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Due Diligence on Public Funds in Funds-of-One

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Fund Finance Friday has previously reported on the continuous rise of public pension money in private equity. Generally, such investments are made in commingled funds with a diversified group of investors, but we also commonly see these public pension and retirement funds (each, a "Public Fund") invest in a fund-of-one vehicle where all or substantially all of the assets are from the Public Fund (a "Fund"). Such Funds are commonly known in the industry as an "SMA" (separately managed account). For purposes of this article, I will refer to such Funds as SMAs. *Fund Finance Friday* has also previously covered SMAs and related documentary considerations – for example, the (in)famous investor consent letter ("Investor Consent Letter") is often critical from a lender's underwriting perspective.

In this article, I will focus on the recommended scope of due diligence to be conducted when an SMA's sole investor is a Public Fund to ensure that both the Public Fund has the authority to invest in the SMA (the "Investment") and to confirm that there is no obvious prohibition of the Investment under state law.

Here at Cadwalader, the recommended scope of due diligence entails a review of the (i) applicable limited partnership agreement ("LPA"), investment management agreement, private placement memorandum, subscription agreement and side letter (collectively, the "Fund Documents"), (ii) applicable state constitution and statutes (the "State Documents") and (iii) publicly available records ("Public Records," together with the State Documents, the "State Reference Materials"). Although due diligence of a Public Fund in an SMA often consists only of the Fund Documents, lenders should consider broadening the scope of diligence to include State Reference Materials.

Fund Documents

In all subscription credit facilities, we recommend due diligence on the Fund Documents to ensure the documents are valid, binding and enforceable against the investor(s) and to identify any issues which may result in an investor being excluded from the borrowing base.

It is common for a Public Fund to make representations in various agreements regarding its authority to enter into the Fund Documents and that doing so does not violate applicable law. For example, an LPA might provide that: "[t]he Investor has all requisite power, authority and capacity to acquire and hold the Interest and to execute, deliver and comply with the terms of each of the instruments required to be executed and delivered by the Investor in connection with the Investor's subscription for the Interest, including the Partnership Agreement and this Subscription Agreement, and such execution, delivery and compliance does not conflict with, or constitute a default under, any instruments governing the Investor, or violate any law, regulation or order, or any agreement to which the Investor is a party or by which the Investor may be bound."

Furthermore, we would expect to see in the Investor Consent Letter standard language such as "[w]e hereby represent and warrant that, as of the date hereof… (c) the Subscription Agreement (as modified by the Side Letter) and this letter have been duly authorized, executed and delivered by us and confirm the accuracy of the representations made by us therein and herein; (d) the Subscription Agreement (as modified by the Side Letter), the Partnership Agreement (as modified by the Side Letter), and this letter constitute our valid and binding obligations, enforceable against us in accordance with their terms, subject to applicable bankruptcy, insolvency, fraudulent transfer, reorganization, moratorium and other laws affecting creditors' rights generally from time to time in effect and to general principles of equity; and (e) we have the power and authority required to execute and deliver the Subscription Agreement (as modified by the Side Letter) and this letter, and to perform our obligations thereunder and hereunder."

Taken together, it is clear that a Public Fund has represented that it can enter into the Fund Documents and that entering into the Fund Documents won't violate applicable law. It is worth noting that it is always the case in these circumstances that these representations are somewhat circular. If there is a breach of the representations because the Public Fund cannot make its Investment as a matter of state law, there is no one from whom the SMA (and, by extension, the lenders) could seek recourse absent an indemnity from the investment manager, which is unlikely to be given by a Public Fund (or most other investors).

A common issue that arises in the review of Fund Documents when dealing with government instrumentalities like Public Funds is the reservation of sovereign immunity, which *Fund Finance Friday* has previously **discussed**, and should be flagged for the lender's consideration.

State Constitution and Statutes

Each of the 50 U.S. states has its own state constitution and code of laws, which provide for the formation of one or more retirement systems for public employees in such state, such as Public Funds. State statutes will also set forth and establish the governance of the Public Fund. Due diligence will identify whether or not the Public Fund was properly formed pursuant to state law and ensure that the board or other applicable authority has the power to (i) control the Public Fund, (ii) contractually bind the Public Fund or, if relevant to the contemplated Investment, to delegate such authority to an investment manager, (iii) enter into and perform the contemplated Investment on behalf of the Public Fund, and (iv) disburse funds belonging to the Public Fund to the SMA. This due diligence will provide greater certainty and comfort to the representations

made in the Fund Documents discussed above. As mentioned above, it is also possible that, as a state instrumentality, the Public Fund may have a claim for sovereign immunity, and such claim should be flagged for the lender's consideration.

Public Funds are generally subject to certain statutory diversification and investment limitation requirements. Unfortunately, law firms cannot diligence whether or not as a factual matter a Public Fund is in compliance with all those requirements.

Due diligence on State Documents is generally limited to state law and will not otherwise include local or municipal law, which is a more lengthy and expensive process that goes beyond what many lenders are typically concerned about (*i.e.*, due authorization and capacity) with respect to these Public Funds. Lenders should consult with both their external counsel and their internal legal and credit teams to identify whether there is an internal need or policy requirement to further expand the scope of due diligence to include local and/or municipal law. If a lender desires to include local and/or municipal law within the scope of the due diligence, then it will be necessary to retain local counsel to undertake a substantive analysis of any issues raised in the due diligence or whether other issues should be considered.

Public Records

As a Public Fund, the investment policies and minutes of the board of trustees of the Public Fund will generally be publicly available. The investment policies should be reviewed to ensure that the Investment, as well as any delegation to an investment manager (if relevant), is compliant with investment guidelines and restrictions applicable to the Public Fund. The minutes should be reviewed to ensure that the Investment and the proposed commitment amount in the SMA have been recommended to the board and that the board has voted on, authorized and approved – ideally, unanimously – the proposed Investment. Holding board meetings and maintaining minutes is just one of many aspects of good governance, and may also be statutorily required for a Public Fund. The minutes will oftentimes take note of the investment practices and policies of the Public Fund, and state how the Investment (i) complies with applicable investment guidelines and restrictions, including (if relevant) any delegation made to an investment manager in connection with the Investment and (ii) is in the best interests of the Public Fund to meet and satisfy its investment goals.

Conclusion

As a final note, lenders should work closely with counsel to determine when it makes sense to broaden the scope of diligence from only Fund Documents to also include State Reference Materials. Doing so is both prudent and practical given the role of the Public Fund in the SMA and the limited investor base.