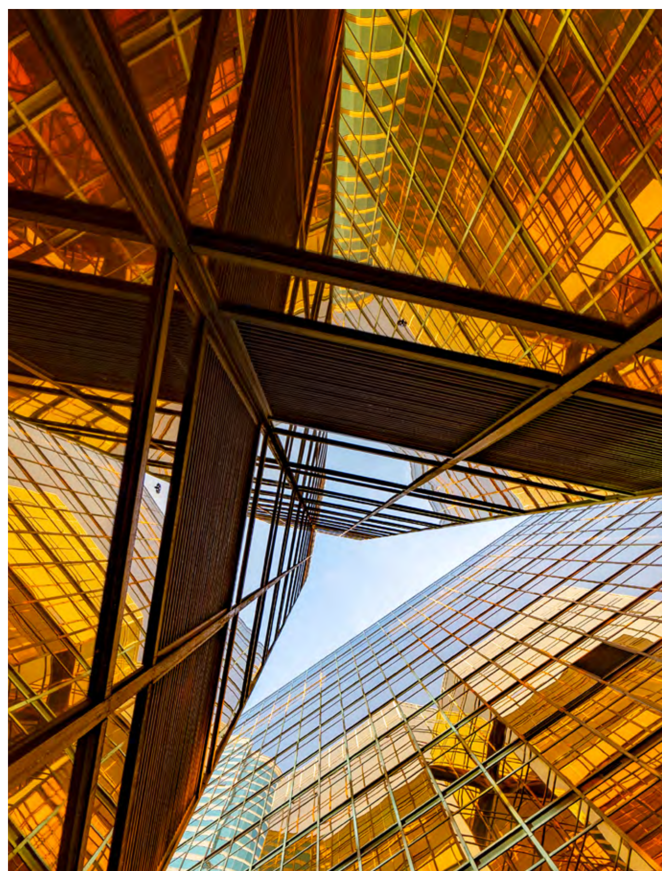
International: Pre-funding — the secret to a smooth closing or a minefield of risks?

Faced with a challenging deal-making environment, volatile geopolitical backdrop and rising cost of capital, dealmakers are increasingly concerned about risks inherent to the closing mechanics of complex acquisitions. In acquisition finance, there is scrutiny to ensure committed funds arrive on time and utilization mechanics adapt to facilitate funds flow and not vice versa. In this edition of In the Know we look at developments in pre-funding structures and documentation in both the syndicated and private credit markets.



Key takeaways

- Pre-funding is increasingly common to adapt utilization mechanics to deal dynamics, but market participants need to be aware of the risks pre-funding may pose to their interests.
- A number of commercial and legal issues should be addressed in the documentation to ensure the parties are clear on how pre-funding works in practice and what happens if the transaction does not proceed as planned.

Risk matrix

Structuring the drawdown operation is an exercise in balancing the borrower's, the lender's and the facility agent's needs against the risks entailed for each party. These will vary depending on the complexity of closing funds flow, the number and nature of the lender(s), the time zones and currencies involved, and the nature and policies of the facility agent. With deal volume compressed, borrowers face stiff competition with other potential bidders to ensure their acquisition structure is compelling in terms of process and certainty.

Borrower	Lender	Facility Agent
Maximize flexibility to ensure that debt funding arrangements do not constrain closing mechanics	Comply with any constraints on accessing/calling and moving funds	Ensure sufficient time to perform necessary administrative actions
Minimize notice and costs	Minimize risks between calling on funds and receipt by borrower	Minimize 'personal' exposure
Achieve certainty of funds	Compensation for funds 'deployed'	Ensure ability to claw back and be indemnified for wrongful payments

What is pre-funding?

Which pre-funding structure is used will depend upon a number of factors, including the following:

- **What makes pre-funding necessary?**

Pre-funding is not required on all transactions. However, it can provide a useful mechanic to facilitate a complex funds flow. For example, where there are a large number of different lenders operating in different time zones and with different policy requirements, pre-funding can front-end some of the logistical challenges this presents. In the same way, pre-funding can help if the borrower is required to make payments to a range of vendors and other recipients to complete a transaction. Finally, where there is particular focus on certainty of funding, pre-funding can provide both the borrower and the vendor with comfort that the funds are available.

- **Transaction size and whether syndicated or private credit market**

Large-cap transactions may benefit from pre-funding to optimize payment flows, particularly where the financing is broadly syndicated. Pre-funding may also be relevant in the private credit market where direct lending funds are constrained by the terms on which they are able to call funds from their limited partners. Many funds have mitigated this though short-term capital call borrowing, but rising debt costs can mean that pre-funding is more economically efficient.

- **Identity of market participants — willingness/ability to accommodate a particular structure**

Not all market participants can accommodate all types of pre-funding. The facility agent needs to be sufficiently capitalized to front the utilization of all commitments, and even then, needs to be assured of each lender's creditworthiness.

In the private credit market, the underlying fund documentation will place certain constraints on a direct lending fund that may prevent it from drawing funds until certain conditions are met, which may make pre-funding challenging.

What are the key discussion points?

- **Required notice time**

In an acquisition context, a shorter notice period to draw funds may help borrowers meet the demands of the seller and present a competitive solution against other bidders. This must be balanced against the need to calculate and notify amounts, effect currency conversions, and receive/send multiple payment instructions.

Timing difficulties fall into a number of categories, as follows:

  - Time zones/currencies: where closing funds flow involves different currencies and time zones, there can be an insurmountable problem with transmitting money within the business day and hours of operation of the payment systems in one time zone or currency, and it being received "for value" within the recipient's business day.
  - Administrative practicalities: particularly for large syndicates and complex closings, a facility agent may be hard pushed to complete the necessary administrative steps to calculate, notify, receive, check, process and transmit multiple payments to multiple recipients in a compact timescale.
  - Sources of funds: the ways in which lenders fund themselves may affect their ability to respond quickly to utilization requests. Private credit funds may first need to make their own drawdown request from the investors in their fund, or draw on their own credit line, before they can pass monies to the borrower. That process will have its own timetable, which may be significantly longer than the 1-3 business days' notice to drawdown typically seen in syndicated loans.

- **Certainty of delivery of funds by lender(s)**

For committed facilities, each lender has an obligation to make its participation in a loan available if the borrower's request complies with the relevant contractual conditions. Accordingly, the following is applicable:

  - A lender will be in breach of the facility agreement if it fails to do so
  - The other lenders are not obliged to "make up" the difference if a lender fails to fund.

Any failure may severely affect the borrower. If it is unable to quickly source funds elsewhere, it may be unable to complete an acquisition. "Defaulting Lender" and "Increase" provisions may assist, but they are not a 'silver bullet', as they take time to implement and require other lenders to be willing to increase their commitments.

Where it is particularly important for all funds to be available early on a planned closing date to give parties certainty that closing can go ahead and all funds move as needed on that day, pre-funding by the facility agent or the lenders may be agreed.

- **Certainty of facility agent passing through funds**

"Impaired Agent" provisions are sometimes included in facility documentation. A facility agent is impaired if, among other things, it fails to make a required payment or becomes insolvent. In these circumstances, payments may be routed directly between the lenders and the borrower.

- **Certainty of closing occurring**

Utilization requests are usually irrevocable. A borrower is committed to taking out the loan once the request is submitted and is required to indemnify lenders for any costs, losses or liabilities incurred in funding (or making arrangements to fund) their participations if a requested loan is not actually made.

Pre-funding/fronting by facility agent

The facility agent may agree to advance funds to the borrower before it actually receives all the funds from the lenders. This directly addresses many of the administrative practicalities and time zone issues referred to above, but poses a risk to the facility agent if there is a delay or default in the lenders putting it in funds in short order.

Some facility agents are unable or unwilling to pre-fund, or may only do so in certain circumstances. Where a facility agent does so, it will wish to mitigate its risks by including a "clawback" provision specifying that if any lender fails to put it in funds after it has fronted the loan disbursement, it can clawback that amount from the borrower on demand. It will also require the defaulting lender and/or borrower to indemnify it against any funding costs incurred as a result of the pre-funding arrangements, or if the utilization is not made on the utilization date. However, the facility agent will still be exposed to litigation and insolvency risk on the borrower and defaulting lender if it needs to enforce the clawback and/or indemnity provisions.

The facility agent's clawback right also poses a risk for the borrower. It may be unwilling or unable to refund loan proceeds, particularly if these have already been passed through to a third party, such as the vendor in an acquisition financing context.

Pre-funding by Lenders

Alternatively, the parties may agree that the lenders will pre-fund their participations ahead of the anticipated utilization date.

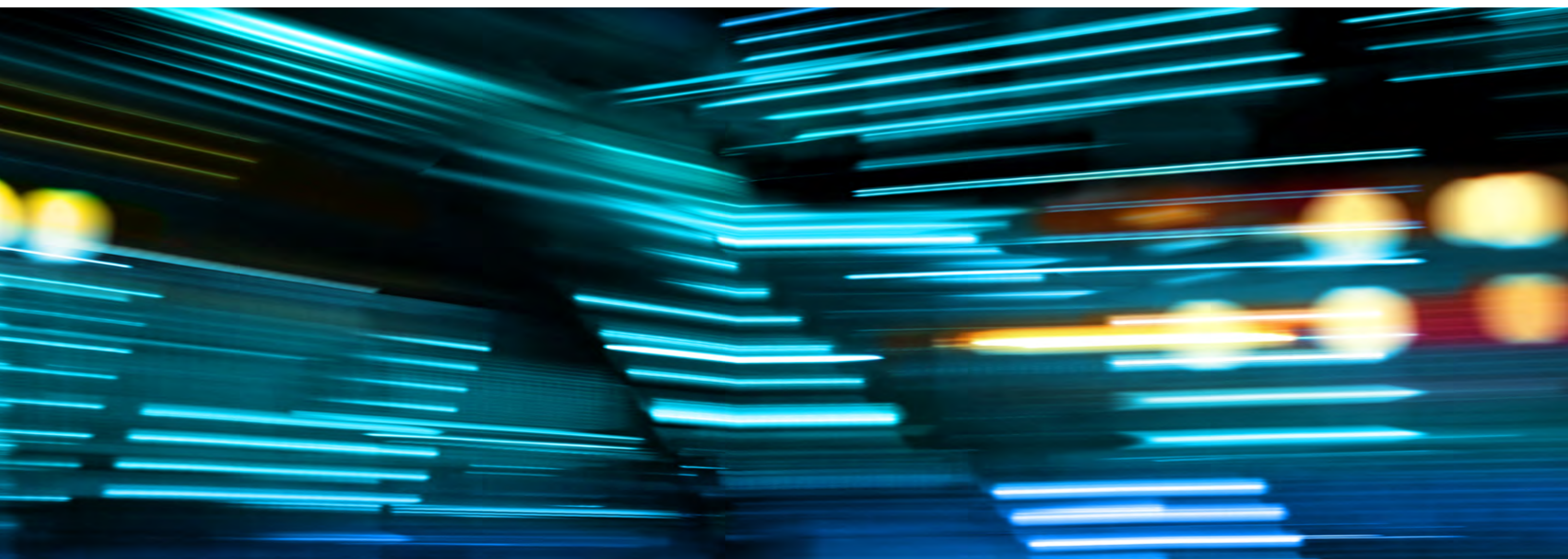
In the syndicated context, the funds are held by the facility agent, which is then able to start sending closing funds flow payments at the start of business on the utilization date, instead of first waiting to receive payments from the lenders.

This provides certainty to the borrower that all required funds will be available on the utilization date, but it extends the drawdown timetable. There is also credit risk on the facility agent for the period during which it holds the funds.

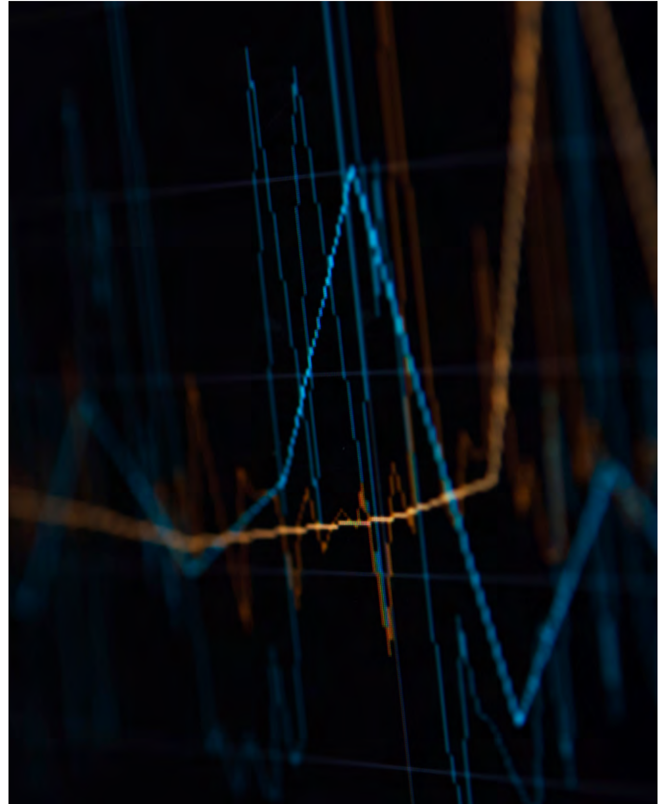
In the private credit market, where the notice period for utilization is typically much longer than the syndicated market, some private credit funds agree to call funds ahead of final documentation. Many funds will look for a funding indemnity to mitigate the risk on costs if funding does not occur. In some cases, the funds will be paid directly to the vendor's solicitors, who will hold the funds to the order of the direct lender pursuant to a solicitor's undertaking, only to be released on closing.

From the lenders' perspective, pre-funding requires them to deploy funds "pre-closing", so there are a number of questions to answer in advance, as follows:

- **Interest:**
  - When does interest start to accrue? Generally, some form of interest will accrue once the pre-funded amounts are received by the facility agent or the vendor's solicitors (i.e., prior to the utilization date).
  - Is margin included? Margin represents credit risk on the borrower, so arguably, pre-funded amounts should attract the underlying reference rate only.
  - Extended or stub interest period? Parties may agree to extend the interest period backwards to commence on the date pre-funded amounts are received by the facility agent. The alternative is a short stub period to cover the period starting on that pre-funding date and ending on the utilization date.



- **Failure to complete:**
  - An extended utilization timetable requires the borrower to decide earlier on a definite closing date, increasing the potential for this to be incorrect. If the deal collapses entirely or is merely delayed, pre-funded amounts would typically be returned by the facility agent to the lenders. If funds were paid directly to the vendor's solicitors, the solicitor's undertaking may include a longstop date on which the funds are automatically returned to the direct lender if the closing has not occurred. In acquisition finance, strong borrowers will often negotiate a "no closing no fees" arrangement. The question is whether pre-funded amounts should also be caught within that arrangement, so that no interest is payable.



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