Fund Finance

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The state of play on overcall limitations in the U.S.

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Introduction

Overcall limitations ("**Overcall Limitations**"), in their most simple form, limit the ability of a private equity fund (each, a "**Fund**") to overcall capital (each, an "**Overcall**") from its limited partners (each, an "**Investor**") to make up for shortfalls created by other Investors' failure to fund an original capital call ("**Capital Call**") as a result of a default or excuse.

Because lenders' (each, a "**Lender**") underwriting expectation is that each Investor is jointly and severally obligated to fund up to the full amount of its unfunded capital commitment ("**Unfunded Commitment**"), both established players and new entrants in the subscription facility (each, a "**Facility**") market continue to wrestle with the various forms of Overcall Limitations found in Fund partnership agreements ("**Partnership Agreements**").

Any Overcall Limitation is a credit exception that must be addressed. And their presence is meaningful: a full 38% of the 252 Facilities that Cadwalader, Wickersham & Taft's United States Fund Finance team worked on in 2017–2018 included some form of Overcall Limitation. In this chapter, we describe the various forms of Overcall Limitations that are most prevalent in Partnership Agreements and discuss their underwriting implications. We also describe the steps Lenders are taking in the market to mitigate the increased risks created by their presence as applied to a particular Facility. Finally, we provide some market color around the treatment of Overcall Limitations in practice, including their actual prevalence, impact on Facility pricing and likely future evolutions.

Percentage of Prior Call Overcall Limitations

Formulation. Historically, the most prevalent form of Overcall Limitation limits the amount a Fund can overcall from its non-defaulting Investors as a percentage of their original Capital Call. With brilliant creativity, we call this a "**Percentage of Prior Call Overcall Limitation**". Here is an example of a typical formulation:

"In the event that an Investor defaults on a Capital Call, the GP may require all of the non-Defaulting Investors to increase their Capital Contributions by an aggregate amount equal to the shortfall; provided that no Investor will be required to contribute an amount in excess of 50% of the amount specified in the original Capital Call."

This means, if an Investor defaults or is excused from funding a Capital Call, the Fund is authorized to overcall to make up the shortfall, but no Investor has to fund more than

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50% of the amount it originally funded. In our 2017–2018 portfolio, nearly 20% of the Fund borrowers had a Percentage of Prior Call Overcall Limitation in their Partnership Agreement. While the 50% in the above example is a common percentage limit threshold, 35% is also seen with frequency, and we have recently seen a Partnership Agreement where the threshold was set at 20%.

Default Inflection Point. To properly underwrite a Percentage of Prior Call Overcall Limitation, the Lender should determine what percentage of Investors must default to leave the Lender's loans uncovered by Unfunded Commitments. We call this threshold the "**Default Inflection Point**". Below, we illustrate a simple example. We hypothetically assume a 50% Percentage of Prior Call Overcall Limitation and then simulate scenarios where 30% and then 35% of the Investors default. As you can see, the example illustrates that the Default Inflection Point is 33.33% with a 50% Percentage of Prior Call Overcall Limitation.

Assumptions

	$ 100,000,000	Aggregate Unfunded Capital Commitments
	30%	Advance Rate
	$ 30,000,000	Availability
	$ 10,000,000	Loan Outstanding
	$ 10,000,000	Capital Call to Repay Loan
50% of Prior Overcall Limitation in the LPA		
	30%	Investors Default on Capital Call
	$ 7,000,000	Capital Call Proceeds Received ($10,000,000 x 70% = $7,000,000)
	$ 3,500,000	Overcall to Non-Defaulters, Capped at 50% ($7,000,000 x 50% = $3,500,000)
	$ 10,500,000	Total Capital Contributions Received, Lender Gets Repaid ($10,500,000 > $10,000,000)
50% of Prior Overcall Limitation		
	35%	Investors Default on Capital Call
	$ 6,500,000	Capital Call Proceeds Received ($10,000,000 x 65% = $6,500,000)
	$ 3,250,000	Overcall to Non-Defaulters, Capped at 50% ($6,500,000 x 50% = $3,250,000)
	$ 9,750,000	Total Capital Contributions Received to Repay Loan ($6,500,000 + $3,250,000)
	$ -250,000	Deficit Owed to the Lenders ($10,000,000 - $9,750,000 = $250,000)

> The Investor Default Inflection Point is 33.33% with a 50% Percentage of Prior Call Overcall Limitation

Remember, it is essential to note that the borrowing base does not protect the Lender; Overcall Limitations apply to all Investors, even those that are excluded from the borrowing base. So what happens when the percentage limit threshold is set lower? The model figure below assumes a 20% Percentage of Prior Call Overcall Limitation. As you can see, the Default Inflection Point drops to slightly under 17% of Investors.

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Assumptions

	$ 100,000,000	Aggregate Unfunded Capital Commitments
	30%	Advance Rate
	$ 30,000,000	Availability
	$ 10,000,000	Loan Outstanding
	$ 10,000,000	Capital Call to Repay Loan
20% of Prior Overcall Limitation in the LPA		
	15%	Investors Default on Capital Call
	$ 8,500,000	Capital Call Proceeds Received ($10,000,000 x 85% = $8,500,000)
	$ 1,700,000	Overcall to Non-Defaulters, Capped at 20% ($8,500,000 x 20% = $1,700,000)
	$ 10,200,000	Total Capital Contributions Received, Lender Gets Repaid ($10,200,000 > $10,000,000)
20% of Prior Overcall Limitation		
	18%	Investors Default on Capital Call
	$ 8,200,000	Capital Call Proceeds Received ($10,000,000 x 82% = $8,200,000)
	$ 1,640,000	Overcall to Non-Defaulters, Capped at 20% ($8,200,000 x 20% = $1,640,000)
	$ 9,840,000	Total Capital Contributions Received to Repay Loan ($8,200,000 + $1,640,000)
	$ -160,000	Deficit Owed to the Lenders ($10,000,000 - $9,840,000 = $160,000)

> The Investor Default Inflection Point is slightly over 16.5% with a 20% Percentage of Prior Call Overcall Limitation.

Underwriting implications. Lenders should consider the Default Inflection Point for a Fund in connection with the granularity of its Investor pool. Simulations should be run where all of the non-borrowing base Investors default and where the largest Investors default, as any combination of Investors theoretically could default. Only after getting comfortable with the likelihood of these risks should a Lender proceed. Of course, Investor pools can change over time (typically but not definitively increasing granularity, which is better for Overcall Limitation risk). The Facility market also has decades of underwriting history where Investor defaults are extremely rare, so this is often a risk Lenders are willing to accommodate (at acceptable thresholds) for top tier sponsors.

Intersection with Cumulative Investor Default Trigger. The Facility market typically includes an event of default trigger tied to a certain percentage threshold of Investors defaulting on Capital Calls (going forward, the "**Cumulative Default EOD**"). A typical Cumulative Default EOD would be triggered if 10–15% or more of the Investors are delinquent on Capital Calls for an agreed period of days past the date due. Lenders, of course, underwrite Facilities with the expectation that the credit wherewithal of unaffiliated Investors is minimally correlated. Thus, the purpose of the Cumulative Default EOD is to function as an early warning signal and protect the Lenders if something is going systemically wrong. Overcall Limitations have a direct linkage with a Facility's Cumulative Default EOD that often appears to be overlooked.

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For example, consider a hypothetical Facility with an exceedingly tight 20% Percentage of Prior Call Overcall Limitation. Assume the Cumulative Default EOD percentage in the credit agreement is set at 20% of aggregate capital commitments (admittedly, off market on the high side, but helpful for an illustrative example). Below is a calculation of how this could play out. Assume the following:

$100,000,000	Aggregate Capital Commitments
$100,000,000	Aggregate Unfunded Capital Commitments
$65,000,000	Facility Borrowing Base
$20,000,000	Loan to Acquire the Initial Investment
$20,000,000	Capital Call Made to Repay Loan
18%	Investors Default on Capital Call
$16,400,000	Capital Call Proceeds Received from Original Capital ($20,000,000 x 82% = $16,400,000)
$3,280,000	Overcall to Non-Defaulters, capped at 20% ($16,400,000 x 20% = $3,280,000)
$19,680,000	Total Capital Contributions Received to Repay Loan ($16,400,000 + $3,280,000 = $19,680,000)
-$320,000	Deficit Owed to Lenders ($20,000,000 - $19,680,000 = $320,000)

This example illustrates that, with a Percentage of Prior Call Overcall Limitation threshold set at 20%, the Fund and Lenders are out of the money if 18% of the Investors default. But what if the Cumulative Default EOD threshold was set at 20%? The Cumulative Default EOD would provide the Lenders no utility. Thus, Cumulative Default EOD percentages, to truly function as an effective early-warning signal, should always be set with an understanding of the Default Inflection Point. If the Cumulative Default EOD percentage is not set well inside the Default Inflection Point, it offers the Lenders little benefit.

Concentration Limit-Linked Overcall Limitations

Formulation. Funds typically have concentration limits ("**Concentration Limits**") on the size of their investments ("**Investments**") included in their Partnership Agreements to ensure that the Fund invests in a reasonably diversified portfolio of Investments. A typical Concentration Limit would prohibit the Fund from investing greater than 15% of its aggregate Investor capital commitments in any single Investment. "**Concentration Limit-Linked Overcall Limitations**" cap a non-defaulting Investor's obligation to fund an Overcall at the amount of the Concentration Limit if it were applied on an individual basis. That is, each Investor's maximum exposure to a particular Investment stops at, for example, 15% of its Capital Commitment. Approximately 10% of the Facilities in Cadwalader's 2017–2018 portfolio included this type of Overcall Limitation. While these limits get papered in a variety of ways, this is a common formulation:

"*In the event an Investor defaults on a Capital Call, the GP is authorized to make a subsequent Capital Call on the non-defaulting Investors, provided that such non-defaulting Investor shall not be required to fund an amount with respect to any single Investment in excess of the investment diversification limit set forth in section [x] of the Partnership Agreement if such limitation was applied on a partner-by-partner basis.*"

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Thus, for a very small Investment, a Concentration Limit-Linked Overcall Limitation is borderline meaningless. But, in reverse, if a large Investment was acquired that required each Investor to fund 15% of its Capital Commitment originally, and any Investor defaulted, no Overcall at all would be authorized. Thus, the Lender's overcollateralization varies with the size of any particular Investment, which complicates underwriting.

Use of proceeds limitations as a mitigant. Lenders frequently use a limitation on the use of loan proceeds in the credit agreement as a mitigant. The limitation is typically set at a percentage below the Concentration Limit-Linked Overcall Limitation to create an overcall buffer for the benefit of the Lender. For example:

"*No Borrower shall at any time use the proceeds of any Loan or Letter of Credit extended to such Borrower to acquire an Investment or otherwise finance an Investment or any costs and/or expenses related thereto if the aggregate Capital Commitments of the Investors of such Borrower to be called for such Investment are greater than 10% of the Aggregate Commitments of the Investors.*"

The provision does not restrict the Fund from making Investments over the 10% use of proceeds restriction; the Fund just cannot use the Facility to finance their acquisition. To size the acceptable degree of buffer, Lenders convert the buffer into its mathematical equivalent as a Percentage of Prior Call Overcall Limitation. For example, setting the use of proceeds limit at 10% on a 15% Concentration Limit is the equivalent of a 50% Percentage of Prior Call Overcall Limitation, and hence affords a 33.33% Default Inflection Point.

LPA buffer as a mitigant. Some Funds are now utilizing an explicit buffer of say 5% or 10% above the otherwise applicable Concentration Limit-Linked Overcall Limitation. This embedded buffer is hardwired directly into the Partnership Agreement and could greatly assist the Fund in two ways: (1) giving it flexibility to actually overcall if needed for the investment once contributions exceed the maximum investment threshold (how else could a Fund effectively function?); and (2) by negating the need for the use of a proceeds haircut in the credit agreement and thereby increasing the size of investments that are permitted to be financed under the Facility. Such a provision authorizes the Fund, in the context of a Concentration Limit-Linked Overcall Limitation, to call more – up to 20% or 25% of an Investor's commitment – with respect to any investment, even when the per investment diversification limit for the Fund is set at a cap of only 15% of total Capital Commitments.

Management Fee Overcall Limitations

Formulation. 21% of the Facilities in our referenced portfolio included a "**Management Fee Overcall Limit**", which prohibits the Fund from making Overcalls if the purpose of the Capital Call in question is to pay the Fund's sponsor's management fees. There is a certain logic to this: When an Overcall is made with respect to an Investment, the non-defaulting Investor gets a larger percentage of the Investment allocated to its capital account. With respect to management fees, there is no corresponding benefit to the Investor (although it does, of course, have an interest in the sponsor remaining solvent to manage the Fund). While Management Fee Overcall Limits can be articulated in a variety of ways, a common formulation is:

"With respect to any amount ***(other than the Management Fee)*** *that is in Default, the GP may increase the Capital Contributions of the Investors that have funded the amount specified in the Capital Call that is the subject of the Default."*

Lender implications and market compromises. The Facility market has taken the position that, depending on specific language, a prohibition on Overcalls for paying management fees

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may also apply to a Capital Call to repay debt if that debt was used to fund management fees. Thus, lending into a complete non-Overcall scenario conflicts with Lender underwriting guidelines and Lenders have refused to lend for this purpose. But, borrowing for this purpose is a nice utility for a Fund afforded by a Facility and the raw dollar amount at issue is relatively small with a natural cap.

With Investor defaults being rare and Funds wanting this use, Lenders are increasingly getting comfortable finding compromises. Some of the compromises that have been making headway include: (1) the Fund sponsor expressly agreeing (via an indemnity, giveback or otherwise) that if a loan is not repaid because of the Overcall Limitation, the sponsor will return the fees to the Lender; (2) the Lender will lend for management fees, but only if certain NAV thresholds are satisfied to bolster the Lender's secondary source of repayment; and (3) other conditions, such as no defaulting Investors and a tighter clean down period and/or cap on the amounts for such loans.

Market developments and practical considerations

In reviewing our data on Overcall Limitations, two counterintuitive points emerged: First, the larger Facilities to the top tier sponsors were far *more* likely to include some form of Overcall Limitation. That is, the sponsors with the greatest negotiation leverage are more likely to give Overcall Limitations to Investors than smaller sponsors. This begs the question as to whether Investors actually value Overcall Limitations and are insisting on them or if, instead, Overcall Limitations just repeat in certain new Funds because of repetition of historical precedent documentation. We would note that, while the Institutional Limited Partners Association ("**ILPA**") has been relatively quiet as to Overcall Limitations in its various guidelines, there is a 50% Percentage of Prior Call Overcall Limitation in the model Partnership Agreement that ILPA published in the fall of 2019.

Second, for as much heartburn as Overcall Limitations rightly cause Lender credit committees, their presence does not seem to result in risk-adjusted pricing. Rather, our average Facility with some form of Overcall Limitation priced 13 basis points *inside* average pricing for Facilities without any limitation. Facility size and sponsor assets under management size had a far higher correlation on spreads than Overcall Limitations.

Conclusion

In early 2020, Cadwalader will rerun its data analysis to see how Overcall Limitations in 2019 evolved. Anecdotally, we have not seen any material differences. The good news is that the vast majority of funds do not have Overcall Limitations. Where Overcall Limitations are present, we are seeing more Funds in their Partnership Agreements explicitly carve repayment of debt out from the application of the limitation, which results in Lenders giving full underwriting benefit to the Investors and optimal lending terms for Funds.

We are also seeing Funds embed their own buffer in their Concentration Limit-Linked Overcall Limitation, a thoughtful development. We think Management Fee Overcall Limitations are increasing. However, with a historical investor default rate of near zero, all of our collective learning on Overcall Limitations is yet to have much meaningful practical application. We are all, of course, completely content if this remains only an academic exercise.

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Wes has served as lead counsel on many of the largest and most sophisticated fund financings ever consummated, notably having assisted more than 35 banks as lead or syndicate lender during the past two years, with transaction values totalling in excess of $35 billion. Many of the transactions he advises on are precedent-setting, carrying unique structures and complex international components – whether that be foreign limited partners or funds, multicurrency advances or foreign asset investment.

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