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Financing funds of one: A borrower's field guide

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Introduction

Subscription facilities for funds of one are trending, as fund sponsors, and investors alike, realise the operational efficiencies and competitive advantages they can provide. In addition, as the subscription facility market evolves, a larger number of lenders are willing and able to meet the demand. Historically, lenders have not shown much enthusiasm for funds of one, given their concentrated risk and lack of overcall rights compared to larger, more diversified funds. More recently, however, lenders are increasingly amenable to these types of products as a means to expand their Rolodex and broaden ties to existing clients. Still, even seasoned fund sponsors might be wary of what to expect when arranging financing for a fund of one. This chapter aims to demystify that process.

As a threshold matter, in order for a fund sponsor to successfully finance a fund of one, it is imperative that the fund has the support of its investor. From the lender's perspective, it is effectively underwriting a single investor's capital commitment, and is relying entirely on the creditworthiness of such investor and the strength of its obligation to fund capital contributions pursuant to the terms of the fund's constituent documents. A lender will often require some level of involvement from the investor, whether in the form of an investor consent letter or delivery of KYC information. Therefore, cooperation from the investor is key to securing a facility on the best possible terms.

Diligence and KYC process

The financing process inevitably requires the sharing of fund documentation and potentially sensitive investor information with the lender. At a minimum, the fund will be required to deliver the following as part of the lender's diligence and KYC process: (i) the certificate of limited partnership or other certificate of organisation of the fund, its general partner (or similar managing fiduciary) and any other relevant credit parties; (ii) the limited partnership agreement or other governing agreement of such parties; (iii) the investor's subscription agreement; and (iv) the investor's side letter, if any.

None of the foregoing requirements is unique to a fund of one, but they will be subject to closer scrutiny than they would otherwise be in a commingled fund. The fund's limited partnership agreement and the investor's subscription agreement provide the foundation for the facility, as they constitute the source of the lender's collateral. Recall that the collateral security for any subscription facility is comprised of the investor's uncalled capital commitment, the right of the fund and/or its general partner to call capital from the investor, and the fund's right to receive capital contributions.

A separate chapter could be dedicated to lenders' review of fund documents but, in short, the lender will want comfort that the fund documents permit: (i) the performance by the fund of its obligations under the facility; and (ii) the pledge by the fund and its general partner of the collateral thereunder. Further, the lender will diligence the fund documents to confirm that none of the provisions therein compromise the lender's foreclosure rights. However, it should be noted that any shortcomings in the fund documents may be addressed in an investor consent letter.

At this stage in the process, confidentiality is likely to be of utmost concern to the investor. Fund sponsors should be mindful of any confidentiality restrictions contained in the investor's subscription agreement or side letter, as they may need to obtain the investor's waiver or consent prior to sharing such information and documentation with the lender. While a redacted subscription agreement or side letter may be acceptable to a lender under certain circumstances when financing a diversified fund, a lender to a fund of one will expect such documents to be delivered without redaction.

At a minimum, the lender will need to ascertain the identity of the investor, the amount of its capital commitment and the investor's contact information. In addition, if the investor has no credit rating or its financial information is not publicly available, the lender may require additional information in order to obtain credit approval. In such case, the fund sponsor should confirm whether the investor is willing to provide financials, which will ultimately be shared with the lender (both at the initial closing of the facility and on an annual basis thereafter). If the direct investor in the fund is a special purpose vehicle or a shell entity, or if the lender is otherwise unable to obtain financial information sufficient to determine the investor's creditworthiness, it is likely that the lender will request information regarding the investor's parent or beneficial owner(s).

Comfort letters

If a lender is ultimately relying on the creditworthiness of an investor's parent, such entity may be required to execute a comfort letter. The content of the comfort letter may vary, but usually it is a short form document whereby the signatory: (i) confirms that it has an equity interest in the investor; (ii) acknowledges that the investor has subscribed to the fund; and (iii) agrees that it will cause the investor to meet its payment obligations under the fund's governing agreement and the investor's subscription agreement as and when they become due. This final clause may take various forms depending on the relationship of the parent to the investor and the lender's requirements. For example, the investor's parent may agree that it will cause the investor to have sufficient liquid assets, that it will keep the investor adequately capitalised or, simply, that it will influence the investor to the best of its ability. This document is executed by the investor's parent and delivered to the lender, but the lender need not be a party.

To clarify, a comfort letter is not a guarantee of the investor's obligations under the fund documents (which a fund sponsor may wish to avoid from an investor relations perspective, and which should not be necessary). Rather, such a letter should be sufficient to establish a credit linkage between the investor and its parent and bolster the lender's confidence in the investor's ability to fulfil its capital commitment.

Investor consent letters

While investor consent letters might be considered a relic of the past, they are often a prerequisite to financing a fund of one. In such cases, the investor executes a consent letter directly in favour of the lender, thereby establishing privity between the lender and the investor. The consent letter will contain a number of reps and warranties and acknowledgments, but perhaps most importantly from the lender's perspective, the investor acknowledges its obligation to fund capital contributions pursuant to capital calls duly made in accordance with the fund documents, without counterclaim, offset or defence of any kind, including Section 365 of the U.S. Bankruptcy Code.

This provision is often met with resistance by investors for several reasons. Investors are often (understandably) hesitant to waive any counterclaim, offset or defence they may have; however, it is helpful to clarify that such waiver only applies in the event that the lender makes a capital call and, in such event, the investor retains any counterclaim, offset or defence that it may have *vis-à-vis* the fund and the fund's general partner. In any case, the capital call by the lender must be duly made in accordance with the fund's constituent documents and the investor's subscription agreement and side letter. In no event should such a letter compel the investor to fund capital contributions in excess of its unfunded capital commitment or to repay indebtedness incurred for a purpose for which the investor would otherwise not be obligated to fund. Further, the letter will provide that any capital contributions made by the investor in response to a capital call must be deposited into an account of the fund that has been pledged to such lender; under no circumstances should the letter require capital contributions to be made directly to a lender.

It is important to remember that the lender's authority ultimately stems from that of the general partner. As a result, the lender cannot exercise any rights that the general partner would not otherwise be permitted to exercise. In addition, there is often a misperception that the investor's execution of the letter will cause it to be personally liable for the fund's indebtedness. Although the investor has entered into a contractual undertaking with the lender, the investor's obligations are limited to those set forth under the fund's constituent documents – namely, to fund capital contributions with respect to its unfunded capital commitments into an account of the fund as and when due. Ultimately, the obligations imposed on the investor by virtue of the consent letter should not be more onerous than those imposed under the fund's limited partnership agreement or the investor's subscription agreement and any side letter.

A lender may also require that the investor make certain representations and warranties in the investor consent letter. For example, the investor consent letter may include representations that: (i) the subscription agreement and the investor consent letter have been duly authorised, executed and delivered by the investor; and (ii) the subscription agreement, the partnership agreement and the investor consent letter constitute valid and binding obligations of the investor that are enforceable against the investor in accordance with their terms.

A lender may also want to ensure that the investor comes into the deal "clean", i.e., that as of the date it executes the investor consent letter, the investor does not have any knowledge of a default under the fund's partnership agreement or subscription agreement, or any claim, right of offset or defence that would adversely impact its obligation to fund. These provisions are not usually controversial. However, negotiations may hit a stumbling block when addressing sovereign immunity.

Sovereign immunity rights, a frequent point of contention between lenders and investors, limit the circumstances under which certain state and governmental actors can be subject to suit. This immunity is particularly problematic if the partnership agreement or side letter contains a provision whereby the investor expressly reserves its rights to sovereign immunity. Consequently, the lender may propose including a waiver of sovereign immunity in the investor consent letter. The investor may be reluctant to waive sovereign immunity as a matter of internal policy, or it may be prohibited from doing so as a matter of law.

Commonly, the lender and the investor agree to a middle-of-the-road approach relying on an exemption for commercial activities. In those cases, the investor does not explicitly waive its sovereign immunity but, instead, acknowledges its contractual liability with respect to its obligations under the partnership agreement and the subscription agreement, and/or that the performance of its obligations thereunder constitutes a commercial act. Otherwise, to the extent an investor reserves its rights with respect to sovereign immunity, and the investor is unwilling to make any acknowledgment with respect to its commercial obligations in its investor consent letter, the lender will have to reevaluate the business risk associated with lending against such investor's commitment.

In some cases, the lender might be willing to proceed on the basis of the investor's track record of funding. In other cases, the lender may agree to move forward, subject to increased fees or pricing or tighter covenants. To the extent the fund sponsor is aware of the investor's sensitivities related to sovereign immunity, the fund should make every effort to address those concerns in advance of negotiating the definitive documentation for the fund's credit facility.

Given the fact that the investor consent letter may be a gating item to closing, it is recommended that the fund sponsor involve the investor early in the financing process, so that any threshold issues can be identified and hopefully resolved. Fund sponsors should anticipate a longer lead time for negotiating and finalising the investor consent letter, which is often dependent on the responsiveness of the investor (and its appetite for the financing). Ideally, the investor consent letter is prepared concurrently with the term sheet for the facility (or even at the time of the investor's subscription to the fund), and socialised with the investor before the commencement of negotiations for the credit facility. As the investor reviews the letter, the fund might consider sharing the term sheet, or a summary of key terms, as a means of providing context and stemming any concerns.

Structuring considerations

Various factors influence the structuring of a facility for a fund of one, including the flexibility afforded under the fund's governing agreement and the expectations of the investor. A fund of one may obtain its own facility on a standalone basis, assuming it has procured a lender. Alternatively, a fund of one may be added to an existing facility as a parallel fund borrower.

There are, of course, several benefits to joining the fund of one to an existing facility: (i) both the existing borrowers and the fund of one enjoy the benefits of a larger borrowing base; (ii) such approach is likely to be more palatable to the lenders, given the additional collateral; (iii) the fund of one may receive better pricing terms than it would otherwise; and (iv) the fund of one (and, in turn, its investor) save on documentation and execution costs related to a separate facility.

Although there may be synergies to adding a fund of one, there are also some caveats to consider when joining a fund of one to another facility. Due consideration should be given to the potential impact on the liability of the funds at issue. Each borrower is ordinarily severally liable for its obligations under a subscription facility, subject to the cross-collateralisation of each of the other members of such borrower's borrowing group. If an event of default occurs under the facility with respect to any particular fund borrower (including the fund of one), each borrower is deemed to be in default and the lender can ultimately exercise remedies against any of the members of such defaulting borrower's borrowing group.

As a threshold matter, the fund sponsor should confirm whether the constituent documents of the fund of one and the other relevant funds permit such funds to cross-collateralise each other's obligations. Assuming cross-collateralisation is permitted under the applicable constituent documents, the fund sponsor should also confirm that adequate disclosure has been made to the investors, and that such cross-collateralisation is in alignment with investors' expectations. If the fund of one cannot cross-collateralise the main fund or vice versa, the fund of one may still be joined to the existing facility. However, the credit agreement would likely have to be amended to provide for two separate borrowing bases. Further, the lender may request an amendment to accommodate the joinder, which may call into question the efficiencies of joining the fund of one to an existing facility in the first place.

Given the structural complexities discussed above, a separate facility may offer the best path forward for a fund of one. That said, not all lenders are willing to lend to funds of one and, as a consequence, the fund will necessarily be working with a smaller universe of lenders. Lender appetite may be reduced if the investor has opt-in or opt-out rights with respect to any investment. These are ultimately relationship-based transactions, so the fund sponsor might reach out to its existing subscription facility lender(s) who are already familiar with the fund structure, management and investment strategy.

If the fund sponsor chooses to move forward with its existing subscription facility lender, the parties can leverage off the existing precedent, thereby reducing documentation costs and streamlining execution. In any event, it is most efficient to base the definitive documentation on the existing loan documents for the related main fund, subject to any changes that are required in light of the fund's organisational documents or as otherwise agreed.

Documentation

When negotiating a standalone credit agreement for a fund of one, the fund sponsor should be mindful of certain sticking points which are unique to funds of one.

- ***Investor transfers***: Customarily, subscription facilities will not impose restrictions on an investor's ability to transfer its interest in the fund; rather, an investor transfer is permitted, subject to: (i) compliance with sanctions; (ii) notice to the administrative agent and delivery of related transfer documentation; and (iii) payment of any mandatory prepayment to the extent the transfer results in a borrowing base deficiency.

  This mechanism is the right result for a commingled fund, as investors should be able to freely transfer their interests in compliance with the fund's organisational documents, without obtaining lender consents. However, for a fund of one, it is not unusual for a subscription facility lender to prohibit any investor transfers without lender consent.

Such a prohibition may be viewed as reasonable in this limited circumstance, given the lender is relying entirely on the investor's capital commitment as its primary source of repayment. Still, any lender consent requirement should be circumscribed such that consent may not be unreasonably withheld, delayed or conditioned. A fund sponsor might also consider pre-clearing transfers to affiliates, subject to delivery of a new or updated investor consent letter, if requested.

- ***Exclusion events***: A fund sponsor should expect exclusion events to be tighter for a fund of one than they may otherwise expect for a commingled fund. For example, if an investor is subject to an involuntary bankruptcy proceeding, ordinarily the investor is not excluded from the borrowing base, unless such proceeding is not dismissed or stayed for a period of 60 days. A lender may not be willing to sit on the sidelines for quite as long when lending to a fund of one and may push for this grace period to be shortened. Similarly, if an investor in a fund of one fails to fund any capital contributions beyond the due date therefor, such failure to fund is subject to closer scrutiny and, consequently, a shorter grace period.

  A lender might also demand a broader exclusion event for any circumstance or event having a material adverse effect on the investor's ability to perform its funding obligations under the fund documents. For a commingled fund, such an exclusion event would ordinarily apply solely to unrated investors, on the basis that a lender could rely on the credit rating of a rated investor (which would be subject to a downgrade upon the occurrence of a material adverse event). Although such an exclusion event affords the lender more discretion, it's not uncommon in the context of a fund of one.

  Also, to the extent an investor consent letter is executed, several of the exclusion events will likely be expanded to include references thereto. For example, the investor will likely be excluded from the borrowing base if it breaches a material provision of its investor consent letter or makes a representation or warranty therein that proves to be materially inaccurate when made.

  Of course, if an exclusion event occurs with respect to the fund's sole investor, the fund will have no borrowing base. In a diversified fund, the occurrence of an exclusion event might give rise to a borrowing base deficiency, and consequently, a mandatory prepayment obligation. In a fund of one, the occurrence of an exclusion event which is not remedied within a short period of time may be fatal to the facility.

- ***Events of default***: With a few limited exceptions, events of default under a subscription facility should not be triggered by the actions of a single investor. However, when negotiating a subscription facility for a fund of one, it is unavoidable that certain events affecting the investor will also impact the facility. For example, if an exclusion event with respect to the sole investor in a fund of one continues uncured for a specified period of time, it may result in an event of default or an early termination of the facility.

  If the fund sponsor is concerned about the implications of a default (for example, a cross-default to another facility or agreement), the fund sponsor may opt for the uncured exclusion event to trigger an early maturity rather than an event of default. Likewise, a lender may push for an event of default if the sole investor fails to fund a capital contribution when due, subject to a grace period. In contrast, a failure to fund by investors in a commingled fund would generally have to be significant to trigger a default under the facility.

Finally, some lenders may insist upon an event of default in the case of a bankruptcy event with respect to the sole investor in a fund of one. As a bankruptcy proceeding involving the investor would already result in an exclusion event, which would, in turn, result in an event of default, fund sponsors should be mindful as to how these two provisions might interact. While it is inevitable that the viability of the facility is dependent on the creditworthiness of the investor, it is important to strike the right balance, and circumscribe the events of default accordingly.

Separately, while some standard terms in a form credit agreement may make sense for a large commingled fund, they may not work when applied to a fund of one. Fund sponsors should carefully review their precedent credit agreement for any updates that should be made in light of the fund's structure and operating agreement. Below are a few examples.

- ***Opt-in and opt-out rights***: As a condition to borrowing, oftentimes the fund must confirm that no investor is entitled to exercise an excuse or exemption right in respect of such borrowing, except as otherwise disclosed to the administrative agent. This can be challenging for funds of one where the investor has opt-in or out-out rights with respect to any investment. For example, a side-car vehicle might be formed alongside a main fund to allow an investor participating in the main fund to effectively increase its commitment with respect to any investment, at such investor's option.

  In such case, as a condition to any borrowing, a lender may require delivery by the fund of evidence that such investor has waived its opt-out right or exercised its opt-in right, or a certification by the fund with respect thereto. Alternatively, to the extent the opt-out right expires by a certain date, the borrower could time the delivery of the borrowing request to follow such date, and be able to make the requisite certification. This latter option requires diligence on the fund's part, but avoids the need for any cooperation on the part of the investor.
- ***Borrowing conditions***: Given the bespoke nature of a credit facility for a fund of one, the lender may propose additional borrowing conditions corresponding to unique features or limitations contained in the fund's operating agreement. This is fine in principle, but such conditions should not be any more onerous than those contained in the fund's operating agreement. In any case, such conditions are arguably unnecessary if there is a covenant that the borrower will only use loan proceeds in accordance with its partnership agreement.
- ***Ratings requirement****:* Fund sponsors should pay special attention to any ratings requirement, with the understanding that there will be no borrowing base to support the facility if the investor fails to meet such requirement. If the investor is unrated, the lender may instead look to the rating of the parent or credit support provider.
- ***Investor reporting***: Pursuant to the terms of the credit facility, a fund may be obligated to share with lenders any notices, reports, documents or other communications delivered to its investors generally. In the case of a fund of one, it is important that this covenant be limited to material documents and communications, and/or expressly exclude any such documents or communications that would not be shared with substantially all investors in a traditional commingled fund.

As the credit documentation for a fund of one is largely driven by the structure of the fund and its organisational documents, there is no one-size-fits-all approach. These facilities are bespoke by nature and require cooperation among all interested parties to achieve a successful outcome.

Conclusion

While the investor may not be a party to the facility, its influence is felt throughout the financing process. Collaboration among the fund's credit counsel and fund formation counsel is therefore key to managing the investor relationship and ensuring smooth negotiations. At the very least, the investor consent letter (or comfort letter) will require the investor's buy-in, which might be challenging. The fund sponsor and legal counsel should carefully steer investor communications and manage lender expectations accordingly.

The terms of the credit agreement are also directly impacted by the creditworthiness of the investor and the terms of its capital commitment. As the fund's partnership agreement is ultimately the governing document of the lender's collateral, it is recommended that credit counsel coordinate with fund formation counsel to tailor the credit documentation accordingly. Given the complex mechanics described above, it is paramount that fund sponsors engage experienced legal counsel to traverse the financing process and circumnavigate any issues before they arise.

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