

Fund Finance Friday



Fund Domicile Selection: Tradition, Evolution and Market Forces

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Elon Musk made headlines earlier this year when he shifted Tesla's incorporation from Delaware to Texas. This was in reaction to a Delaware court's striking down his pay package—a high-stakes case of taking your ball and playing elsewhere. Some commentators expressed surprise at the Delaware ruling since Delaware courts have typically deferred to the decisions of management and shareholders, especially when they are in agreement (the shareholders approved the pay package). This got me thinking about a key foundation in fund finance that we rely on every day but often take for granted: domicile selection for funds.

The conversation around fund domicile selection has grown more nuanced in recent years, though the fundamental calculus remains largely unchanged. While emerging jurisdictions periodically attempt to position themselves as alternatives, the gravitational pull of traditional fund domiciles remains powerful, driven by factors that newer entrants struggle to replicate.

Delaware: The Power of Network Effects

Delaware's continued dominance in U.S. fund structuring tells us much about how the fund formation market values certainty and efficiency over marginal innovations in other jurisdictions. The sophisticated Chancery Court system, combined with an extensive body of partnership and limited liability company law precedent, creates a legal infrastructure that other U.S. states have found nearly impossible to replicate. This advantage compounds as each new decision further deepens the precedential framework that funds and their counsel rely upon. The market's familiarity with Delaware structures creates powerful efficiencies in fund formation and finance.

When a credit facility references Delaware partnership law concepts, even newer concepts such as a Delaware partnership series, lenders and their counsel can rapidly assess the implications without the friction that novel jurisdictional questions introduce. This efficiency translates directly into cost savings and execution speed—advantages that become more pronounced as transaction complexity increases. In addition, fund counsel are accustomed to giving Delaware legal opinions covering key issues in the transaction, such as due formation and capacity to enter into the loan documents. Perhaps less obvious, the comfort and ability of borrowers to deliver a variety of representations in loan documents rests upon legal predicates ultimately derived from foundational Delaware statutes and case law. On the lender side, the due diligence of collateral is done in the shadow of Delaware law, where the courts will enforce bargains struck between investors and funds in the limited partnership agreement in a way that even third parties can predict with great accuracy.

Texas and Florida: Challengers with Challenges

Recent years have seen other states attempt to compete for fund business. Texas and Florida, in particular, have made noteworthy efforts through targeted legislative reforms and tax policies. However, these initiatives highlight why displacing Delaware remains challenging. While a favorable tax environment or modernized digital asset provisions might appeal in isolation, fund sponsors consistently prioritize the comprehensive certainty that Delaware's legal system provides. It's possible, however, that future innovation, such as tokenization of fund interests, may provide an opening for challenger jurisdictions.

Cayman Islands: Adaptive Resilience

The Cayman Islands' evolution as a fund jurisdiction presents a masterclass in adaptive regulation. Initially chosen for its tax neutrality and regulatory flexibility, Cayman has maintained its position by consistently modernizing its legal framework while preserving the core advantages that attracted funds in the first place. Recent regulatory pressures, particularly around transparency and economic substance, have tested this adaptive capacity. Cayman's response has been sophisticated—implementing necessary compliance frameworks while minimizing operational friction for funds. The introduction of enhanced AML requirements and beneficial ownership reporting could have threatened Cayman's efficiency. Instead, the jurisdiction has turned regulatory compliance into a strength, with a deep reserve of service providers efficiently managing these requirements. Emerging competitors, particularly Singapore with its Variable Capital Company structure, have attempted to challenge Cayman's offshore prominence. However, these efforts underscore how much of Cayman's advantage lies in its accumulated market experience. Fund finance lenders have decades of experience with Cayman vehicles, resulting in standardized approaches to everything from security interest perfection to regulatory compliance representations and covenants.

Luxembourg: The European Sophisticate

Luxembourg's position in the fund landscape illuminates how regulatory access can trump traditional efficiency considerations. The jurisdiction's role as a gateway to European markets has only grown in importance post-Brexit, with the EU marketing passport becoming even more valuable for global managers. The sophistication of Luxembourg's fund regime reflects a deliberate strategy of regulatory innovation within established parameters. The Reserved Alternative Investment Fund ("RAIF") structure exemplifies this approach—offering efficiency while maintaining regulatory credibility. This balance has proven particularly attractive to institutional managers who value both speed-to-market and regulatory robustness. The very popular SCSp retains its position as the jewel in the crown in the Luxembourg fund product stable, owing to its familiarity to sponsors, tax-transparency and ability to access the AIFMD marketing passport by appointing an authorised AIFM. Recent developments in Luxembourg have focused on enhancing its position in growth areas like sustainable finance and digital assets. These initiatives demonstrate Luxembourg's understanding that maintaining its position requires constant evolution. However, the jurisdiction has managed this innovation while preserving the stability that institutional investors and lenders value.

Practical Implications for Fund Finance

For fund finance professionals, these jurisdictional dynamics have significant practical implications. Documentation for Delaware vehicles benefits from decades of market standardization, allowing rapid execution of even complex financing structures. It's a luxury we take for granted every day that we document complex and nuanced facilities without the governing law of the fund (Delaware) ever being a question for significant risk analysis. Let's hope it stays that way. Cayman vehicles require additional regulatory compliance provisions, but these have become well understood and efficiently managed. (We all remember closing deals in our pajamas during the pandemic where the final point was the compliance covenant with the Cayman Private Funds Act—which these days are happily in the rearview mirror). Luxembourg structures demand greater attention to regulatory overlay, particularly around AIFMD compliance but, again, the market has developed standard approaches to these requirements. Credit analysis across these jurisdictions increasingly focuses on substance and compliance capabilities rather than pure structural considerations. This shift reflects both regulatory evolution and market maturity. Lenders now regularly evaluate factors such as economic substance compliance and regulatory reporting capabilities alongside traditional credit metrics. There are other jurisdictions worthy of discussion—Ireland, for example—but this article has focused on the three most popular options for fund formation.

Looking Forward

The Cadwalader partners will see you in Miami in February, where we will have comprehensive data on fund domicile selection in 2024's year in review. The future of fund domicile selection likely involves evolution within established

jurisdictions rather than dramatic shifts to new locations. The network effects that reinforce the position of traditional fund domiciles are, if anything, growing stronger as regulatory complexity increases. Emerging jurisdictions may find niches in specific market segments, but wholesale shifts seem unlikely. For fund finance practitioners, this suggests a future of incremental adaptation rather than fundamental change. Documentation and credit analysis will continue to evolve, particularly around regulatory compliance and sustainability considerations. However, the fundamental frameworks that have developed around Delaware, Cayman and Luxembourg vehicles will likely remain the market standard. The real innovation in fund domiciles may come not from new jurisdictions but from how traditional jurisdictions adapt to emerging market demands. Whether addressing digital asset custody, sustainability requirements or new forms of fund democratization, the established jurisdictions' ability to evolve while maintaining stability will likely determine their continued dominance.