Private Equity Law Report
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April 28, 2020

CO-INVESTMENTS

The Co-Investment Continuum: Direct and Indirect Structures That Empower LPs (Part Two of Two)

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Co-investments come with certain challenges and risks, including the potential to inhibit a GP's ability to close deals, exit investments or maximize value for investors in its main PE fund. GPs may lack the negotiating leverage to avoid those issues, however, as LPs in co-investments seek increasing amounts of control and access. That is particularly the case when an LP is an anchor investor in a sponsor's main PE fund or where a sponsor has a limited track record. In those contexts, GPs have several options for structuring their co-investment programs to meet LP desires while potentially protecting their own interests.

This two-part series describes common co-investment structures and the factors a fund sponsor must consider when deciding which approach to offer its LPs. This second article outlines direct and indirect co-investment structures that afford LPs more discretion on which investment opportunities they will pursue or bypass. The first article addressed longer-term structures GPs can use to pursue several co-investment opportunities, including to give the sponsor more control over LPs' co-investment commitments.

See "Sadis & Goldberg Seminar Highlights the Ample Fundraising and Co-Investment Opportunities in the Private Equity Industry, Along With Attendant Deal Flow and Fee Structure Issues" (Dec. 8, 2016).

LP-Controlled Co-Investment Structures

Co-investment structures are sometimes driven, at least partly, by LPs' negotiating power. Most LPs are drawn to co-investments as an opportunity to average down the management fees and carried interest paid to GPs across their PE portfolios. Some LPs, however, also desire the ability to take more control over their PE exposure and obtain more direct access to deals in a way that would be impossible through blind-pool fund commitments alone.

Those LPs want the ability to select individual co-investment opportunities, or the option to shape their exposure to promising companies, industry sectors or geographic regions. Other LPs want to use co-investments to seize some control over the pace of their capital commitments to GP. Finally, some LPs view the co-investment process as an opportunity to work more closely with a GP as a form of training for their internal investment staff or

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learning more about investing in a particular industry.

In light of those desires, PE sponsors often consider the following co-investment structures to grant proactive LPs more autonomy and discretion in the process.

See "Recent Trends in Key PE Terms Impacting Alignment of LP and Manager Interests" (Nov. 19, 2019).

Direct Investments

One approach is for PE sponsors to allow co-investors to take direct equity stakes in a portfolio company. The appeal of this structure can sometimes be driven, at least in part, by particularities of the deal in question. For example, a GP pursuing a deal with only one or two co-investors might consider it more efficient to set it up as a direct co-investment instead of setting up a separate legal structure for the co-investors.

Although a direct investment in a portfolio company seems straightforward, there are several different ways that type of co-investment can be structured, including:

- LPs acquire a minority stake directly in the portfolio company;
- LPs purchase a minority stake in a holding company co-owned by the co-investors and the fund's LPs; or
- all or some of the LPs invest in the underlying company through a blocker corporation for tax or governance purposes.

Regardless of how they are structured, direct co-investments are appealing to investors because of the increased information rights they typically attain via voting or observer seats on the underlying company's board of directors. Those enable co-investors to communicate directly with the company's management team and receive information typically provided to other stakeholders (*e.g.*, lenders), said Latham & Watkins partner Amy R. Rigdon. "In a direct co-investment, the LP can be more of an active participant – particularly if there's no holding company and they're going directly into the portfolio company, they arguably have a lot more insight into the portfolio company."

See "Current Scope of PE-Specific Side Letter Provisions: Co-Investment Rights, LP Advisory Committee Seats and Parallel Funds/AIVs (Part Two of Three)" (Mar. 26, 2019).

Factors to Consider

When considering whether to offer a direct co-investment, a GP must take into account a range of factors, including the number and identity of co-investors; regulatory issues; and tax concerns. For example, direct co-investments are "typically more favored by institutional investors with some wherewithal about investing," said Rigdon.

See "Regulatory Risks and Important Tax Considerations in PE Co-Investments (Part Two of Two)" (Jun. 25, 2019).

In addition, a GP's status can factor heavily into whether a direct co-investment approach is pursued. The structure is more common where LPs have greater negotiating leverage, such as when they are an anchor or seed investor in an emerging manager's fund. In those scenarios, GPs have an incentive to concede more control in a co-investment to appease the LP.

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Further, the structure can be used to allow co-investors to become acquainted with an emerging manager with a limited track record. "An institutional investor may be less familiar with the independent sponsor that sourced the co-investment opportunity than with established sponsors of blind-pool, committed PE funds, said Winston & Strawn partner Bradley S. Mandel. "In that case, the LP may be looking for more protections, control and information rights than if it were co-investing alongside a sponsor with whom it's invested in five or six funds."

See "How Emerging Fund Managers Can Raise Capital in a Challenging Market Without Overstepping Legal Bounds" (Aug. 4, 2016).

Risks of Direct Co-Investment

Direct co-investments can be risky, however, for GPs preferring to maintain strict control over purchasing, operating and exiting a portfolio company. If a direct stake is not carefully structured, then the alignment of interests between the fund investors and the co-owners of the portfolio company can be frayed. For example, a co-investor could seek to retain its minority stake after the main PE fund exits the investment or use its seat on the company's board of directors to undermine the GP's operation of a portfolio company.

For another structure carrying alignment risks, see our two-part series on structuring PE club deals: "Overview of the Process, Possible Structures and Their Recent Evolution" (May 7, 2019); and "Key Deal Documents and Eight Essential Practice Tips to Navigate Deals" (May 14, 2019).

Typically, GPs structure the direct co-investments to maintain full control over those decisions, but that is harder to accomplish than in situations when co-investors invest indirectly. "The control isn't to be greedy; there are some real legal concerns around control because the GP has a fiduciary duty to its main fund," noted Rigdon.

If co-investors have increased rights and direct access to a portfolio company, the GP needs to carefully balance its foregone control with the fiduciary duties owed to investors in the main PE fund, advised Rigdon. "It's a little bit easier to feel like everything's aligned when you're using a co-investment vehicle that's pari passu with the main PE fund because the sponsor controls both and can make decisions affecting both sets of investors the same way."

Further, a direct co-investment can delay completion of a deal in the first place because more owners are involved. "It is difficult on the best days to negotiate the transaction documents and close an acquisition on time, but the process can be slowed further if more co-investors are directly involved in the process," observed Rigdon. "It can also irritate the portfolio company because now it has ten buyers instead of just one. "

To mitigate those risks in a direct co-investment context, a fund sponsor may require co-investors to grant the sponsor a proxy to control the vote for co-investors' ownership stake. A similar proxy may also be arranged if the co-investors own shares through a blocker company for tax purposes.

See "Investment Vehicles, Investor Rights and Restrictive Covenants in PE Co-Investments (Part One of Two)" (Jun. 18, 2019).

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Indirect Co-Investments

Another option GPs typically prefer is to use a co-investment vehicle that creates an indirect ownership relationship for the participating LPs.

Corporate Structures

The approach often involves forming a vehicle – either a special purpose vehicle (SPV) or another corporate structure – that pools co-investment ownership, although a number of complex variations are possible. For example, the main PE fund's investment can be through one corporate structure and the co-investors' commitments through a different SPV, with blocker structures used for shareholders of each as needed.

Although it is more work for the vehicle to be formed on an ad hoc basis for each co-investment, that approach is popular for allowing a GP to vary the terms according to the needs of the deal or group of participating co-investors, noted Rigdon. The peril, however, is that LPs generally have more room to negotiate the terms of their participation, added Pepper Hamilton partner Julia D. Corelli. "LPs will say, 'we don't want to pay this, or want to receive that,' and you're at the whim of the people who have the money that you need to close the deal."

For more insights from Corelli, see "Study Describes PE Co-Investment Trends and Manager Reluctance to Disclose Deficiencies (Part Two of Two)" (Mar. 26, 2019).

Alternatively, a pre-negotiated, "evergreen" co-investment vehicle can be used, which is only adapted to meet the needs of a specific deal. That vehicle can be a class- or series-based entity, with a single class or series for each co-investment in a portfolio. "That works well if you have a lot of the same investors putting up the investment dollars," observed Corelli. "It is also effective if there's no liability that passes through for the underlying portfolio companies; for example, you wouldn't use it with certain types of oil and gas investments."

In a series-based entity, each series' assets are insulated from the liabilities of the other series by statute as long as each series' books and records are maintained as if they were separate partnerships. Conversely, a class-based entity allows a sponsor to contractually achieve the same results without keeping separate books and records for each class, explained Corelli. "I happen to prefer the class-based approach because, with series-based vehicles, you might as well have one partnership for each deal and series. The only things you're saving are the franchise fees and formation costs in the state in which you formed."

See our three-part primer on deal-by-deal funds: "Structural Overview and Investor Perceptions Affecting Adoption" (Feb. 18, 2020); "Key Fundraising and Structural Considerations" (Feb. 25, 2020); and "Balancing Deal Uncertainty Against Attractive Carry Opportunities" (Mar. 3, 2020).

Potential Pros and Cons

GPs often prefer indirect co-investments, as they generally allow them to retain more control over the arc of the process. GPs can structure the co-investment vehicles to always vote in tandem with the main PE funds on decisions like selling a portfolio company, or otherwise ensure the co-investment vehicles operate in lockstep with the main PE funds.

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In addition, indirect co-investment structures also appeal to co-investors by enabling them to negotiate for many of the information and observation rights typically available with a direct co-investment. "If GPs are willing to give minority governance rights to sizable co-investors, that can still occur through a co-investment vehicle," noted Rigdon. "Large, anchor co-investors can receive board seats or observer seats at the portfolio company despite investing through a co-investment vehicle." Indirect structures are not without drawbacks, however. They are generally more cumbersome and costly to establish and run than the direct co-investment approach. In addition, having the same GP in charge of multiple vehicles with overlapping financial interests requires additional attention and care to avoid conflicts of interest.

See "What Legal, Regulatory and Operational Challenges Do Single-Asset Funds Present for Managers?" (Mar. 24, 2020).

Pledge Funds

Another approach that PE sponsors can use to grant co-investment opportunities is by using a pledge fund, which involves a soft investor commitment to the fund that affords LPs flexibility to join investment opportunities at their discretion. GPs typically have some protections, however, as investors are penalized or removed from the fund altogether if they forgo too many investments, either in total or consecutively.

See our three-part guide to pledge funds: "High Upside Fee Structure and Other Incentives for Adoption" (Apr. 9, 2019); "Key Investment Management Agreement Provisions" (Apr. 16, 2019); and "Deal Uncertainty Issues and Three Investment Vehicle Structures" (Apr. 23, 2019).

Although a good idea in theory, GPs prefer not to use pledge funds because they do not improve LP uptake on individual co-investment opportunities or save GPs from creating multiple corporate structures on ad hoc bases. "Pledge funds are probably the least prevalent of the co-investment programs because they are a lot of work to bring together without providing GPs meaningful certainty," observed Rigdon. "You've created a structure with no commitments where participants retain their ability to decide whether to participate in particular co-investments."

In fact, using a pledge fund to offer co-investments can complicate the process for GPs by requiring them to establish and fundraise for the fund while simultaneously negotiating commitments to the main PE fund. "It can be a useful tool, but it can divert time and attention away from the main fund negotiation, which is what everyone's focused on," said Simpson & Thacher partner David J. Greene. "That attention can be difficult to justify for an ancillary product when there might not yet be a deal to co-invest."

Also, pledge funds also create questions about fees and the mechanism for funding commitments, added Greene. There are expenses associated with the vehicle that the sponsor needs to pay despite there being no guarantee of deals, he noted. "An LP may make an upfront commitment, but that can't be drawn down for an investment unless the LP permits it or makes a specified commitment for each individual investment," he explained. "So, a source of funds is needed for costs from creating and operating the vehicle, which are often carefully scripted in the pledge fund's limited partnership agreement."

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Those reasons, among others, account for the limited adoption of pledge funds in the co-investment context. "I know of some large PE shops that have those types of programs, but they're not as popular as direct co-investments, committed co-investment funds (*i.e.*, 'top-up funds') or single-asset co-investment vehicles," explained Rigdon.

Instead, pledge funds are often used to test the waters with an emerging manager or fundless sponsor before making a traditional PE commitment, Rigdon observed. "Emerging managers use pledge funds to generate track records and generate some momentum to maybe raise a blind-pool fund or grow a blind-pool fund."

For more on emerging managers, see "Investor Gatekeepers Advise Emerging Managers on How to Stand Out When Pitching and Marketing Their Funds" (Dec. 15, 2016).

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