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Subscription Facilities: Analyzing Overcall Limitations Linked to Fund Concentration Limits

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As the subscription credit facility (each, a "Facility") market has evolved further from its real estate fund roots and deeper into the buyout fund and private equity world, lenders (each, a "Lender") active in the space have increasingly found overcall limitations ("Overcall Limitations") in the partnership agreements or other governing documents (collectively, "Fund Documentation") of their prospective fund borrowers (each, a "Fund").

These Overcall Limitations take various forms, but in each case limit the ability of the Fund to call capital (each, a "Capital Call") from its limited partners (each, an "Investor") to make up for shortfalls created by other Investors' failure to fund their Capital Calls (each, a "Defaulting Investor"). Such Overcall Limitations fundamentally conflict with a Lender's general expectation in a Facility that each Investor is jointly and severally obligated to fund Capital Calls up to the full amount of its unfunded capital commitment ("Unfunded Commitment"). Therefore, Lenders have naturally taken a skeptical view of such Overcall Limitations due to the credit implications of such provisions. As described below, there are three primary forms of Overcall Limitations and one particular form that is linked to a Fund's investment diversification or concentration limits (a "Concentration-Linked Overcall") that has proved especially troubling for Lenders. This is because the application of such limit means that the degree of overcollateralization afforded to the Lender varies with the size of any particular Fund investment (each, an "Investment"). This variation in the overcollateralization cushion complicates the credit analysis, adding another variable required to be modeled in order to assess the actual credit impact of the Overcall Limitation on a Facility. This Legal Update provides background on Overcall Limitations generally and proposes structural solutions to address some of the issues presented with certain Concentration-Linked Overcalls.

Background

The collateral for and expected source of repayment of a Facility is the Unfunded Commitments of the Investors. As described below, Facilities are underwritten based on an analysis of selected high credit-quality Investors that comprise a borrowing base (the "Borrowing Base") as well as upon an analysis of the likelihood of Defaulting Investors. Analyzing these issues turns, in part, on the contractual provisions governing payment of Unfunded Commitments in the Fund Documentation. Funds have historically taken a two-pronged approach in their Fund Documentation to mitigate the risk and impact of Defaulting Investors, providing for: (1) severe and almost draconian default remedies (e.g., Fund Documentation often provides, for example, that the Fund may sell a Defaulting Investor's equity interest at a significant discount, oftentimes 50% or more,

to a third-party Investor) and (2) the ability of the Fund to make additional Capital Calls on any non-Defaulting Investors up to the amount of their Unfunded Commitment to compensate for any shortfall created by a Defaulting Investor's failure to fund (such subsequent Capital Call, an "Overcall").[2] The first prong aims to discourage any Investor from defaulting on its obligations in the first instance, whereas the second prong is designed to permit the Fund to continue to conduct its business (consummate Investments, repay debt, etc.) despite the existence of a Defaulting Investor. This approach has worked extremely well historically as very few Investor defaults have been reported, even at the height of the financial crisis.

The typical Fund approach to mitigate Investor defaults described above and the resulting high quality of Investor funding performance has led to a robust Facility market, as Lenders favorably view the asset-class on a risk-adjusted basis. Facilities, therefore, have been structured on the premise that Funds will employ the above approaches. That is, as with virtually all asset-based credit facilities, Facilities are typically structured assuming the ability of one receivable (here, an Investor's Unfunded Commitment) to overcollateralize any other defaulting receivable (here, a Defaulting Investor's Unfunded Commitment). To buffer defaults, Facilities employ Investor eligibility criteria for inclusion in the Borrowing Base and often use tiered advance rates for various types of Investors, including, in some cases, Investor concentration limits. The eligibility criteria for an Investor to be included in a Borrowing Base is intended to ensure that the Lender only advances against Investors of a sufficient credit quality; the Borrowing Base and its components provide structural mitigants to allow for a certain predicted percentage or number of Defaulting Investors (times a stress factor) to be absorbed while still permitting the Lender to be repaid in full from the proceeds of Capital Calls from remaining Investors. Thus, in a standard Facility, the structure provides that the Lender only takes the payment risk of the Investors that meet the applicable eligibility criteria (the "Included Investors"), so that if there is a Defaulting Investor, the Fund (or if necessary the Lender) could issue Overcalls on the non-Defaulting Investors to repay the resulting shortfall up to their then-Unfunded Commitments. As described below, Overcall Limits in the Fund Documentation cut against these traditional asset-based lending constructs, as they create both a contractual limitation on the Investors' funding obligation as well as potential credit exposure for the Lender to non-Included Investors.

Overcall Limitation Formats

While Overcall Limitations are still relatively rare in the Fund Documentation of Funds who typically use Facilities, there are several varieties that are commonly seen. Three of the most common formulations are detailed below.[3]

1) Percentage of Prior Capital Call.

One form of Overcall Limitation caps an Investor's obligation to fund an Overcall at a predetermined percentage of the initial Capital Call (a "Percentage of Prior Call Overcall"). The limitation is often styled as follows:

> If any Investor defaults on its obligations to fund any Capital Call hereunder, the General Partner shall be authorized to make a subsequent Capital Call on the non-Defaulting Investors for the resulting shortfall, *provided that no such non-Defaulting Investor shall be obligated to fund such a subsequent Capital Call in an amount in excess of [50]% of the amount it initially funded pursuant to the original Capital Call.*

In practice, this means that if an Investor contributed $1,000,000 with respect to an initial Capital Call, that Investor would only be obligated to contribute up to $500,000 pursuant to an Overcall to make up any shortfall created by a Defaulting Investor, even if its Unfunded Commitment was far in excess of $500,000. The percentage restriction in Fund Documentation is sometimes as low as 15% or 20%.[4]

2) Percentage of Capital Commitment.
Another type of Overcall Limitation formulation caps an Investor's obligation to fund an Overcall at a predetermined percentage of the Investor's Capital Commitment. This limitation is typically styled as follows:

> If any Investor defaults on its obligations to fund any Capital Call hereunder, the General Partner shall be authorized to make a subsequent Capital Call on the non-Defaulting Investors for the resulting shortfall, *provided that no such non-Defaulting Investor shall be obligated to fund such a subsequent Capital Call in an amount in excess of [15]% of its Capital Commitment*.

Under this type of Overcall Limitation, if an Investor has a capital commitment (its "Capital Commitment") of $10,000,000, such Investor is only obligated to contribute up to $1,500,000 to make up any shortfall created by a Defaulting Investor. Care should be taken in reviewing the applicable Fund Documentation to determine if this form of Overcall Limitation applies to each Overcall or all Overalls in the aggregate.

3) Concentration-Linked Overcalls.
Funds often have individual and aggregate concentration limits on their Investments ("Concentration Limits") built into their Fund Documentation to ensure that the Fund invests in a reasonably diversified portfolio of Investments. These Concentration Limits may restrict the Fund from investing, for example, greater than [15]% of the aggregate Capital Commitments of the Investors in any single Investment or greater than [25]% of the aggregate Capital Commitments in Investments in a particular geographic region or in any particular industry sector. These Concentrations Limits of course vary across Investment asset classes and are individually tailored in connection with a particular Fund's investing objectives. Concentration-Linked Overcalls cap a non-Defaulting Investor's obligation to fund an Overcall at the amount that would be the most such Investor would have to fund if the applicable Concentration Limit were applied on an individual basis, as opposed to an aggregate basis. Thus, they seek to keep any particular Investor's exposure to a particular Investment from exceeding the Concentration Limit. The limitation has been styled as follows:

> If any Investor defaults on its obligations to fund any Capital Call hereunder, the General Partner shall be authorized to make a subsequent Capital Call on the non-Defaulting Investors for the resulting shortfall, provided that no such non-Defaulting Investor shall be obligated to fund such a subsequent Capital Call if it would result in such Investor exceeding the concentration limits set forth in Section [X] as to its individual Capital Commitment.[5]

This formulation means that if the Fund Documentation includes a Concentration Limit that no single Investment may comprise more than 15% of the Fund's aggregate Capital Commitments, no Investor would have to make Capital Contributions with respect to such Investment (i.e., the original Capital Call plus the Overcall) in excess of 15% of its own Capital Commitment. Thus, at the extreme, if an Investment was acquired that required each Investor to fund 15% of its Capital Commitment originally, and any Investor defaulted, there would be no contractual obligation remaining on the non-Defaulting

Investors to fund any Overcall to make up the shortfall.

Implications for Lenders

LIMITATION ON OVERCOLLATERALIZATION

The implications of Overcall Limitations for Lenders are material in several obvious ways. First, the Lender may not have the full benefit of the entire pool of Unfunded Commitments to support repayment. For example, let us assume the following hypothetical at the maturity of a Facility:

Hypothetical

- $200 million of Unfunded Commitments
- $50 million Borrowing Base
- $20 million Loans outstanding
- $20 million initial Capital Call to repay Loans
- a Percentage of Prior Call Overcall set at 50%

If 25% of the Investors (by Capital Commitments) default on the initial $20 million Capital Call, it would result in capital contributions ("Capital Contributions") received of $15 million, leaving $5 million of Loans due and owing. If the Overcall is issued to the non-Defaulting Investors, they are obligated to fund up to $7.5 million (50% of their funded $15 million), and hence the Lender is covered.[6] However, if 50% of the Investors default on the initial $20 million Capital Call, only $10 million would be collected, leaving $10 million of Loans due and owing. The Overcall would only produce $5 million (50% of $10 million), leaving the Lender uncovered for the final $5 million, despite ample Unfunded Commitments.[7] With a Percentage of Prior Call Overcall set at 50%, the percentage of Investors (by Capital Commitments) that must default in order for the Loans not to be repaid in full by Unfunded Commitments (the "Inflection Point") is 33.3%. If the Percentage of Prior Call Overcall is 25%, the Inflection Point is 20%.

EXPOSURE TO NON-INCLUDED INVESTORS

Second, an Overcall Limitation greatly shifts credit risk from just Included Investors to all Investors, which means additional reliance on the creditworthiness of those Investors that the Lender excluded from the Borrowing Base in the first instance. For example, in the above hypothetical, a majority of the 50% of Investors that default on the initial Capital Call could all be excluded Investors, thereby triggering the Overcall Limitation on the obligation of the Included Investors to fund the Overcall. That is, the actual advance rate against the Unfunded Commitments of the Included Investors is materially higher from what the Lender contemplated for the Facility as a result of the Overcall Limitation. And the repayment proceeds are still insufficient, despite ample Unfunded Commitments from Included Investors, a Borrowing Base far in excess of the Loans outstanding and an all-in implied advance rate of only 25%. The Borrowing Base, its structured advance rate and concentration limits, simply do not completely protect against Overcall Limitation risk, even when structured tightly.

MARKET RESPONSE

Lenders in the Facility market of course have taken a concerned view of Overcall Limitations. Fortunately, they present infrequently and when they do, Funds and Investors have been relatively amenable to comments from the Lender to explicitly carve the Facility out from their restrictions. However, there are from time to time situations where a particular Fund sponsor (a "Sponsor") has a fully closed Fund with Overcall Limitations and amending the Fund Documentation is not commercially feasible. In these cases, Lenders often have to make a determination as to whether they can get

comfortable with the Overcall Limitations or if they are unable to proceed with the Facility.

Evaluating and Mitigating Overcall Limitations Generally

It is extremely difficult for a Lender to craft an overarching policy position as to which Overcall Limitations are acceptable and which are not, as the impact of Overcall Limitations requires case-by-case analysis and cannot be viewed in a vacuum. For one thing, they are articulated slightly different in each Fund's Fund Documentation, so their actual application can differ. Additionally, the ramifications of such limits differ extensively based on the constituency of the overall Investor pool in a Fund. An Overcall Limitation's potential impact is of greater concern to a Lender where a Fund is comprised of only three Investors versus a Fund with a very granular pool of Investors. Similarly, where a Fund is comprised of 50% high net worth individual Investors compared to one that has all rated, institutional Investors, such concerns may be heightened. At a minimum, a Lender must determine the Fund's Inflection Point to better understand the implications of a particular Overcall Limitation and the practical risk presented. For example, with a Percentage of Prior Call Overcall set at 50%, and hence an Inflection Point of 33.3%, a Lender would want to evaluate both the largest Investors (to see how many and which individual Investors could default before exceeding 33.3%) as well as the credit wherewithal and granularity of the bottom 33.3% (based on credit risk) of the Investor pool (to evaluate the likelihood of defaults exceeding the Inflection Point). Some Funds may have a single Investor whose Capital Commitment as a percentage of the whole is itself in excess of the Inflection Point, in effect creating the potential for single counterparty exposure risk. Additionally, the analysis is often clouded when a Fund has had its first but not its final Investor close, as the Lender is forced to try to perform a credit analysis without the full information required to accurately analyze the actual Investor pool.

Structuring for Concentration-Linked Overcalls

CHALLENGES ANALYZING CONCENTRATION-LINKED OVERCALLS

Concentration-Linked Overcalls are particularly difficult to analyze because they turn on the size of the Investment as a percentage of the aggregate Capital Commitments, and hence, they can either be a virtual non-factor or a complete contractual prohibition on Overcalls, depending on the size of the Investment at issue. For example, if the linked Concentration Limit is 15%, and the Investment at issue is only 3% of the aggregate Capital Commitments, the Concentration-Linked Overcall is of almost no practical effect whatsoever. Of course, if the Investment is 14.5% of the aggregate Capital Commitments, there is precious little overcollateralization or margin for error.

The concept is further complicated in several additional ways. First, Concentration Limits are not typically a simple test of Investment acquisition cost to aggregate Capital Commitments, they are normally a test of Capital Contributions called or to be called with respect to an Investment to the aggregate Capital Commitments. So, for example, if a portion of the Investment acquisition cost is to be financed with asset-level leverage, that portion is only relevant to the extent the financing is subsequently replaced with Capital Contributions (which, of course, can be challenging to forecast perfectly at the time of acquisition of the Investment). Further, Investments often include "Follow-on Investments," and Fund Documentation is often not explicit as to whether Capital Calls to fund "Follow-on

Investments" should be bundled with Capital Calls for the initial Investment for purposes of a Concentration-Linked Overcall. Additionally, Funds often have multiple categories of aggregate Concentration Limits, each of which has to be calculated, tracked and abided by. These aggregate Concentration Limits and the related tracking are less transparent to a Lender, as a Lender cannot perfectly determine whether any particular Investment fits within a Concentration Limit with certainty and must largely rely on the Sponsor's categorization. And finally, there is timing mismatch between the moment in time when the Fund borrows under the Facility to finance an Investment and the subsequent time when the Fund actually makes the Capital Call. In this circumstance, at the time of funding, the Lender in effect has to rely on a Fund's good faith belief as to how much capital it will be calling in the future with respect to the Investment.

USE OF LOAN PROCEEDS LIMITATION

If a particular Concentration-Linked Overcall applies to Capital Calls to repay debt (and not just to Capital Calls to fund Investments), to get comfortable with the limitation Lenders may want to consider structuring limitations on the use of Facility proceeds. For example, if a Fund has a Concentration Limit for individual Investments of 15%, a Lender may want to prohibit the use of Loan proceeds to acquire large Investments that come close in size to the 15% level to ensure that the Lender will have an adequate cushion of Overcalls on non-Defaulting Investors. So, for example, the Lender could set a percentage (the "Maximum Percentage") at the threshold of its comfort level under the circumstances to always ensure an available Overcall cushion between the Maximum Percentage and the 15%, and restrict the use of Loan proceeds with respect to Investments that are in excess of the Maximum Percentage. Setting the Maximum Percentage will depend on the particular Fund, Sponsor and Investor pool, but suppose, for example, that the Lender would be comfortable under the circumstances with a 33.3% Inflection Point (as if there was a Percentage of Prior Call Overcall framework set at 50%). In such a case, the Lender could set the Maximum Percentage as the mathematical equivalent of the 50% Percentage of the Prior Call Overcall for each Concentration Limit. For a 15% Concentration Limit, the math is simple and the Maximum Percentage would be 10%. Hence, the Fund could use Loan proceeds under the Facility for Investments in which less than 10% of the aggregate Capital Commitments would be called, but would be prohibited from using Loan proceeds for Investments in excess of 10% of aggregate Capital Commitments. For the Fund's aggregate Concentration Limits, the Maximum Percentage would float such that each level was set at the 33.3% Inflection Point.

ADDITIONAL MITIGANTS

Setting the Maximum Percentage requires care and consideration of all the relevant criteria for the particular Fund. It also requires a high degree of confidence in the Sponsor, as the Lender will be relying on the Fund to accurately predict anticipated Capital Call amounts for Investments, accurately classify Investments for purposes of aggregate Concentration Limits, and accurately address the potential impact of subsequent Follow-on Investments. These reliances may, in certain circumstances, require increased due diligence on Sponsors, thus potentially limiting the use of this structure to only highly-experienced, trusted Sponsors with demonstrated track records. Additionally, in certain circumstances, additional asset-level mitigants and "skin in the game" requirements may be appropriate to bring a particular Facility with a Concentration-Linked Overcall back to the intended credit profile. Examples include (i) covenants to periodically call capital to ensure

the earlier detection of Defaulting Investors and because Investors periodically investing fresh equity are less likely to be willing to forfeit such equity by defaulting, (ii) minimum net asset value requirements to buffer the secondary source of repayment, and (iii) asset-level leverage limitations to reduce volatility with respect to the equity position of the Fund. In addition, Lenders may want to exercise greater control over transfers by non-Included Investors since the Lenders have exposure to all Investors when Overcall Limitations are applicable.

IN PRACTICE

In practice, many Funds do not actually acquire a large number of Investments that bump up against their Concentration Limits, and therefore, the use of proceeds limitation has been an acceptable work-around for both Lenders and Funds in certain Facilities. Further, to the extent the Fund wants to acquire an Investment in excess of the applicable Maximum Percentage, it would not be prohibited from doing so with equity; rather, it is only prohibited from doing so with Facility proceeds. Similarly, if a Fund desires to make additional Investments which would put it above the Maximum Percentage with respect to a particular aggregate Concentration Limit, it can do so by simply paying down the Loan related to the initial Investment prior to consummating such additional Investment.

Conclusion

While Overcall Limitations are still relatively rare in Fund Documentation, when applicable they become an important focus of the underwriting analysis for Lenders considering a Facility. Lenders must evaluate not just the Borrowing Base for such Facility, but the Sponsor, the Fund and the Investors as a whole, to adequately understand the risks of Investor defaults exceeding the Inflection Point. Fortunately, Investor default numbers have historically been many multiples shy of even the tightest Inflection Points and with structural mitigants many Lenders are able to find solutions to enable Funds (at least those formed by well-established Sponsors) to benefit from Facilities. Funds considering the possibility of a Facility should, whenever possible, avoid or narrowly tailor Overcall Limitations to scope out Capital Calls to repay a Facility, as their inclusion, even when accommodated, results in greater due diligence time, expense and legal costs and, most importantly, less favorable Facility terms and pricing.

Endnotes

[1] Ann Richardson Knox is a partner in the Banking & Finance practice at Mayer Brown and oversees the Fund Finance team in the New York office. Kiel Bowen is a partner in Mayer Brown's Banking & Finance practice, where his practice centers on fund finance.

[2] In this Legal Update, we discuss Overcall Limitations in the context of Defaulting Investors, but the concept is also often equally applicable with respect to any Investors that are excused from participating in any particular Investment under the terms of the applicable Fund Documentation.

[3] An Overcall Limitation in any Fund Documentation must be examined individually, as there are many slight variations to the examples provided herein, any of which could impact its prospective applicability to, or impact on, a Facility.

[4] From time to time, we have seen Overcall Limitations surface in side letters of individual Investors as well. While not as dramatic as a Fund-wide Overcall Limitation, individual Investor Overcall Limitations present interesting wrinkles for Lenders as well.

[5] Some Concentration-Linked Overcalls apply only with respect to Capital Calls to make an Investment and not with respect to Capital Calls to repay indebtedness. Some formulations can be ambiguous as to whether they would apply with respect to a Capital Call to repay loans under a Facility ("Loans") if the Loans were used to acquire an Investment. Hence, again, any particular Overcall Limitation must be analyzed individually.

[6] We assume all non-Defaulting Investors fully fund the Overcall. It is of course theoretically possible that certain non-Defaulting Investors fail to fund the Overcall leading to successive Overcalls.

[7] Note that we are by no means saying that the Lender will definitively take a loss in this circumstance. Facilities are full-recourse obligations of the Fund and the Fund very well may be able to satisfy its payment obligation by the liquidation of Investments. Additionally, the Fund and ultimately the Lender will have claims against the Defaulting Investors which may also result in repayment proceeds and transfers of Defaulting Investors' positions may produce creditworthy substitute Investors.

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