The Challenges of Managing a Customized Fund Structure: What Fund Managers Should Know about Single-Asset and Single-Investor Funds

A Practical Guidance® Practice Note by
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This practice note discusses the advantages and challenges of pursuing a single-asset or single-investor fund structure and offers tips to fund managers looking to pursue these arrangements with investors. 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 may elect to pursue opportunities through vehicles designed to acquire a single asset.

Single-investor funds, often called funds-of-one, deploy capital on behalf of a sole investor (or group of affiliated investors). Single-investor funds often invest in multiple securities, transactions, and acquisitions. Like single-asset funds, single-investor funds have increased in popularity as investors are seeking customized structures, in turn requiring managers to become adaptable to these bespoke vehicles.

Distinguished from funds that invest in many assets and transactions, or cater to many investors, single-asset funds and single-investor funds involve unique legal, regulatory, and operational challenges, including structure, fees and expenses, term and liquidity, and follow-on investments and restructurings.

Sometimes single-asset or single-investor funds operate alongside, or may even co-invest with, larger commingled funds. For context on these situations and related issues, see Co-investments Guide: Issues to Spot and Raise When Making a Private Equity Direct Co-investment, Side Car Funds: Solutions for Sourcing Capital, and Single Asset Fund Recapitalizations: Key Considerations for Sponsors and Investors.

Why Use Customized Funds?

Managers, as well as investors, find single-asset and single-investor funds appealing for a variety of reasons.

Single-Asset Funds

Managers may form a single-asset fund as a co-investment vehicle to invest in excess capacity with respect to securities also being purchased by the manager's other funds and accounts, including its flagship funds. In essence, the manager has access to additional deal flow, its other funds and accounts have received their full allocation of the opportunity (based on the manager's investment allocation policy, and generally taking into consideration investment strategies, investment guidelines, risk parameters, and concentration limits). The manager may elect to offer the excess capacity directly to co-investors, who then invest in their own names in the opportunity, or the manager instead may elect to form a new vehicle, pool capital from the co-investors, control the investment, and charge fees with respect to the new vehicle.

In addition, managers—often newer managers—may form a single-asset fund to build a track record and brand name that can be used to launch commingled, multi-asset funds in the future.

Other managers proactively have built investment strategies based on single-deal investments. These managers 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.

Single-Investor Funds

The single-investor fund structure often is investor, rather than manager, driven. Single-investor funds often are requested, or even required, by investors seeking a bespoke structure. From a manager's perspective, it typically is preferred to have all investors in comingled funds, reducing economic, administrative, and operational burden. However, if an investor is particularly influential, its investment size is sufficiently large and/or its portfolio or structuring needs are amply unique, a manager may be receptive to a fund-of-one. A manager's determination to move forward with a fund-of-one often comes down to the investor and its relationship with the manager. Managers amendable to a single-investor structure generally are well-acquainted with the underlying investor and are prepared to work closely with that investor, much more closely than in a traditional multi-investor structure.

Investors may seek a fund-of-one structure because they desire a bespoke investment objective or strategy or because they desire more transparency or control than would be available to them in a comingled fund. For instance, if an investor wants to employ the manager's primary investment strategy, but has significant investment restrictions imposed by its own investment guidelines, its trustees or other stakeholders, or its regulatory or tax considerations, a single-investor fund may be the most practical way to tailor the investment strategy to the investor's needs.

Single-investor funds also allow customization for other terms and conditions that otherwise would be predetermined in a flagship fund. For investors and managers, this flexibility to negotiate key business and legal terms may pave the way for a more successful relationship. However, this also can present intrinsic risks for the manager; an investor in a fund-of-one will have a certain set of expectations with how the fund should run, and unlike other fund structures, where terms may be later negotiated into a side letter, the investor likely will aim to exercise as much control over the terms and strategy of the fund from the start.

Legal Structure and Domicile

Single-Asset Funds

Single-asset funds typically are structured as Delaware limited partnerships or Delaware limited liability companies. Where feasible based on the fee structure, jurisdiction of the target asset, and the expectation of investors, a Delaware limited liability company may be 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. If a Delaware limited partnership is employed, especially in the context of co-investment vehicles where the manager is likely to form multiple of these entities, sometimes several times per year, managers may consider using a single general partner entity. So long as the carried interest earned by that general partner is withdrawn from the general partner entity as soon as it is receive from the underlying fund.

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.

Single-Investor Funds

As a creature of negotiation and customization, single-investor funds may be formed in any number of jurisdictions, may be any variety of legal entity, and may be treated as partnerships, C corporations, or disregarded entities for U.S. federal income tax purposes. The most important considerations will be where the investor is located, the existing jurisdictions in which the investor pays taxes, where the assets are traded or located, and applicable tax treaties.

Importantly, where the investor in a single-investor fund seeks significant consent and governance rights, that investor should be particularly thought about what those rights mean for liability protection. To avoid jeopardizing their limited liability status, investors in a single-investor fund need to avoid (and managers should be wary of) taking control over substantive investment decisions and strategy, typically left for the manager.

Fees

In a traditional multi-asset and multi-investor 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 or single-investor 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. For additional context on fee structures and disclosures, see Fee and Expense Disclosures in Private Equity.

Single-Asset Funds

Whether a manager charges management fees with respect to a single-asset fund often depends on the purpose 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. In nearly every instance, managers are entitled to incentive compensation—whether a performance fee, incentive allocation, or otherwise—in connection with a single-asset fund. The amount of that incentive compensation often, but not always, tracks the compensation paid in respective of the flagship or parallel funds and accounts investing in the same asset. Alternatively, there are often circumstances in which the manager actually receives higher incentive compensation with respect to single-asset funds; if the manager is not receiving a management fee, it should be entitled to more payment for delivering performance results to the investor.

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. Managers cannot and should not favor (or create the impression of favoring) fee-paying clients over non-fee-paying clients.

Single-Investor Funds

As is the case for many terms with respect to single-investor funds, the management fee and incentive compensation is highly customized. With respect to single-investor funds trading pari passu to a comingled fund, the fees typically mimic those of the flagship fund; there is no difference in strategy, leverage, or other terms that justify a deviation.

Expenses

Single-Asset Funds

Single-asset funds present material challenges when it comes to managing expenses. Perhaps the most unique challenge with respect to single-asset funds relates to ensuring the availability of adequate assets to pay fund expenses. In a multi-asset fund, depending on strategy and structure, there are a number of resources (i.e., additional subscriptions, capital calls, and assets) available to pay fund expenses.

With respect to a single-asset fund, however, the available sources are limited. There generally is only one infusion of capital and the proceeds of one disposition available to pay fund expenses. Additional, and often more tailored and thoughtful, accommodations must be made to provide cash for fund expenses.

For instance, the manager may require investors to contribute additional capital on a quarterly or annual basis to satisfy the amount of expenses actually incurred. There is, as with all drawdown funds, a risk to the fund of failure or delay by investors to make capital contributions. Investors naturally fear an unlimited obligation and often seek caps on the aggregate amounts to be contributed. While managers often are amenable to these types of caps with respect to single-asset funds, they must carefully and thoughtfully decide whether to exclude unmeasurable, unanticipated, and extraordinary expenses, such as litigation and indemnification obligations, from any expense cap. Notwithstanding any expense cap, investors typically are not subject to an unlimited obligation to continue to contribute capital to the fund, even to satisfy the most extraordinary of expenses.

Single-Investor Funds

Due to the customization of a single-investor fund, investors may negotiate for specific and unique expense restrictions, whether caps or a far more limited list of expenses that even qualify as fund expenses that may be charged to the fund and, ultimately, the investor. In addition, investors in a fund-of-one frequently require additional reporting requirements with respect to expenses, costs of which the manager may or may not bear. Unlike in a multi-investor fund, it is typical that the manager does not bear any extraordinary or unique reporting requests from investors. This is a harder point to negotiate when a manager is only aiming to fulfill the requests of one investor.

Unique Regulatory and Compliance Considerations

Single-Asset Funds

Particular regulatory and compliance considerations may arise in connection with single-asset funds. For instance, if a single-asset fund is investing in an initial public offering, it must limit the investment by restricted investors under *FINRA Rules 5130 and 5131 to 10%* and 25%, respectively. As a result, most restrictive investors will elect not to invest, or to invest only in a very limited amount, in such single-asset funds. For additional information on compliance requirements, see Registered Investment Adviser Handbook Chapter 7: Substantive Requirements (Advisers Act) and Registered Investment Adviser Handbook Chapter 8: Substantive Requirements (Other Securities Laws).

Single-Investor Funds

Additional regulatory and compliance considerations also may arise with respect to single-investor funds. For instance, jurisdictions requiring look through to underlying investors—whether for tax, regulatory, or other considerations, particularly if triggered based on certain ownership thresholds—might be less appealing to these types of funds, where disclosure of its underlying investor become more likely.

Term and Liquidity

Single-Asset Funds

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 and private securities that are expected to become publicly traded within a short period, the manager generally has a specified time frame in which it believes the stock price will be optimized. During that period, investors generally 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 negotiate for 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 realized 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.

Single-Investor Funds

The term of a single-investor fund very typically is negotiated. It is not unusual, for instance, for an underlying investor ultimately to have the right to wind down the fund, generally after a specified period of time and in circumstances that do not provide more favorable liquidity rights than would be available under the standard withdrawal terms of such fund. In addition, the underlying investor is more likely to negotiate for-cause removal rights with respect to the manager which, in many instances, may be more expansive than the similar removal rights in any pari passu comingled fund managed by the same manager.

Follow-On Investments; Restructuring

Single-Asset Funds

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 often is 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.

However, in certain circumstance, including with respect to liquid assets, follow-ons are less typical and rarely anticipated and, as a result, 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.

Single-Investor Funds

A single-investor fund's participation in follow-on investments generally is less complicated or limited. The fund often, although not always, has additional dollars (from further investments or capital contributions by the underlying investors) or recycled capital available from the disposition of other assets to fund the follow-on investment—if that is what the manager deems prudent and advisable, in accordance with the investment guidelines of the single-investor fund. In this sense, a single-investor fund is more like a typical comingled fund.

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