CADWALADER

Intersections: Overcall Limitations/Investor Default EOD and Related Entities/Exclusion Events

April 26, 2019 | Issue No. 26

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The Intersection of Overcall Limitations and the Investor Default EOD Trigger

April 26, 2019 | Issue No. 26

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The subscription facility (each, a "facility") market has for ages included an event of default trigger tied to a certain percentage threshold of investors failing to timely fund their capital calls (going forward, the "Cumulative Default EOD"). A typical Cumulative Default EOD would be triggered if 10-15 percent or more of the investors are delinquent on capital calls for longer than, say, five business days from 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 with the fund and/or the investor pool. The 10-15 percent threshold is seen so frequently that it is hard to argue it is not a market standard. But should it be?

A lot has changed since that standard was developed. The Facility product grew up in the real estate space where there were historically hardly ever overcall limitations in fund partnership agreements. Over time, and as the product has permeated buyout and other asset classes, overcall limitations have become far more prevalent. And overcall limitations have a direct linkage with a transaction's Cumulative Default EOD. That linkage often appears to be overlooked.

For example, consider a hypothetical transaction with an exceedingly tight overcall limitation: 20% of the original capital call. That is, if an investor or investors defaulted on a capital call, the fund is authorized to call upon the non-defaulting investors to make up the shortfall, but only up to 20% of the amount of their original capital call. 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 an overcall limitation threshold set at 20% of the prior call, the fund and lenders are out of the money if as few as 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 in our example.

Thus, Cumulative Default EOD percentages, to truly function as an early-warning signal, should always be set with an understanding of the inflection point at which an overcall limitation could keep the lenders out of the money (for a 30% of prior call overcall limitation, the investor default inflection point is just over 23% and for a 50% of prior call overcall limitation, the inflection point is around 33.3%). If the Cumulative Default EOD percentage is not set well inside the overcall limitation inflection point, it offers the lenders little benefit.

Interestingly, a minority of banks in the United States that have historically banked the venture capital and buyout community have set their Cumulative Default EOD percentage at 5% of total commitments. Perhaps they have this credit analysis more rightly sized than the market as a whole.

Who (When) You Gonna Call?

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Traditionally, subscription finance facilities treat investors in two ways. For “regular” investors, they are either included or excluded from the borrowing base or leverage covenants depending on their financial status and/or their behaviour as investors. For investors which are also GPs or managers, the concerns are more around a change of control of the GP or manager or something worse (for example, a voluntary or even compulsory removal of a GP or manger and whether there is an acceptable replacement).

One common feature (whether for regular investors and/or the GP or manager) in traditional subscription facilities is that the focus has been pretty much exclusively on the investors themselves. For a “regular” investor to be excluded from the borrowing base (or the leverage covenant), the relevant event has to occur in respect of the investor itself. For a change of control to apply to a GP or manager, the relevant provisions are often drafted in such a way that the only relevant event will be a change in the direct ownership of that GP or manager. It will not often cover an insolvency of the owner of the GP or manager.

In some situations, these arrangements should be perfectly adequate, particularly where the investor is itself a substantive entity capable of providing the relevant commitments and/or operating in its own right and on its own behalf. But what happens where the investor (including the GP or manager) is not itself a substantive entity and is simply a vehicle for and reliant on another entity?

In that case, the risk becomes somewhat different, because if the investor is reliant on another entity either for funding and/or operations (and that other entity itself suffers from a change in financial status or behaviour) then that will obviously impact significantly on the investor itself. For a regular investor in this position, for example, an insolvency of the entity on which it is dependent for funding commitments could leave that investor clearly unable to fund those commitments (even if the investor itself had not been directly otherwise affected). For a GP or manager, an insolvency at a higher level could impact both on the ability of the GP to fund its own commitments—and that in itself could adversely affect the behaviour of other investors—and/or lead to difficulties in continuing to operate the fund (if the GP or manager is reliant on that entity for providing and paying for the relevant operational and management resources).

In effect, lenders have a choice: They can leave things as they are and wait for whatever happens at the level of an investor’s holding company or entity to impact directly on the investor itself; or they can consider whether they need to make changes to their documentation to ensure that where a significant event occurs at a higher level than the investor which impacts the investor that event will more immediately trigger an exclusion event from a borrowing base or leverage covenant or a change of control. We are increasingly seeing moves towards the latter approach.

On the Move–Fund Finance Tidbits

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On the Move

Emma Wallace has joined Silicon Valley Bank as a Managing Director in its Global Fund Banking Group. She joins from State Street, where she was a Managing Director heading up the Capital Call Finance business. Emma brings a wealth of international banking experience, including originating, structuring and executing subscription and asset backed loans. At SVB, Emma joins a Fund Banking team that has banking relationships with more than 2,200 private equity and venture capital firms globally.

Fund Finance Hiring

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Fund Finance Hiring

- Signature Bank seeks to add a Relationship Specialist in its Fund Banking Division. Focused on providing personalized banking services to financial institution customers, the position will be based in New York. Candidates should bring a minimum of five years of financial services experience demonstrating high-level client support. Interested applicants can find more information **here**.
- National Australia Bank is seeking an Associate to join its New York-based Fund Finance team. The role will include supporting origination, structuring, credit submissions, and portfolio management across private equity and publicly listed funds. Key products include subscription finance, hybrids/NAVs, redemption facilities and foreign exchange. For further information please contact Alex Bolton (**alex.bolton@nabny.com**) or Nick Woutas (**nicholas.woutas@nabny.com**).
- Cadwalader has opportunities for both associates and staff attorney applicants to join the firm's Fund Finance practice in Charlotte. More about those opportunities and a link to apply are available **here**.

FFA NexGen Announces NYC Event

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The Fund Finance Association's Next Generation initiative announced a May 15 event in New York. Titled "A Future in Fund Finance," the panel session will start at 7 p.m. at Morgan Stanley's offices at 1585 Broadway. Panelists include David Wasserman, Managing Director at Morgan Stanley; Eric Schwitzer, Partner at Paul Hastings LLP; and Timothy Bailey, Director at Fortress Investment Group, and will be moderated by Jorge Grafal, Associate Director at National Australia Bank. A cocktail reception will follow the panel. To register, click **here**.

Fund Finance Calendar

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Fund Finance Calendar

Upcoming Events in Fund Finance

July 25, 2019	Women in Fund Finance Wit & Wisdom Breakfast Meeting, Allen & Overy, London
September 24, 2019	3rd Annual Asia-Pacific Fund Finance Symposium, Four Seasons Hotel, Hong Kong
October 17, 2019	Cadwalader Finance Forum, The Ritz-Carlton, Charlotte, North Carolina

If you have an event that you would like listed on the *Fund Finance Friday* calendar, please email us at **fund-finance-friday@cwt.com**.