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Fund Finance COVID-19 Cocktail Recipe: QBs on the Rocks, One Part Recallable Capital with a Dash of Overcalls

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This week, I decided to reflect on a few topics that have repeatedly come to mind during the turbulence of the last few months.

QBs in Distress

No, I'm not referring to Tom Brady in his new but ugly Tampa Bay orange being furiously chased by the Carolina Panthers defensive line (one can hope!), but rather to a different QB: Qualified Borrowers under subscription lines of credit. We have recently noted the rise of Qualified Borrowers in our market trends, including an excellent **summary** published by my colleagues Trent Lindsay and Chris Montgomery.

With the LBO market being limited, we have seen an enormous increase in Qualified Borrower joinders under facilities as a way to effectively provide cheap and easy liquidity to fund portfolio companies. A once rarely used mechanic in subscription lines, the QB joinder option is now en vogue. Sponsors are adding with frequency. The underwrite is to the funds and the existing capital call collateral granted under the facility. The QB itself has no investors and provides no collateral. The funds will irrevocably guaranty payment of all obligations of the QB. It's important to ensure that the fund's LPA permits guaranties of portfolio company debt and that the investors have all waived offset, counterclaim or defense of any kind relating to repayment calls (which would extend to repayment of QB debt if the guarantees are so authorized).

But given the rise of QBs and the increased activity of opportunistic distressed-focused funds, will we see the fall of QBs? And are you protected if your QB goes insolvent?

It's not uncommon for a QB to be in distress. Most facilities require only KYC on the QB and a signed promissory note and guaranty from the fund borrowers to back the QB loans. The QBs themselves are typically not underwritten in any meaningful way. Thus, a lender should be satisfied that any QB loans are adequately supported by recourse at the fund level and its first-priority security interest in the uncalled capital of the fund's investors. It's unlikely that assets at the QB level will be unencumbered and certainly may be of little value in a distress scenario anyway.

Generally speaking, most lenders will require that a QB default trigger an EOD on the entire facility. This would cover off any bankruptcy risk as an insolvent QB or one that fails to timely pay would bring down the whole facility. However, distressed-focused funds will often argue that one bad apple shouldn't ruin the whole tree. If the funds and investors are performing and otherwise in compliance with the credit facility, then a QB default should be segregated. In such a situation, the QB default (if the sole issue on the facility) would trigger a standstill and/or drawstop that would permit the funds to promptly (generally within 10 days) repay any obligations of the QB and remove it from the line or else face a full EOD. Some lenders may also require a provision that would auto-convert (typically at reference rate) any outstandings of the defaulting QB to be immediate loan obligations of the guaranteeing fund borrowers, thus bringing the defaulted QB loans to zero and removing the defaulted QB from the facility. Effectively, the idea is to put the lender in the situation where it is facing only the fund for repayment and enforcement of the obligations. The lender is protected from additional risk that is isolated to the QB.

Total Recall

Fund sponsors have been savvy during this crisis, resulting in no shortage of LPA amendments whether it be for the purpose of adjusting investment criteria, reducing commitments to less favorable strategies for reallocation to newer opportunities or increasing limits on recallable capital. The latter category – increasing recallable capital buckets – has picked up steam of late.

Fund LPAs generally permit some level of recallable capital. When funds invest and subsequently return distributions to investors, the GP will typically have discretion to earmark the distributions as amounts that replenish an investor's uncalled capital and are thus recallable as if never initially called. Many LPAs will limit recallable capital to a level of no more than say 25% or similar of the investor's commitment amount and may also have parameters that recallable capital cannot in the aggregate exceed 100% of distributions made to the investor and/or can only be deemed recallable if returned within a certain time period – *i.e.*, within 18-24 months of the investment or the end of the investment period, etc.

As a way to shore up more available capital to invest in unforeseen opportunities and/or to enhance value on existing portfolios in the current environment, many fund sponsors have opted to amend LPAs to raise the limits or extend the time periods for recallable capital. This generally works in the lenders' favor on a subscription line as (1) it aligns the parties' interest with maintaining or improving fund performance and (2) it replenishes collateral as more uncalled capital becomes available. That said, lenders should be mindful of consent standards on these LPA amendments and be sure they are comfortable that a material level of investors are on board and that the strategy otherwise makes good sense.

Lenders should also ensure that the credit documents contain baseline recallable capital provisions and protections. For example, borrowing credit is generally only given to recallable amounts if (1) the borrower provides copies of the distribution notice sent to investors, which notice should inform each investor of the amount of the distribution that is deemed recallable, and the resulting uncalled capital of such investor, and (2) the general partner provides a certification as to the amounts distributed, deemed recallable and the resulting impact on uncalled capital plus typically confirming the actions have been completed in conformance with the LPA. The first is important to estop any investor from claiming that its uncalled capital was unknowingly increased, and the second as a matter of confirming compliance with the fund documents (and thus that the investors have no defense).

We shall see if this trend continues beyond COVID times and if it has the effect of extending facilities beyond maybe what was originally contemplated, given the injection of additional collateral and need for the fund to service its portfolio/pursue new investment streams.

One Size Does Not Fit All (Overcalls)

Overcalls are a topic that can send a chill down the spine of any banker (particularly if they weren't expecting it in their borrower's LPA!) and one that has been analyzed and written about with great frequency. In this note, I would like to point out some recent trends we have seen and dispel some misconceptions.

Overcalls must be analyzed on a fund-by-fund basis: I recently had a discussion with borrower's counsel after trading drafts back and forth that contained use of proceeds limits due to an LPA overcall limit. We seemed to be talking past each other, but then I realized the issue. An overcall limit cannot be viewed in a vacuum as a binary issue – *i.e.*, if a 20% per investor limit is acceptable on one facility or for one sponsor or bank, it does not mean that such limit is always acceptable simply as a matter of precedent without regard to the particulars. For example, if acceptable for a highly granular fund with billions in capital without tight or even no use of proceeds limit, it does not (and almost certainly will not based on underwriting and modeling the inflection point) be acceptable for a highly concentrated fund of very few investors, regardless if the sponsor or bank are the same in each case. It was a helpful conversation to make me realize that sometimes the lawyers can get too wrapped up in precedent from deal to deal without considering the actual practical implications for a given deal and the risk impact. The investor pool matters greatly.

More funds adding carve-outs to LPAs: Given the somewhat credit-challenged environment, we have found fund sponsors to have more flexibility of late to include carve-outs in LPA overcall limits that permit calls for debt repayment up to full remaining capital. This has been a positive development, obviously, and one that enhances the risk profile and makes the fund more attractive for lenders and with better financing terms. Hopefully, the trend will stick!

One-off side letter issues: We have also seen a recent increase in investors, typically on a one-off basis or a small cluster of investors in a larger fund, requesting fund sponsors for overcall limits in the investor's side letter. This presents a number of potential challenges for lenders. First, the lender needs to understand the limit and should try to negotiate a carve-out for the facility, as in the case where the limit is housed in the LPA. Second, if the limit will in fact

apply to calls to repay debt, then the side letters should be crafted in a manner that limits the exposure to other investors such that no other investor is able to opt for the same provision via MFN rights. This could be disastrous for a lender who enters a facility and underwrites no overcall limitation, and then subsequently one is introduced via a large influential investor's side letter and then further perpetuated via MFN elections. If arising after the facility closing, the lender should be careful that it has adequate consent rights and exclusion events to prevent such a disaster. If known at the closing, the lender should underwrite the facility based on the overcall applying across the entire fund if the limit is electable by other investors. Where limited to a select few investors, these are often the largest investors and the modeling could present challenges unless there is a highly diverse pool and/or an acceptably high limit. Again, the investor pool and particulars matter. Not all overcalls are created equal.