Proskauer

Private Credit Deep Dives – Call Protection (United States)

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“Call protection” (which is referred to as a “prepayment fee”, “prepayment premium”, “call premium”, “prepayment penalty”, “non call”, “hard call”, “soft call” or “make whole”) is a core economic term in leveraged financings. The underlying premise is that, having advanced a loan, a lender should have contractual assurance that it will earn the agreed level of yield on that loan for a certain period of time after closing (and that the borrower will not be permitted to prepay the loan a day after closing, for example, thus depriving the lender of substantially all the interest income it expected to earn when executing the transaction without paying a fee or premium). Lenders will most acutely feel the risk of being prepaid early in a transaction when they fear a near term decline in interest rates. Currently, the bank driven credit markets remain unsettled, and there is an acknowledgement from market participants that the levels of pricing for new private credit deals are very attractive in comparison to the last couple of years of this credit cycle. Accordingly, lenders will be eager to lock in these returns for a reasonable period rather than risk being quickly refinanced with cheaper debt if more optimal credit conditions suddenly return. This is particularly the case for private credit providers that are increasingly financing deals that would previously have gone to the broadly syndicated market. While that market currently remains largely closed to new primary underwriting, in the event it fully reopens in the near future, the pricing levels that are achievable will likely be inside of the minimum rates of return for most private credit providers.

This deep dive with Bharat Moudgil (Partner) and Noah Travis (Associate), lawyers in Proskauer’s Private Credit Group in Los Angeles and Boston, will explain how call protection is commonly structured in today’s market and how sponsors have sought to limit its scope as well as describing the current hot topics and potential pitfalls for various deal sizes.

Click here to read how call protection is commonly achieved in the current European Market, as explained by Daniel Hendon (Partner) and Phil Anscombe (Associate).

Historically, there have been three primary methods of achieving call protection for lenders:

- First, by agreeing that the loan cannot be prepaid (or, in the language of bonds, cannot be "called") within a certain period. This is what was originally meant by "non call," and it is rarely seen in unitranche facilities.
- Second, by agreeing that if the loan is prepaid within a certain period (confusingly, this is sometimes referred to as a "non call period", despite the fact the loan can actually be "called" or prepaid during that period), then the borrower must nonetheless pay all the interest that would otherwise have accrued on the amount being prepaid up until the end of that period. This is more accurately described as a "make whole" (as the lender is "made whole" for, among other things, the interest and any premium or penalty it anticipated otherwise receiving for that period) and is less common in the market except in junior debt facilities and lower middle market sponsored and sponsor-less unitranche transactions in the US. For example, Proskauer's 2022 U.S. deal data showed less than 20% of deals had make whole protection. If included, the make whole provision will include not only the margin but also the appropriate prevailing reference rate at the time of prepayment (and giving effect to any reference rate floor).
- Third, by agreeing that if the loan is prepaid within a certain period, a simple premium amount must be paid (calculated as a percentage of the principal amount being prepaid). This is the most common formulation in the market. Proskauer's 2022 deal data showed that upwards of 80% of deals had some form of this type of premium (with no make whole protection). There is a system of shorthand for describing this premium. If you see a protection expressed as 102 or 103, for example, that means that a premium of 2% or 3% applies on the principal amount being prepaid in the relevant year. These data points being expressed sequentially suggests that these regimes follow one another sequentially in time for that particular deal, so if you see 102/101, that means there is a 2% premium in year one and a 1% premium in year two. It is important to note that the second and third approaches above may also be combined on any particular transaction with this approach (e.g., NC1/102/101).

In recent years, sponsors have increasingly used their market power to limit the amount of call protection that might be payable, the time period during which it applies and also what triggers payment. While this is generally subject to significant negotiation between business principals, the common areas of contention are as follows:

1. **High level terms** – Proskauer's 2022 U.S. deal data reflected that the simple 102/101 schedule was present in an overwhelming majority of the tracked deals.

Additionally, 71% of deals had no call protection in year three. Despite the prevalence of the 102/101 schedule, there was notable increase in deals with a 3% premium for year one in the second half of 2022 (up from 11% to 28%). Likewise, the percentage of deals with a 2% premium in year two also increased from 16% to 28% in the second half of that year. It is worth noting that there is some variation within product type, with sponsor-less transactions and subordinated instruments (whether second lien, HoldCo PIK or otherwise) typically commanding a more robust call protection regime. Signs are that lenders are insisting on better call protection in the current market as shown by the increase in the premiums over the second half of 2022. Whether or not this is a sustainable trend will become clearer in the coming months.

2. **Type of prepayment** – While it was once the case that any prepayment of a term facility would trigger a prepayment premium, the market has chipped away at that hard and fast rule in prior years. In certain sponsor favorable upper middle market transactions, for example, the protection is typically limited to what is known as “soft call” (i.e., lenders commonly receive 101 protection for six months only from closing and on a “soft call” basis). What is typically meant by “soft call” is that lenders are only protected in the instance of a “repricing event”. So, the protection only applies upon a voluntary prepayment of the existing facility funded by new indebtedness, where the primary purpose of that refinancing was to reduce the applicable cost of debt to the borrower group. Notably, 90% of US deals in 2022 had call premiums on voluntary pre-payments subject to certain carve outs. Call protection will also sometimes apply to any prepayment (whether voluntary or mandatory) made in connection with a major liquidity event (i.e., any change of control, sale of substantially all assets or any IPO). Though in some cases, these liquidity events may trigger only a “discounted” premium, i.e., 50% of the call protection that would otherwise be payable, or there could be a whole-sale carveout of prepayments made in connection with those events. Additionally, 79% of deals in 2022 contained call protections on select mandatory prepayments. Most commonly, these protections apply when such mandatory prepayments are made with debt incurrence proceeds. It has become significantly less common to see call protection for other classes of mandatory prepayments (e.g., excess cashflow sweeps (which never triggers a premium), proceeds of asset sales, etc.) on the basis that these are credit enhancing payments that were contractually required by the lender rather than directly benefiting the sponsor, but certain of these are still seen on a small minority of deals. Some lenders historically also required call protection to apply upon acceleration (such that their claim upon enforcement crystallizes the call protection amount as being due and payable) or when being “yanked” from a deal (meaning either being prepaid or replaced by another lender due to refusing to consent to certain amendments,

being replaced due to an illegality issue or otherwise). Though this type of "hard" call protection is less frequently found in upper middle market transactions or competitive middle market deals.

3. **Net present value** – Where a "make whole" applies, sponsors often look to reduce the amount of call protection that becomes due by applying a "net present value" calculation to the projected interest accrual. The rationale for this is that if the facility had otherwise remained outstanding, the lender would have received its usual interest payments periodically up until the end of the relevant period. Instead, it will be receiving the equivalent amount of call protection in cash up front on the date of prepayment, meaning that cash could in theory be reinvested in risk-free assets with an almost guaranteed level of economic return for the rest of the make whole period. As a result, sponsors will suggest that the projected interest accrual amount be discounted (at an annual rate approximate to a risk-free rate) from the end of the make whole period back to the date of prepayment, so as to ensure the lender is not better off than it would have been had the deal continued. While this is not always accepted by lenders, it is a relatively common feature of the private credit market. In terms of the rate that is used for discounting, this is typically tied to the relevant currency (so, for example, it may be US treasuries of the equivalent tenor for USD, UK gilts for GBP and German bunds for EUR). When rates were very low, it became common to use a rate with 0.50% headroom to those government rates, but in the current market, some lenders prefer to remove the headroom concept.

4. **Permitted refinancings** – Sponsors frequently propose that where a prepayment is made in connection with a refinancing (whether that is a refinancing led by the same sponsor or a refinancing in connection with a change of control/exit) and the same lender participates in the new financing, then call protection will not apply. The rationale for this is that the lender will likely be earning "new money" fees for the new financing and should therefore not also receive a premium on the prepayment of the existing debt. While lenders are generally amenable to this, they look to ensure they are in no worse a position as a result, usually achieving this by saying the exception applies on a lender-by-lender basis, i.e., just because one existing lender participates in the subject refinancing, it does not mean that all lenders lose their rightful premium.

5. **Deemed cash** – In certain transactions, borrowers are sometimes given the (limited) ability to capitalize a portion of their interest payments, rather than pay the interest in full and in cash, by way of exercising a "PIK toggle". For example, if a facility has a margin of 7.00%, it might be possible for 2% of that margin to be capitalized (perhaps for a limited number of interest periods and subject to certain caveats), provided that capitalized margin is paid with a PIK premium of 0.5%

(i.e., the cash pay margin would be 5.00% and the capitalized margin would be 2.50%). This feature is a particularly hot topic in the current market, with spiraling interest rates on floating rate debt meaning the pressure on company cashflows to meet their interest costs are often very significant (and a PIK toggle can help alleviate some of that pressure). The PIK premium (i.e., the extra interest that is charged when interest is to be capitalized) is justified on the basis that the lender is effectively taking on additional credit risk by agreeing to defer receiving that cash payment until maturity. Some sponsors therefore argue that when calculating a make whole, you should calculate it on the basis that all interest would be 100% paid in cash (on the basis that the make whole is received today, so there is no such additional risk that warrants additional premium). However, certain lenders will take the view that projected interest accruals should assume the same level of PIK toggle usage that is currently in effect at that time. Where there is an actual permanent PIK component to a facility (as opposed to a temporary PIK toggle usage), this debate becomes even more contentious, as the assumed PIK capitalizations may form a core part of the lender's projected return on its investment.

6. **PIK** – Certain aggressive sponsors have proposed that prepayments of principal that constitutes previously capitalized PIK interest (as opposed to principal that was originally advanced as a loan) be exempt from call protection, which is typically resisted by lenders.

7. **Delayed draw timing** – Some lenders traditionally took the view that the relevant call protection period for a facility should run from the date on which that facility is first drawn. As such, an acquisition financing facility, refinancing facility or other "day one" facility would have a call protection period running from the original closing date. However, for delayed draw facilities, lenders may take the view that the period for such facilities should run from the date on which they were first drawn (or even that each individual loan should have a call protection period running from the date on which it is drawn). Sponsors have consistently pushed back on this, insisting that call protection periods for all committed facilities should run from the original closing date – while there are exceptions, this has become the most common market position. Lenders can still be successful at "resetting" the call protection clock when subsequent new money is funded by way of incremental facilities, but that is a negotiated point in each deal.

In summary, current market conditions have led to the entrenchment of the simple premium regime. Notwithstanding that fact, there remain numerous means by which sponsors look to limit such premiums through complex exceptions, carve outs and discounts in addition to headline terms. We expect this pressure from sponsors to continue, particularly as the private credit product continues to evolve and compete directly with the syndicated lending markets (and we may see an increasing bifurcation between large deals and true mid-market deals). For any related questions on this topic, please reach out to your contact within Proskauer’s Private Credit Group.

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