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Concentration-Linked Overcall Limitations

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We have seen multiple partnership agreements this week that include an embedded buffer in the concentration-linked overcall limitations – a thoughtful evolution that provides a safety net to both the fund and its lender.

First, let's refresh. Most funds have a per investment diversification or concentration limit of around 15% of aggregate capital commitments (the "15% Cap"). Concentration-linked overcall limitations, kryptonite to the fund finance banker, tie the permissible amount a fund is authorized to overcall as a result of investor defaults or excuses back to the 15% Cap. This is in contrast to the more standard overcall limitation that limits the amount of the overcall to something like 35% or 50% of the original capital call. Many a deal has been shelved because the lender could not get comfortable with the limitations. The typical concentration-linked overcall limitation is phrased something like:

> In the event a limited partner defaults on a capital call, the general partner is authorized to make a subsequent capital call on the non-defaulting limited partners to make up the shortfall, *provided that such non-defaulting limited partner shall not be required to fund an amount with respect to any single investment in excess of the investment diversification limit for the fund set forth in section [x] of the partnership agreement if such limitation was applied on a partner-by-partner basis.*

Thus, with the above language, the fund is authorized to make a default overcall, but only up to the point where 15% of the investor's capital commitment is allocated to the applicable investment. This, of course, gives the investor some comfort that its interest in the fund will have some level of diversification in the underlying investments. But if a fund buys an investment already sized at the 15% Cap and any investor defaults, no other investor is obligated to fund any overcall to make up the shortfall at all, even for a *de minimis* amount. Ouch. That could suck.

Lenders, of course, underwrite transactions with an expectation that the fund can overcall on non-defaulting investors all the way up to their then unfunded capital commitments, so any

limitation on that authority is a credit exception. Many funds are successful in getting an express carve-out to their overcall limitations that make them inapplicable for capital calls to repay debt. That is an optimal outcome for the fund and the lender, and results in the fund getting preferred terms in a credit facility. But what about funds without such a carve-out?

We have for years incorporated a solution into credit agreements to address this risk – the "Use of Proceeds Restriction." The Use of Proceeds Restriction only authorizes a fund borrower to use loan proceeds with respect to investments in which less than, say, 10% of aggregate capital commitments are expected to be called. This way, the fund always has the buffer between the 10% and the concentration-linked limit of 15% to overcall from the non-defaulting Investors. The fund is not prohibited from buying a maximum-size investment of, say, 14% or 15%; it just cannot use the credit facility to finance its acquisition. While this works in many cases, in certain funds it massively curtails the utility (and, in some cases, the viability) of a credit facility. This is especially true when the fund has had a first but not final investor close. The 15% Cap at an initial investor closing can sometimes prohibit even very small investments. Practitioner's note: During a fund's investor fundraising period, it may make far better sense for the 15% Cap to be based on anticipated fund size instead of actual fund size.

The embedded buffer we have been seeing assists the fund. It authorizes the fund, in the context of an overcall, to call 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 the 15% Cap. That way, the fund can always overcall into the buffer, and the fund will not find itself without an overcall option should it make a maximum-size investment. This makes perfect sense – how else could a fund effectively function if it bought a 15% investment and even a single investor defaulted? The buffer in turn takes some pressure off the threshold where a lender needs to set the Use of Proceeds Restriction, thereby increasing the size of investments that are able to be financed under the credit facility.

One interesting practitioner's note: A credit agreement's restriction on partnership agreement amendments would typically prohibit an LPA amendment that added an overcall limitation, as that amendment would fall within the prohibited scope of amendments to "Capital Commitments, Capital Calls, the Collateral, etc." But, if a lender relied on an embedded buffer like what is described above and the fund sought to amend the partnership agreement to increase the investment diversification limit itself (thereby reducing the protective buffer), would it be enough to trigger a "Material Amendment"? While we think such an LPA amendment should fall within the catch-all standard for any lower case "material adverse effect" to lenders and thus trigger a "Material Amendment," it would be prudent to explicitly capture any amendments with overcall implications within the definition.