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Article

Lending to Single Investor Funds: Issues in Connection with Subscription Credit Facilities

By Mark Dempsey and Claire Ragen[1]

Fund As the subscription credit facility market continues to experience steady growth, lenders seek to expand their lending capabilities beyond traditional subscription credit facilities to commingled private equity investment vehicles (“Funds”). One way lenders have accomplished this is by lending to Funds that have a single dedicated investor in the Fund (each, a “Fund of One”). By way of background, a subscription credit facility (a “Facility”) is a loan or line of credit made by a bank or other credit institution (a “Creditor”) to a Fund that is secured by (i) the unfunded commitments (the “Capital Commitments”) of the investors to fund capital contributions (“Capital Contributions”) to the Fund when called from time to time by the Fund (or its general partner, managing member or manager (a “Manager”)), (ii) the rights of the Fund or its Manager to make a call (each, a “Capital Call”) upon the Capital Commitments of the investors and the right to enforce payment of the same and (iii) the account into which investors fund Capital Contributions in response to a Capital Call.[2]

A Fund of One has one investor (which is typically a well-established institutional investor) (the “Investor”). The respective rights and obligations of the Investor and the Manager are primarily contained in the limited liability company agreement, the limited partnership agreement or an investment management agreement of the Fund of One (the “Governing Agreement”). A Fund of One may also have an equity interest from an additional party (typically an affiliate of the sponsor and Manager of the Fund of One), but the additional party’s equity interest is often small compared to the equity investment of the Investor. A number of institutional Investors have shifted towards investing in Funds of Ones for a number of reasons, including: (i) a Fund of One offers greater control of all aspects of the investment process (such as investment decisions and reporting), (ii) Funds of One usually have reduced management fees, (iii) the investment mandate can be custom-tailored for the Investor and (iv) the Investor is protected from co-investor default risk.[3] Many institutional investors, including state pension plans, foreign pension plans and sovereign wealth funds, have been known to use a Fund of One as an investment vehicle. Although a Manager will control the Fund of One and have primary responsibility for conducting the operations and making investment decisions for the Fund of One, the level of involvement and control by an Investor in a Fund of One can vary. The level of involvement of the Investor is generally shaped by the specific investment policies and experience of the Investor’s personnel in the type of investments intended to be made by the Fund of One, the relative negotiating power of the Investor and the Manager and, in some cases with respect to certain foreign investors, the desire to avoid

having effective practical control over the Fund of One in order to be eligible to achieve desirable US federal income tax treatment on the investment.

This article addresses issues and documentation considerations for Facilities to a Fund of One.

Governing Agreement Issues

Not all potential Fund of One borrowers have a Governing Agreement that is able to support a Facility. To be suitable for a Facility, the Governing Agreement should, among other things, expressly authorize the Manager to obtain a Facility on behalf of the Fund of One and provide as collateral the right to call upon the unfunded Capital Commitments of the Investor. For purposes of this article, we assume that the Capital Commitment of the Investor is an equity commitment and the Investor is fully obligated to fund upon a validly issued Capital Call from the Manager or the Creditor pursuant to a pledge of the Manager's rights. Three common concerns regarding the Governing Agreement of a Fund of One in particular are: (1) the consent rights of the Investor with respect to borrowings and the operating budget, (2) limitations on the right to pledge the Capital Commitment of the Investor and (3) enforcement rights against the Investor if the Investor fails to fund its Capital Commitment.

Consent rights afforded to an Investor under the Governing Agreement for a Fund of One may be quite broad. For example, the Investor may have consent rights for each investment with respect to each borrowing and/or the budget. This is unlike a commingled Fund with a large number of Investors, in which the mandate to the Manager with respect to investments is often broad in nature, and consent is not generally required prior to each investment. Furthermore, the Investor in a Fund of One may have a consent right regarding all borrowings of the Fund of One (or a consent right for all borrowings above a particular threshold amount) and/or the right to approve the Fund of One's operating budget. In a commingled Fund, by contrast, there is typically a provision in the Governing Agreement permitting borrowings and giving authorization to the Manager to set the Fund's operating budget. If the Investor has a consent right with respect to individual borrowings and the operating budget, the Creditor may consider making it explicit in an Investor Letter (as described in "Facility Documentation Considerations" below) that the Investor consents to the Facility and agrees to fund Capital Contributions to the Creditor during an event of default under the Facility.

There may also be limitations in the Governing Agreement regarding the amount of the Investor's Capital Commitment that can be pledged to the Creditor as collateral for the Facility. For example, if an Investor has a Capital Commitment of $100 million, the Governing Agreement for the Fund of One may provide that only 80 percent ($80 million) of the Investor's Capital Commitment may be pledged to the Creditor. In this case, the Creditor would only consider $80 million as part of the borrowing base for the Facility, not the total $100 million Capital Commitment. In addition, there may be issues with tracking (whether or not capital that has been called is part of the Capital Commitment that may be pledged to the Creditor). One solution is to provide in the Governing Agreement or subscription documents, as applicable, that the Investor has two Capital Commitments: one Capital Commitment that may be pledged to a Creditor and one that may not be pledged. In addition, the Creditor may require that the reporting of Capital Calls clearly sets forth the Capital Contributions that have been called and what portion is part of the Capital Commitment that has been pledged to the Creditor.

Finally, Funds of One differ from commingled Funds in their treatment of defaulting Investors. In a typical Governing Agreement for a commingled Fund, there are often draconian enforcement rights with respect to Investors that fail to fund Capital Contributions when due, including a forced sale of the defaulting Investor's interest in the Fund at a discount of up to 50 percent as well as loss of distribution rights and other rights such as participating in future

investments of the Fund and voting. In a Fund of One, however, there are typically narrower enforcement rights under the Governing Agreement (often limited to default interest and the right of the Manager to pursue ligation against the Investor), and the Manager does not have the ability to call on other Investors to make up the defaulting Investor's shortfall. In addition, it is unlikely that the Manager's Capital Commitment would be sufficient to make up the shortfall caused by the defaulting Investor. The Creditor may consider seeking additional credit support from the Manager, a sponsor of the Manager or a parent entity of the Investor to address the limited enforcement rights in the Governing Agreement.

Facility Documentation Considerations

While a Facility for a Fund of One is generally similar to a Facility for a commingled Fund in terms of closing documentation, a Facility for a Fund of One may require a few specific changes in order to give the Creditor comfort from an underwriting perspective.

First, the Creditor may require an investor letter (the "Investor Letter") from the Investor in a Fund of One in connection with the Facility. An Investor Letter is an acknowledgement made by an Investor in favor of a Creditor in which the Investor makes representations, acknowledgements and covenants relating to the pledge to the Creditor of the right to receive and enforce the Facility collateral. It is also not uncommon for the Creditor to require an investor opinion (an "Investor Opinion") from legal counsel of the Investor stating various legal conclusions with respect to the Investor, such as the valid existence and good standing of the Investor and the corporate power and authority to execute the Investor Letter. Although there is a market trend away from requiring an Investor Letter and an Investor Opinion for Facilities generally, it is still common for a Creditor to require this additional documentation in a Facility for a Fund of One where the Creditor is relying on the Capital Commitment of a single Investor for repayment.

A second issue for a Creditor to consider is the proper advance rate against the Capital Commitment of the Investor. In a Facility in which there are numerous Investors, the Creditor will often advance against different percentages of each Investor's Capital Commitment depending on the creditworthiness of each Investor based on the Creditor's underwriting of each Investor (for example, the Creditor may advance 90 percent against well-established institutional Investors and 70 percent against other designated Investors). For a Fund of One, the analysis may be similar and the advance rate for that single Investor may depend on what the Creditor would normally advance against that particular Investor in the case of a Facility to a commingled Fund. However, an important consideration for the Creditor is how much overall exposure the Creditor has to that particular Investor across the Creditor's other Facilities, such as exposure to that Investor in Facilities to commingled Funds in which that Investor has also invested.

Alternatively, the Creditor may decide to advance a lower percentage against the Investor's Capital Commitment than it would otherwise in case of a Facility to a commingled Fund because the Creditor does not have certain benefits related to a Facility for a commingled Fund. Most notably, the Creditor is relying on the Capital Commitment of a single Investor in a Fund of One and does not benefit from the reduced risk that comes with diversification from relying on the Capital Commitments of numerous Investors in a commingled Fund. In a commingled Fund, a Creditor typically advances loans against the Capital Commitments of only well-established institutional Investors and certain other Investors in the Fund, although the Creditor takes as collateral the Capital Commitments of all Investors in the Fund. In a Fund of One, the Creditor does not have such additional collateral from other Investors aside from the sponsor

Capital Commitment, which is often just a fraction of the Investor Capital Commitment, and that is likely insufficient to cover any shortfall.

Events that would remove an Investor from the borrowing base ("Exclusion Events") in a Facility to a Fund of One will often be similar to what would be found in a typical Facility. Such Exclusion Events generally include the Investor filing for bankruptcy, judgments against the Investor over a certain threshold amount, failure to make a Capital Contribution within a certain time period, transfer of the Investor's interest in the Fund of One and default under the Governing Agreement or other subscription documents. However, the Exclusion Events in a Facility to a Fund of One may be more stringent in a few respects, including with respect to a cure or grace period. If any credit support is provided by a parent of the Investor (as discussed more fully below), the Exclusion Events typically extend to the parent of the Investor as well. Also, if the Investor executes additional documentation supporting its obligations to fund Capital Commitments in the form of an Investor Letter (as discussed above) and the Investor violates the term of that Investor Letter, there may be an Exclusion Event relating to that breach. If there is an Exclusion Event and there are amounts outstanding under the Facility, then the Investor's removal from the borrowing base is likely to result in a mandatory prepayment event under the Facility.

Another difference between a Facility to a commingled Fund and a Facility to a Fund of One involves Creditor consent for an Investor to transfer its interest in the commingled Fund or the Fund of One, as applicable. In a Facility to a commingled Fund, the Creditor may be more comfortable permitting an Investor to transfer its interest (subject to any necessary prepayment under the Facility) because the Creditor's collateral includes the Capital Commitments of many other Investors. However, for a Fund of One, because the Creditor's underwriting of the Facility is strongly tied to its underwriting of the single Investor, a transfer by that Investor may likely require additional credit approval. Therefore, it is typical that a Facility to a Fund of One prohibits the Investor from transferring its interest in the Fund of One without the prior consent of the Creditor. In addition, even if the Creditor ultimately permits the Investor to transfer its interest (for example, to an affiliate of the Investor), the Creditor may require the original Investor to provide credit support for the new Investor.

For a Facility to a Fund of One, the Creditor may also require some form of credit support or other credit enhancement from the Investor, a parent of the Investor and/or the sponsor of the Fund of One. When the credit support is from a parent of the Investor, it is typically in the form of a comfort letter, guaranty or keepwell agreement. Delivery of one of these documents will often enable a Creditor to include a less creditworthy Investor or special-purpose vehicle in the borrowing base. If the credit support is from the Manager or a sponsor of the Fund of One (or principals of the sponsor) or from the Investor itself, such credit support will often be negotiated and a cap may be placed on the guarantor's obligations with respect to the Facility.

Conclusion

Given the utility of these Facilities for Funds in terms of providing liquidity and facilitating investments, the number of Funds seeking a Facility continues to rise as does the demand for Facilities for a Fund of One. With attention to the nuances in the Governing Agreement and related subscription documentation, loans to Funds of One can be made with closing documentation similar to what is required in a Facility to a commingled Fund together with an Investor Letter, Investor Opinion and perhaps a comfort letter or other form of credit support or credit enhancement. Please contact the authors with questions regarding these transactions and the various methods for establishing a Facility in connection with a Fund of One.

Endnotes

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[2] For more background on these terms and related terms used in this article, see "Beginner's Glossary to Fund Finance" in the *Fund Finance Market Review*, Spring 2016.

[3] See "Separate Accounts vs. Commingled Funds: Similarities and Differences in the Context of Credit Facilities" in the *Fund Finance Market Review*, Summer 2013.

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