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Beware Co-Investments In Private Equity Fund Agreements

By **Kenneth Witt and Marc Lieberman** (January 24, 2020, 5:20 PM EST)

We frequently see private equity and venture capital funds present institutional investors with proposed terms in the funds' limited partnership agreements that have the potential to create a misalignment of the investors' and the fund managers' interests.

Kenneth Witt

Co-investments have increased dramatically in the past few years. According to a recent report by Marquette Associates Inc., the value of co-investment deals has more than doubled since 2012, totaling $143.8 billion in 2018.[1]

Many funds and their counsel take the position that the fund manager can freely set up co-investment vehicles separate from the fund and take management fees and a carried interest on the co-investment vehicle's investments.

Marc Lieberman

In our view, this kind of provision may incentivize fund managers to direct eligible investments away from the fund. It also dilutes the management efforts of the fund managers, who should be focused on maximizing value for the limited partners of the funds, not side deals with favored limited partners or other investors.

This type of provision is usually in the guise of an innocuous-looking exception to the requirement that the fund manager not set up new funds until some benchmark is met as to the percentage of fund commitments that have been invested or reserved for investment (60%-80%) or, if earlier, the termination of a five-year investment period.

The exceptions to setting up new funds are typically quite limited and invariably include parallel and alternative vehicles.

Parallel vehicles may be set up to accommodate the special legal, tax or regulatory considerations of certain investors. Parallel vehicles are to be on substantially the same terms as the fund's investments, expenses are borne pro rata with the fund, and dispositions of investments are to occur at the same time and on the same terms as the fund.

Alternative vehicles are set up for a group of limited partners or for all limited partners of the fund for the purpose of making a portfolio investment through an alternative investment structure. Management fees paid to the alternative vehicle by a limited partner reduce its share of the management fee payable to the fund manager, capital contributions are treated similarly, and investment results of the alternative vehicle are aggregated with the fund's.

In other words, parallel and alternative vehicles are set up for investors in the fund, not new parties, and are akin to subsets or divisions of the fund. Correspondingly, the fund manager should be allowed to set them up without running afoul of the limitations on setting up new funds.

Co-investment vehicles are another animal entirely, and adding co-investment vehicles to the

exception on new fund formation merits careful consideration. Fund managers usually have discretion in allocating co-investment opportunities to whomever they choose, including limited partners of the fund as well as outside parties.

Most fund agreements do require that co-investments be made on the same terms and at the same time as the fund's investment. Fund agreements also invariably require that investments that fit the fund's investment criteria be allocated first to the fund. A fund manager should not bring in a co-investor unless the fund does not have enough dry powder to invest or unless there are other compelling reasons, if allowed by the fund's limited partnership agreement, such as an investment by a key strategic player.

Setting up a vehicle for co-investment is not, in and of itself, a problem. However, allowing the fund manager or an affiliate to receive a management fee and/or a carried interest may create a conflict of interest. Such a structure gives the fund manager financial incentives to direct eligible investments away from the fund to co-investors who will pay it additional fees and a carried interest on top of what is payable by the fund investors.

Further, such a vehicle defeats the purpose of the prohibition on new funds during the investment period. The fund manager's management time and attention will be diverted in part to the co-investment vehicle, instead of focused on the fund. Moreover, it is very common that fund managers will require investors in the fund to bear 100% of broken deal costs, thereby freeing co-investors from bearing such expense, which can be significant.

Countervailing considerations include the benefits to the fund investors from incentivizing the fund manager to find new investors to fill in the capital required for a portfolio company investment. Also, co-investors may be seen as free-riding by the fund's limited partners unless the co-investors pay a fee and a carry to the fund manager. Nonetheless, fees and carry are often waived for investors making substantial commitments to co-investment vehicles.

However, in light of the potential conflict of interest explained above, in our view, receipt by the fund manager of management fees and carried interest from a co-investment vehicle should either be prohibited, unless there is prior approval of a majority in interest of the limited partners (or the advisory committee), and/or all such compensation should offset, dollar for dollar, management fees and broken deal expenses payable by the investors in the fund.

The former approach — prior approval by the limited partners — is taken by the Institutional Limited Partners Association Model Limited Partnership Agreement.

Putting some limits on compensation payable to the fund manager of a private equity or venture capital fund by co-investment vehicles is essential for aligning the interests of the fund managers with those of the investors in these increasingly popular vehicles.

Update: This article has been updated to include Marc Lieberman's role in drafting the model limited partnership agreement.

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Disclosure: Lieberman sits on the Institutional Limited Partners Association's task force that drafted its model limited partnership agreement.

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[1] See Sept. 19, 2019 Chart of the Week compiled by Megan Klassa, Research Associate, Marquette Associates (as derived from data compiled by Pitchbook as of Sept. 17, 2019).

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