C A D W A L A D E R

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One Is the Loneliest Number

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When thinking, talking and writing about subscription credit facilities (a "Facility"), the fund in question usually has a diversified group of investors with a wide range of commitment sizes – those funds are commonly referred to as "commingled" funds. On the other end of the spectrum are funds consisting of just one investor (or just a handful of investors) – those funds are commonly referred to as "SMAs" (Separately Managed Accounts). Why do SMAs exist and why would a lender lend to a "fund of one"?

With respect to why SMAs exist, they exist for a variety of reasons, including strategic investment opportunities, timing inconsistencies between the investor and the manager's next fund, changes in pricing structure or simply a relationship-building decision between the investor and the manager. Over the last 12 months, one manager in particular saw a resurgence of SMAs since certain investors perceived this period of distress as an investment opportunity. Often, these requests were coming in faster than managers wanted to raise a fund, so SMAs were a popular choice to allow investors to capitalize on the market dislocation.

As to how they function, sometimes SMAs invest alongside a commingled strategy, but that is not universally the case. In other instances, SMAs may afford an investor access to multiple verticals where diversification is sought. Certain investors may prefer to have discretionary authority or approval rights over investment decisions. Alternatively, they may have sensitivities around investing in certain types of assets depending on their broader mandate, asset allocation, or cultural and ethical considerations.

SMAs frequently seek to take advantage of the convenience and utility of a Facility, no different than commingled funds. However, from the lender perspective, loaning money to commingled funds versus SMAs may be best described as "apples and oranges." As a result, for some

lenders, lending to an SMA simply proves too challenging of a request. Why “apples and oranges”? Because when providing a Facility to an SMA, many (if not most) of the “standard” lender protections with respect to evaluating the ability to ultimately collect on uncalled capital are simply not applicable in the context of SMAs.

Similar to a commingled fund, an SMA lender will have exclusion events with respect to the investor(s) to back out risky investors from the borrowing base and/or coverage ratio. However, unlike a commingled fund, since there may be only one investor, other than creating an event of default, from a collateral perspective, removing “the investor” from an SMA Facility fails to provide any of the collateral protections (or tightened borrowing base or ratio) it would afford in a commingled fund, since the cushion and safety net of overcollateralization and diversity simply doesn’t exist. If one investor defaults, the entire investor base has defaulted, and the lender cannot look to the remaining investor to repay the indebtedness owed by the defaulting investor.

That’s the risk, but since bankers don’t like to lose money, there must be countervailing considerations to explain the fact that SMA Facilities not only routinely get done, but also (as noted above) demand seems to be increasing, especially in the current environment.

For those lenders willing to head down the SMA road, there are unique aspects of lending to an SMA, from both underwriting and documentation perspectives, that must be properly accounted for and considered. From a pure underwriting perspective, lending to an SMA is like making a direct loan to the underlying investor. Thus, regardless of a lender’s relationship with the manager (and whether or not the relationship with the manager is a primary motivation for the Facility), the most prominent and obvious underwriting issue is the creditworthiness of the sole investor.

Investors in SMAs are almost exclusively large institutional funds. This reality means that the investor is likely well known to the lender being approached for a facility. In fact, for some lenders, pre-existing relationships and familiarity with the underlying investor is a gating item to consider underwriting an SMA facility. Similarly, lenders find comfort in manager/investor relationships that have considerable, positive history of working together.

Following along with the “positive track record” on a macro level as to the relationship and prior dealings, on a micro level with respect to the particular transaction a positive track record is often also required. This frequently takes the form of requiring some level of capital to have been contributed by the investor prior to the effectiveness of the Facility (for example, 10% of the capital commitment must have been called and received). This requirement is an attempt to ensure the investor has sufficient “skin in the game,” making a future failure to fund much less likely. From a pricing standpoint, since the SMA Facility lacks the “standard” protections discussed above, they are typically priced higher than a commingled Facility to a similar sponsor.

As in underwriting, the documentation of an SMA Facility also has quite a few nuances to be considered. The previously common practice of obtaining investor consent letters has largely faded into the annals of subscription finance history. There are many reasons for the elimination of consent letters, not the least of which is the fact that limited partnership agreements and other governing documents have improved with respect to expressly

contemplating the existence of and collateral for Facilities. However, in the context of SMAs, this artifact remains alive and well.

For many lenders, the Investor Consent is an absolutely non-negotiable requirement to even consider underwriting an SMA fund for a Facility. Further, in our experience, “best practices” would call for it absent unique circumstances. In response to a request for a consent letter, it’s not unusual to hear a response along the lines of either “those aren’t market” or “you want what from who?” As a result, it’s good to be able to explain the legal foundation to either response. Yes, the investor signed the partnership agreement and, yes, they know about the facility and, yes, they have agreed to have their uncalled capital pledged to the lender. However, an Investor Consent letter serves the purpose of putting the lender and sole investor in direct “contractual privity” – meaning there is now a document between the lender and the investor where the investor has acknowledged to the lender that it knows about the Facility and the fact that it might be required to fund directly to the lender, etc. at some point. Basically, it creates an estoppel argument for an investor that wants to ignore a lender request as simply a problem between the lender and the fund. In addition, an Investor Consent provides an opportunity to: (i) get the popular lender confirmation that the investor is committed to fund its capital contributions without setoff, counterclaim or defense, (ii) address any side letter issues or (iii) deal with sovereign immunity concerns, which are not infrequent for the types of investors frequenting the SMA space. As noted above, Investor Consents faded, in part, due to a cost (consents from most or all commingled investors) versus benefit (acknowledgement of Facility already contained in partnership agreement) analysis which simply no longer supports their existence. However, that cost versus benefit analysis in the SMA space is decidedly reversed. The benefit of an Investor Consent to a lender willing to take the risks unique to SMA Facilities certainly exceeds the cost of getting a consent from a sole investor. Further, if there is a familiarity between the contracting and advising parties, previously-agreed precedent investor letters can be extremely useful in getting these in place with an almost nonexistent cost.

While not a true Investor Consent, in an SMA Facility, sometimes the SMA Facility is more akin to an SMA of an SMA, meaning that the actual investor in the SMA is a special purpose vehicle created by the (typically) institutional investor. As a result, referencing back to the underwriting discussion, while a lender can gain comfort in the fact that an institutional investor has a track record and assumedly substantial financial resources to support its obligation to fund its uncalled capital, when applied to a special purpose vehicle of the institutional investor, that “track record” thread can look thinner.

In these situations, one tool that has been used to bridge this “comfort gap” is to obtain a support letter from the parent entity of the actual special purpose vehicle investor – since they are the entity that is providing the true creditworthiness to support the credit approval. While not legally enforceable documents, comfort letters, typically: (i) confirm that the parent is in fact the parent company, (ii) acknowledge the investor’s commitment and that the commitment is being pledged in connection with the Facility, and (iii) agree that the parent will “cause” the investor to timely fund its obligations (or sometimes agree to ensure the investor is “adequately capitalized”). In some cases, a lender may even require a guaranty from the parent entity – though, not surprisingly, a commitment such as that is a much more difficult request (since it may run against the establishment of the special purpose vehicle in the first place) and is, consequently, rare.

In terms of facility documentation, by comparison to their commingled counterparts, SMAs often see tightened terms. For all the reasons discussed above, there is simply less room for errors or missteps in execution of key aspects of compliance with the documentation. As a result, cure periods for certain events of default are often greatly reduced or, in many cases, simply removed. Further, as referenced above, common exclusion events in a commingled facility (which would simply remove an investor from the borrowing base and/or coverage ratio) are simply immediate events of default in an SMA Facility – if a sole investor in an SMA would need to be excluded from the borrowing base/ratio, *ipso facto*, the Facility simply no longer has a borrowing base or a supportable ratio. For all of these reasons, when lending to a fund-of-one, defaults are more likely to trigger the maturity of the facility.

Ultimately, there are a variety of unique issues facing lenders (and the attorneys that document their deals) when financing an SMA versus a commingled fund. Nevertheless, while those issues can make lending to an SMA more risky, if properly analyzed in the underwriting process and accounted for in the documentation process, those peculiarities and other unique differences can be somewhat mitigated.