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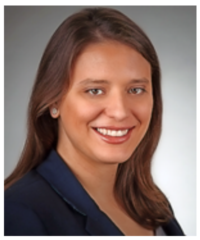
The Bespoke Solution—Advantages and Challenges in Tailoring Single Investor Funds



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The world of private investment funds has been evolving to address the specific goals and expectations of investors, including pension plan sponsors and other investors with specific regulatory and economic needs. As a result, the industry has been moving away from traditional private equity or hedge funds to more complex and tailored funds and other investment products. One structure we have recently seen gain in popularity is the single investor fund (''SIF''). A SIF, also called a ''fund of one,'' is a fund vehicle created at the request of and designed specifically for a single investor or small group of affiliated investors. SIFs allow for several advantages over traditional commingled funds, including:

- Flexibility to negotiate key business and legal terms.
- Tax advantages.

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- Ability to adapt to an investor's specific investment horizon.
- Potential for improved relationships between investors and investment managers.
- Opportunity to receive more customized account reporting.
- Ease of transferability.

This article will discuss each of these advantages, as well as some of the challenges investors may encounter when negotiating a SIF as an investor.

Flexible Negotiation

The single biggest advantage of investing through a SIF is the ability to structure and negotiate economic and legal terms directly with an investment manager. One of the main challenges to traditional commingled investment funds is that, unless they are a seed investor or represent a disproportionately large investment in the fund, an investor has a limited ability to negotiate a fund's economics and other terms, and may be unable to secure terms that are the most advantageous for the investor's particular circumstances.

Generally, a commingled fund will be structured to try to accommodate the differing, and sometimes contradictory tax, regulatory and economic needs of a large number of different types of investors. For example, a commingled fund may:

- make investments that do not fully align with an investor's investment guidelines or that do not appropriately consider an investor's environmental, social, governance or other investment policies;
- have an investment period or fund term that is shorter or longer than an investor desires;
- provide for more generous indemnification terms than an investor desires; or
- result in less favorable tax treatment for an investor than a fund with a different structure or different investment strategy.

These concerns, and others like them, cannot always be adequately addressed through side letters or traditional commingled fund structuring approaches. However, if a SIF is structured and operated specifically for

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a particular investor, its terms can be tailored to that investor's unique needs and preferences.

Because of the ability to customize investment strategies and limitations at inception and to seek consent from only one investor, the mandate of a SIF may be larger or smaller in scope, and a SIF may be able to pivot investment strategies quickly. This can increase the profitability of the fund and reduce costs in ways traditional commingled funds cannot emulate.

In addition, because of the size of the mandate, SIFs often incorporate a lower management fee and performance-based fee than their commingled counterparts. These reduced fees often come in the form of step downs for commitments of certain amounts and may be calculated using contributed, rather than committed, capital.

Tax Advantages

Although many commingled funds attempt to address various tax issues in different ways, the solutions are often difficult to implement because of the different interests of investors with respect to the tax consequences from a particular investment. The fund may even lose potential investors if they want to avoid tax issues that they believe will place them in direct conflict with other co-investors.

For example, some funds will want to make an investment in a limited liability company (LLC) that includes an operating business. If the LLC is treated as tax transparent, tax-exempt and non-U.S. investors could realize Unrelated Business Taxable Income (UBTI) or Effectively Connected Income (ECI). As a result, the fund may attempt to structure the investment in such a way as to avoid UBTI and ECI.

While these attempts would alleviate the tax concerns of tax-exempt and non-U.S. investors, many of the traditional structuring approaches could create additional tax burdens on U.S. taxable investors, who are not concerned with generating UBTI or ECI, or could create a more complex fund structure, which could increase expenses incurred by all investors.

Investors in a commingled fund can also have conflicting objectives with respect to certain state and local tax issues. Certain taxes may apply to some investors and not others, and exemptions may be available for some and not others.

Further, the exemption could be lost depending on the structuring of the fund and how the fund's investments are structured. For example, a tax-exempt investor may be exempt from New York City's Unincorporated Business Tax, but may be subject to such tax as an investor in a commingled fund depending on the circumstances.

Structuring an investment mandate as a SIF allows an investment manager to fully address the tax concerns of a particular investor without the need to consider a structure's effects on other investors.

Investment Horizon Adaptation

Another considerable advantage of a SIF is the ability to more closely align the SIF's investment period and term to an investor's own investment horizon. In a commingled fund, investors are limited to generally inflexible investment timelines set out prior to closing. SIFs, on the other hand can continue for as long or as short a time period as the investor and manager desire.

A SIF can have a set lifetime or be an ''evergreen'' fund that lacks a definitive end and allows for the continual recycling of capital. In such instances, the term of a fund is generally tied to triggers, often based on length of time or performance, upon which a party can suspend or terminate the investment period or the SIF itself. This can allow an investor to focus on monitoring and reinvesting returns, rather than on continuously sourcing managers and deploying repaid capital.

Avoidance of Clawback Issues in Evergreen Funds

When structuring an evergreen SIF, the mechanics of the investment period and the term of the fund are some of the most important aspects of negotiation, especially as they relate to the fund's economics and its distribution waterfall. A ''distribution waterfall'' is the way in which a fund distributes returns to investors and the mechanism through which a manager receives any performance-based allocation. While commingled funds and non-evergreen SIFs generally include distribution waterfalls that tend to follow one of a few standard models, waterfalls in evergreen SIFs tend to be much more complicated.

In a typical commingled fund structure, carried interest is either taken on a deal-by-deal basis or on a total return of capital basis. ''Carried interest'' refers to the share of a fund's profits that is allocated to the manager of a fund as a performance-based fee. In either circumstance, carried interest is paid at regular intervals, before a fund's investment portfolio is fully realized and before the final return of a fund is calculated. This could lead to a fund having overpaid carried interest once the fund's final returns are known. As a result, fund documents generally contain ''clawback'' provisions whereby the carried interest recipient agrees to return any overpayment of carried interest at the end of the life of the fund (subject to certain limitations).

Because an evergreen SIF is continuously recycling capital through an indefinite term, the calculations of carried interest and the clawback obligations become more difficult to determine. Managers generally want to receive carried interest on a regular basis, but an investor is unlikely to be willing to wait an indefinite period of time to recoup an overpayment.

To mitigate this concern, SIFs can be structured as multiple ''pools'' or ''classes'' of assets that operate as a type of fund within a fund. Carried interest and clawback obligations would then be calculated on a pool-by-pool basis. The downside to this structure is that whether the clawback is calculated only within each pool or across all pools, each pool becomes both more important and contested.

For example, if a fund has multiple pools, some of which performed well and some of which performed poorly, a situation may arise where the fund has overpaid carried interest over the life of the fund, but the manager is not required to return any amounts to the investor. Even with this difficulty, most managers and investors are able to come to an agreement regarding economics because of the otherwise favorable economics and other benefits that a SIF offers.

Investor-Manager Relationship

When it comes to negotiating the SIF's terms, neither party has the burden of worrying whether negotiated terms fit neatly within the commingled fund structure or whether other investors will be affected (whether positively or negatively) by those terms. In addition, it benefits both parties to build those customized terms directly into fund documents.

Undoubtedly, one of the most expensive and time-consuming aspects of forming a commingled fund is the negotiation and drafting of side letters—agreements that contain terms that amend and supplement partnership agreements and subscription documents and that may be as long as thirty or forty pages—depending on the investor and the mandate.

Reading side letters in conjunction with commingled fund documents can be challenging at best and can result in unintended consequences or noncompliance at worst, leading to strained relations between manager and investor. Certain (usually non-economic) terms may be easier to negotiate when there is only one other party involved.

Building all of the terms that would otherwise be included in a side letter directly into the partnership agreement may seem difficult at first, but working through each party's potential concerns at the outset of the relationship can improve communication and compliance over the years, and can allow an investor access to and attention from an investment manager that it may not otherwise receive if it were merely one investor among many in a large commingled fund. As a result, the relationship built between the investor and the manager during the negotiation process can be stronger in the long run.

Strategic Customized Reporting and Reduced Costs

A natural extension of the ability to negotiate customized terms is the capacity of the manager to accommodate specific reporting requests from an investor in a SIF. Investors have always sought particular information from their investment managers for a variety of reasons, whether statutory or regulatory or to calculate returns and ratios with proprietary formulas and software.

Although most commingled fund managers do their best to comply with reporting requests, an investor may request information that the manager does not generally supply or information that is not readily available or that may be costly to determine or retrieve. Depending on the type of information requested, a manager may be compelled by fiduciary duty concerns to make this information available to all investors, which could increase the costs associated with preparing and distributing investor reports.

Managers are not likely to bear the expense of this additional reporting, and requiring a fund's other investors (who have not requested the additional information) to bear a portion of the cost raises fairness concerns. On the other hand, reporting by a SIF is necessarily customized for a particular investor, and the single-investor nature of the SIF eliminates any fairness concerns.

Although the requested information may still be more difficult to provide than its standard reporting information, managers (together with their back office providers) are generally more willing to expend the time and effort required to satisfy a SIF investor that is bearing the cost of retrieving the information.

In addition to customized written reports, a larger number of investors have begun requesting that managers hold update meetings, which can occur as often as monthly but are generally held at least quarterly, during which the manager updates the investor on the portfolio and the investor has the opportunity to ask questions about the mandate. Given the sheer number of investors in a commingled fund, such meetings can become unwieldy, and managers may instead hold annual meetings for the fund or, more often, for all of the manager's funds. This results in very little, if any, quality time with each investor.

Investors have attempted to obtain assurances from fund managers that the manager will meet with the investor regularly, with varying degrees of success. However, even if a commingled fund manager agrees to individual meetings in principle, such assurances often do not make their way into governing documents or side letters and are therefore difficult to legally enforce.

In contrast, a fund manager may be more willing to commit in writing to regular meetings with a SIF investor. Such meetings provide the investor with greater access to the manager and greater transparency with respect to the SIF's investment holdings and returns than the investor might otherwise receive in a commingled fund.

Ease of Transferability

Investors in a SIF should also consider what rights to transfer its interest it wishes to negotiate. In some situations, transferability can be easier in a SIF than in a commingled fund and can require less negotiation. In particular, determining the investor's pro-rata interest and any past and ongoing obligations is simpler in a SIF than extricating one investor from a commingled fund, where several interests are involved and only one is transferred.

It is important to note, however, that addressing transferability can be challenging because of the single investor relationship with the manager. The SIF is truly a custom-made vehicle that has been particularly adapted to one investor. Because of the importance of the relationship between the investor and the manager, the manager may be hesitant to consent to the transfer of an interest in a SIF (absent statutory or regulatory issues or affiliate transfers) to a third-party with which the manager has no relationship. However, if an investor in a SIF negotiates terms up front that allow it to exit a SIF (for example, suspension or termination rights), transferability generally becomes less important.

Challenges to SIF Formation

It is worth noting that SIFs can create some challenges for investors. A SIF is considerably more expensive to negotiate and structure than an investment in a commingled fund. It can also take a much longer period of time to negotiate a SIF investment than to review and negotiate an investment in a commingled fund. However, many of these costs are usually offset by the lower operational costs, lower fees and increased flexibility that an investor may experience in a tailored vehicle.

A SIF investor investing in a limited partnership should also take care to avoid actions that could be interpreted as actively participating in the substantive investment decisions and general management of the SIF, as this could jeopardize the investor's limited liability status under applicable law. Although this risk is present for commingled fund investors who participate on investor advisory committees, the risk is greater for SIFs, where one investor can potentially exercise a large degree of control over the fund's investment strategy and operations.

It is therefore important to ensure that the usual roles of passive investor and active manager are maintained and that the interaction between the investor and the manager, though enhanced, is thoughtful and limited in scope.

A final challenge when establishing a SIF relates to so-called ''most favored nation'' clauses (''MFNs''). An MFN is a provision in a side letter agreement or governing document whereby the investor is given the benefit of more favorable terms offered to other comparable investors.

Typically, this benefit is restricted to investors within the same commingled fund or to investors in funds and managed accounts with a similar investment strategy. Because of the high degree of customization of both fund terms and investment strategies and restrictions, a manager may resist granting MFN rights to a SIF investor or argue that no other commingled fund or managed account is sufficiently similar to a SIF to warrant an MFN right.

Conclusion

SIFs have become increasingly attractive to investors that are ever more focused on fees and transparency and seek to invest in products that are more closely aligned with their long term goals. With all the advantages that accompany a SIF, it can be an attractive option for investors willing to commit the time, energy, and resources to structure a SIF that works for both manager and investor.

Certainly, a SIF is not right for every investor, and, as with any investment, the advantages should be weighed against the costs. But, more and more, investors are willing and able to undertake the more complex negotiation and structuring process to reap the rewards that a SIF offers.

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