Hedge Fund Law Report
An Acuris company

Lowenstein Sandler

December 12, 2019

FUND STRUCTURES

What Legal, Regulatory and Operational Challenges Do Single-Asset Funds Present for Managers?

By Eileen Overbaugh, Lowenstein Sandler

Single-asset funds pool capital from multiple investors to invest in a single security, transaction or acquisition. As managers continue to explore offerings beyond traditional strategies and fund structures, they frequently pursue opportunities through vehicles designed to acquire a single asset.

Distinguished from funds that invest in many assets and transactions, single-asset funds involve unique legal, regulatory and operational challenges. This article examines these challenges, including in the context of structure; fees and expenses; term and liquidity; and follow-on investments and restructurings.

See "Operational and Tax Challenges of Hybrid Funds" (May 23, 2019); and "Hedge Fund Managers Turn to Hybrid Fund Structures to Reconcile Fund Liquidity Terms and the Duration of Assets" (Feb. 4, 2009).

Use of Single-Asset Funds

Managers employ single-asset funds for a variety of reasons. First, the manager's existing funds and accounts may already have received full allocations of the asset pursuant to the manager's investment allocation policy and the governing documents of those existing funds and accounts. While those funds and accounts cannot or should not have further concentration in the target asset, the manager nevertheless may believe that the asset is a strong bet. A traditional hedge fund manager, for instance, may seek to accumulate a larger position in a publicly traded company through a single-asset fund, offering existing or new investors the opportunity to increase their exposure to the position through the manager's single-asset fund. In the private equity (PE) context, an investment may not be feasible if the manager cannot find other investors to "fill the book" and provide the full amount of financing or the purchase price sought by the target or seller. In a PE structure, a single-asset fund typically is structured as a co-investment vehicle.[1]

See our three-part series on co-investments in the hedge fund context: "Pursuing Illiquid Opportunities While Avoiding Style Drift" (Feb. 21, 2014); "Structuring Considerations and Material Terms" (Feb. 28, 2014); and "Fiduciary Duty Concerns, Conflicts and Regulatory Risks" (Mar. 7, 2014).

Second, the manager may target an asset that is not appropriate for, or within the investment mandate of, its existing funds and accounts. For managers that operate traditional hedge fund strategies, for example, the single-asset fund may be the first foray into PE or venture capital investments.

Finally, a number of managers proactively have built investment strategies based on single-deal investments. Certain of these managers – often newer managers – are building track records and brand names that can be used to launch commingled, multi-asset funds in the future. Others find that single-asset funds, despite the time and effort involved in continuously fundraising when investment opportunities arise, allow them to focus on their true strengths and talents – sourcing, diligencing, negotiating and adding value to portfolio investments.

Structure

Single-asset funds typically are structured as Delaware limited partnerships or Delaware limited liability companies (LLCs). Where feasible based on the fee structure and jurisdiction of the target asset, a Delaware LLC is often the preferred vehicle because it reduces formation and ongoing entity filing costs; there is no need to incur the costs of creating and maintaining a separate general partner entity.

Because of the limited scope and purpose of the vehicle, managers rarely form feeder funds or blocker entities. If the target investment may give rise to effectively connected income or unrelated business taxable income for non-U.S. investors and U.S. tax-exempt investors, respectively, those investors may elect to form their own blocker vehicles to invest in the single-asset fund.

See "The Effect of 2017 Tax Developments on Advisers to Private Funds: New Partnership Audit Rules, Tax Reform, Blockers, Discounted Gifting, Fee Waivers and State Nexus Issues" (Nov. 30, 2017); and "How Managers Can Structure Direct Lending Funds to Minimize U.S. Tax Consequences to Foreign and U.S. Tax-Exempt Investors: 'Season and Sell' and Blocker Structures (Part One of Two)" (May 18, 2017).

Fees

In a traditional multi-asset fund structure, regardless of strategy, managers and their affiliated entities are entitled to both a management fee and performance compensation. In contrast, there is no market standard for manager compensation with respect to single-asset funds. The type, structure and amount of fees is varied and may be subject to significant investor negotiation; investors are investing in a bespoke product and frequently demand a bespoke fee structure.

Management Fees

Whether a manager charges management fees with respect to a single-asset fund often depends on the genesis of the single-asset fund. Where the fund is established to access excess capacity in a position, managers often do not charge a management fee or instead charge a reduced management fee that is lower than the management fee charged to the other funds and accounts that have taken their full allocation of the asset. If a manager charges different fees among its various funds and accounts, the manager should confirm that the offering documents for the existing funds and accounts sufficiently disclose this potential conflict of interest. Further, when making decisions with respect to the various funds and accounts, managers must carefully consider and evaluate decisions that may benefit or burden one fund or account as compared to the others. Managers should not favor (or create the impression of favoring) fee-paying clients over non-fee-paying clients.

See "Eight Bad Excuses Fund Managers Have Raised Trying to Avoid SEC Sanctions for Fee and Expense Allocation Violations and Undisclosed Conflicts of Interest" (Oct. 13, 2016).

Where a single-asset fund is established for reasons other than accommodating excess capacity, the manager almost always charges a management fee.

Performance Compensation

In every instance, regardless of the genesis of the single-asset fund, the manager or its affiliates are entitled to performance compensation. The performance compensation often is paid only upon the monetization of the underlying asset. As a result, managers typically earn performance compensation only with respect to realized gains; even traditional hedge fund managers likely will not take performance compensation on unrealized gains with respect to the underlying asset.

Fund Expenses

Ordinary-Course Expenses

Perhaps the most unique challenge with respect to single-asset funds relates to fund expenses. In a multi-asset fund, depending on strategy and structure, there are a number of resources available to pay fund expenses:

- uncalled capital commitments;
- new subscriptions;
- dividend payments;
- operating income; or
- disposition proceeds.

With respect to a single-asset fund, however, the available sources are limited. Additional, and often more tailored and thoughtful, accommodations must be made to provide cash for fund expenses.

The manager may elect to upsize the fund size based on the anticipated life of the fund and estimated fund expenses. As a result, the manager will raise an aggregate amount in excess of the actual purchase price of the asset. The risk, of course, is that fund expenses exceed the estimate, especially where the fund's life is extended beyond the expected period as a result of, among other things, poor market conditions or illiquidity of the asset. In distressed circumstances, additional expenses may be well warranted and well spent in pursuing bankruptcy rights against the portfolio company or seeking corporate reorganization with the assistance of restructuring experts. Further, because the estimates rarely take into consideration extraordinary expenses like litigation or indemnification obligations, the manager and its employees may face significant exposure – especially where the underlying asset is illiquid and cannot be readily sold to generate cash to pay for those expenses.

Once an estimate for expenses is determined, managers must then determine whether to require the contribution of all cash required to pay fund expenses upfront at the time of closing or to include a drawdown mechanism, whereby the fund can require investors to contribute capital to pay for fund expenses on a quarterly or annual basis. The contribution of all capital at closing provides the manager with comfort that there will be no defaults and avoids the administrative burden of capital calls. The dormant cash may, however, be a drag on the single-asset fund's internal rate of return (and neither the investor nor the manager receives the benefit of putting that cash to its highest and best use).

See "How Private Fund Managers Can Avoid Common Pitfalls When Calculating and Advertising Internal Rates of Return" (Sep. 7, 2017).

Alternatively, the manager may require investors to contribute additional capital on a quarterly or annual basis to satisfy the amount of expenses actually incurred. As noted above, there is risk to the fund of failure or delay by investors to make capital contributions. Further, investors naturally fear an unlimited obligation and often seek caps on the aggregate amounts to be contributed. As with other expense caps, managers have had mixed success with excluding extraordinary expenses like litigation and indemnity obligations from the cap.

See our two-part series "How Can Hedge Fund Managers Structure, Negotiate and Implement Expense Caps to Amplify Capital Raising Efforts?": Part One (Jun. 20, 2013); and Part Two (Jun. 27, 2013).

Broken-Deal Expenses

The use of single-asset funds increases the risk that a manager will be required to bear the costs of broken or unconsummated deals. In a multi-asset, commingled fund, investors have previously committed or contributed capital, which can be used to pay fund expenses for researching and diligencing potential investments, even if the manager ultimately elects not to invest.

In a single-asset fund, however, investors typically are not legally bound to commit or contribute capital until the investment is nearly final. As a result, if a manager abandons investment in a publicly traded security because the pricing has materially changed or abandons investment in a private transaction because of material concerns discovered in the final phases of due diligence, the manager will have no alternative but to pay the legal, accounting, research and other costs incurred in connection with sourcing and investigating that potential transaction; there is no other source of capital to fund those amounts.

Term and Liquidity

The term of a single-asset fund will vary depending on the nature of the underlying asset and the manager's investment objective and strategy regarding that asset. With respect to liquid assets, such as publicly traded securities, the manager generally has a specified timeframe in which it believes the stock price will be optimized. During that period, investors typically may not withdraw from the single-asset fund. After that period, if the asset has not already been fully disposed and the proceeds distributed, investors may have monthly or quarterly liquidity rights.

While granting those liquidity rights may satisfy investor demand for an exit option, it may be very difficult to implement those liquidity rights in practice; if the manager has not already monetized the underlying asset within the term of the original mandate, there must be a good reason – whether market conditions, financial distress of the target or otherwise. Satisfying those redemption requests also gives rise to significant conflicts of interest among investors in the single-asset fund. The appropriate course of action that generates available cash to satisfy pending redemption requests may not be the best alternative for those investors willing to remain invested in the single-asset fund and its underlying asset for the longer term.

With respect to illiquid assets, the manager generally is given a broader mandate to invest until a liquidity event, such as an initial public offering or a sale of the company. In that case, the investors typically do not have any liquidity rights, and the single-asset fund does not have a fixed term.

See "How Can Liquid Hedge Funds Be Structured to Accommodate Investments in Illiquid Assets" (Feb. 3, 2011).

Follow-On Investments; Restructuring

In a variety of circumstances, it may be necessary or appropriate for a single-asset fund to invest additional amounts in the target asset. For instance, the underlying portfolio company may be engaged in additional fundraising that would dilute the single-asset fund's position, or the portfolio company may be in a distressed situation and need additional capital – debt or equity – to remain financially viable.

Because a single-asset fund has a limited amount of cash available (*i.e.*, only the amount necessary to purchase the original investment, plus reserves for expenses), there must be a mechanism by which the manager can either raise additional capital to make the follow-on investment or offer the follow-on investment to its other funds and accounts or third parties.

The starting point for this analysis is, of course, the governing documents of the single-asset fund itself. With respect to investments in illiquid assets, the manager may agree – or investors may negotiate – from the outset that the single-asset fund's pro rata share of any follow-on investment will be offered to existing investors in the single-asset fund before it may be offered to the manager's other funds and accounts or to third parties. In that case, when the follow-on opportunity arises, the manager must offer the investors a preemptive right to participate. When negotiating and finalizing the terms of any single-asset fund, managers must carefully review and, where appropriate, update their existing investment allocation policies.

See "Best Practices for Hedge Fund Managers to Mitigate the Conflicts Arising From Managed Accounts: Dealing With Trade and Expense Allocations (Part Three of Three)" (Aug. 1, 2019); and "Investment Allocation Conflicts Arising Out of Simultaneous Management of Hedge Funds and Alternative Mutual Funds Following the Same Strategy (Part One of Three)" (Apr. 2, 2015).

With respect to investments in liquid assets, such as publicly traded securities, the single-asset fund's controlling documents often do not contemplate traditional follow-on investments.

With respect to restructurings and reorganizations beyond the scope of ordinary-course capital raising, managers and their lawyers should ensure that the governing documents of any single-asset fund provide the manager with sufficient authority and discretion to restructure the terms of any investment. Specifically, the investment mandate of any single-asset fund should be sufficiently broad so that it permits the manager to modify the type or class of security held by the single-asset fund or the terms (including economic rights) applicable to those securities, in each case, where the manager, acting as a fiduciary, believes that those changes are in the best interests of the single-asset fund and its investors.

Eileen Overbaugh is a partner in the investment management group at Lowenstein Sandler. She advises hedge funds, PE funds and other pooled investment vehicles in connection with structuring, formation and ongoing operations. Offering the benefit of extensive experience, Overbaugh negotiates seed and strategic investments, as well as joint ventures, managed account arrangements and other alternative investment relationships. Her practice is focused particularly on the business arrangements between principals of hedge funds and PE funds, including governance of the investment manager and general partners of those funds.

---

[1] While there is significant overlap between single-asset funds generally and traditional co-investment vehicles specifically, this article focuses on single-asset funds arising in a variety of contexts and not solely on PE co-investments.