# Private Equity Co-Investments

This material has been prepared for the Association of Corporate Growth in July 2013.

Pepper Hamilton LLP
Attorneys at Law

Julia D. Corelli | corellij@pepperlaw.com
P. Thao Le | lep@pepperlaw.com

Interest in co-investment opportunities has increased over the years due to investor demands for lower-cost investments and the need of fund sponsors to differentiate themselves from other private equity firms. As institutional and other fund investors (including high-net-worth individuals and family offices) become more sophisticated in evaluating private investment opportunities, they are seeking co-investment rights as a condition of their investment in private equity funds, and as a way to access more private equity investments while leveraging the costs that they are already paying to fund sponsors.[1] Given the competitive landscape for private equity investments and the challenges of fund-raising, fund sponsors see co-investment opportunities as a means to secure investor commitments, recruit operating partners, and develop relationships with other private equity firms (***PE Firms***).

This paper addresses the practical issues and the legal, economic and governance considerations for successful co-investments.[2]

## Co-Investment Opportunities – Who, Why and When?

**Prospective Co-Investors.** Co-investment rights are opportunistic and are not for everybody. Typically, co-investment rights are offered to fund investors, fund sponsors' operating partners, and other PE Firms, and, in certain instances, to fund principals. A variety of factors may drive a sponsor's willingness to offer co-investment rights, including:

- *Need for Capital* – Co-investment dollars allow a fund to complete an investment if the fund needs additional capital for the investment or the investment limitations set forth in its governing documents would otherwise limit the size of the fund's investment in the proposed investment.
- *Goodwill with Investors* – A sponsor may offer co-investment rights to secure an investor's capital commitment to the fund and to build relationships for future funds.
- *Strategic Benefits to the Portfolio Company* – Co-investors may provide strategic benefits for a portfolio company in exchange for an economic interest in the company. For example, an operating partner that co-invests in a fund portfolio company may serve as an "outside" director on the portfolio company's governing board, introducing strategic relationships to the company, providing discreet IT or other operating systems advice, or offering industry expertise.
- *Skill and Deal Sourcing* – Sponsors may offer a co-investment opportunity to another PE Firm to bring a special skill set to the table for the portfolio company, or to develop a relationship with that firm for future deal-sourcing opportunities.[3]

**Timing.** Co-investment rights generally are discussed with fund investors when they are making capital commitments to the fund. When raising its fund, the sponsor should develop a strategy as to whether, how and when to grant co-investment rights to a prospective investor of the fund and to which investors they should be granted. Fund-raising takes a long time and usually has several unexpected developments. Negotiating definitive co-investment rights can be time-consuming and distracting to the fund-raising process, and granting definitive co-investment rights too early can derail a successful fundraise. Sponsors will need to consider whether the grant of co-investment rights will jeopardize investor relations in the future because not all fund investors will have co-investment rights. The final limited partnership agreement (***LPA***) for the fund and the related side letters will generally acknowledge certain investors' co-investment rights, but leave the sponsor the flexibility to deal with co-investment opportunities in the manner most conducive to adding value to the fund.[4]

While operating partners generally have the right to invest in "their companies" on a fee- and carry-free basis as a perquisite of their role with the fund, other PE Firms are offered co-investment opportunities on a more opportunistic basis. Co-investment opportunities, if any, will likely be offered to PE Firms in connection with the evaluation of an acquisition, and will depend on whether any enhanced value would be gained by the other firm's investment or simply by offering the opportunity to the other PE Firm. Co-investors of any type need to be able to evaluate an opportunity quickly and arrange for capital to be available on short notice to complete an investment. Potential co-investors without sources of readily available capital, or without infrastructure to evaluate risk, are generally not desirable, unless those features are outweighed by other strong benefits such as a strategic expertise or relationship. Even when co-investors can evaluate a co-investment opportunity and have cash readily available for the investment, deal momentum and logistics may merit closing a co-investment after the fund's investment. In that case, the co-investor generally purchases a piece of the fund's investment at cost, and the underlying portfolio company's shareholders' agreement or other governing documents and the fund's LPA must have been crafted in a manner that allows the purchase. While sponsors should always consider the tax impact of such a transfer and the valuation at which the securities will be sold to the co-investor, close proximity in time will generally mean the fund undertakes a taxable transaction in which no gain is realized. If the sponsor is determining the value of the securities being transferred, such determination must be consistent with its valuation policies and well-documented.

> When raising its fund, the sponsor should develop a strategy as to whether, how and when to grant co-investment rights to a prospective investor of the fund and to which investors they should be granted. Sponsors will need to consider whether the grant of co-investment rights will jeopardize investor relations in the future because not all fund investors will have co-investment rights.

Whether undertaken by a fund investor, operating partner or other PE Firm, co-investments are intended to co-exist with a fund's investment in a manner that does not engender conflicts of interest. Generally, a fund's LPA will require that co-investments be invested at the same time and on the same terms and conditions as the fund, and be exited at the same time. However, this may not always be achievable, and sometimes may not be in the best interest of the fund, the co-investors or the portfolio company.

**Disclosing Confidential Information to Co-Investors.** In granting co-investment rights, sponsors can reduce reliance risk[5] if they ensure that the prospective co-investor is able to independently evaluate an investment. Access to confidential information about the investment is fundamental to a co-investor's ability to undertake its own evaluation. Sponsors should ensure that their confidentiality agreements with portfolio companies allow them to share information with "sources of financing" that include co-investors. In negotiating confidentiality agreements, sponsors should also seek to limit the applicability of any non-solicitation covenants on co-investors. To expedite the review process, sponsors may be inclined to share with co-investors diligence reports prepared for the sponsor by legal counsel or other service providers and consultants. In such cases, sponsors should confirm they are authorized to do so. Some service providers such as legal counsel and accounting firms may require the co-investor to sign a "non-reliance" letter as a condition to receive of their diligence reports pursuant to which the legal counsel or accountant intend to have no accountability to the co-investor for the content of the diligence report.[6]

**Deal Documents.** When a co-investment opportunity is identified, generally the parties need to move fast, and deal documents are often presented to co-investors on a take-it-or-leave-it basis. Nevertheless, co-investors should be able to ask questions and express their concerns — and they should be invited to do so. Obviously, if the sponsor is "laying off" a portion of the investment post-closing to the co-investor, there is little opportunity for input on the documentation. Therefore, even if the co-investor invests post-closing, share the documents with the co-investors as soon as they approach near-final form. Providing them and inviting input too early can make the negotiation process chaotic. Timing is very important to the balance of the relationship with the co-investor.

## Co-Investment Structures

In a typical private equity investment, the fund will invest in a holding company, which in turn, will be the parent of the operating portfolio company. Any co-investment would also be at the holding-company level. However, in some instances, co-investors may be permitted to invest directly in the operating portfolio company. Whether the co-investors will be invested directly or indirectly in the holding company (or the portfolio company) will depend on a number of factors including: the co-investors' expectations as to how much control they will have over the investment; how much control the sponsor is to have over the co-investors' investment; whether the sponsor earns separate economics (i.e., management fee and carry) on the co-investment; whether the portfolio company is to have transparency as to the identity of the co-investors; whether the co-investor is an operating partner, and whether flow-through attributes are desired or whether the co-investor's tax status prohibits it from investing in flow-through entities. Co-investors may seek to preserve a good bit of control over their co-investments, resulting in governance issues that sponsors must consider.

**Direct Co-Investment.**

***General Structure.*** With direct investments, co-investors will have a direct ownership interest in the portfolio company or its holding company. Having co-investors at both a holding company level and at the level of a pass-through portfolio company is doable, but less desirable because of the added complexity that brings, particularly in planning for an exit transaction. The co-investors will own their interest either directly or indirectly through a corporate blocker (***Blocker***) as illustrated in Figures 1, 2 and 3 of Appendix A. (See "Indirect Co-Investments - Blocker Entities" below for a discussion on Blockers.) If Co-investors have their own Blocker, they generally control it, though sometimes, the control over Blocker stock is effectively in the hands of the sponsor through a proxy mechanism. Investors that prefer direct co-investment generally have the infrastructure or experience to analyze and, perhaps more importantly, manage individual portfolio positions post-investment.

***Practical Considerations.*** As direct stakeholders of a pass-through portfolio company, direct co-investors can choose to invest directly into the portfolio company and receive flow-through tax benefits, or through the holding company and be blocked from flow-through tax treatment.[7] Either way, the direct co-investor will have direct contact with the portfolio company (or the holding company) and will not have its investment controlled by the sponsor. As such, the direct co-investor can independently exercise its rights as a stakeholder. Sponsors must consider the implications, of the co-investors' control over their investments in the portfolio company. At a minimum, direct co-investors may have statutory inspection rights with respect to the portfolio company's books and records (the costs of exercising which should be made the responsibility of the co-investor undertaking the books and records review). Depending on their investment philosophy, direct co-investors will likely seek customary minority stockholder rights, including preemptive rights, tag-along rights, information rights, registration rights and, when a co-investment constitutes a significant percentage of the portfolio company's equity, a board seat, observation rights and/or consent rights with respect to certain actions. Sponsors should consider negotiating for percentage thresholds on various rights that prevent the co-investor from taking a position contrary to the fund (which will generally entail the fund being bound by the inverse), and requiring the co-investor to be bound by a drag-along provision, voting and equity transfer restrictions, non-solicitation or no-hire restrictions and a confidentiality covenant. To manage the relationship between a sponsor and its co-investors, sponsors should also keep direct co-investors reasonably informed as to material portfolio company developments and to share reports received from the portfolio company.

> When a co-investment opportunity is identified, generally the parties need to move fast, and deal documents are often presented to co-investors on a take-it-or-leave-it basis. Nevertheless, co-investors should be able to ask questions and express their concerns – and they should be invited to do so.

If a co-investor is another PE Firm, such PE Firm will, if only from the standpoint of its fiduciary responsibilities to its own investors, want to maintain control of its own investment; in which case, sponsors must carefully select their co-investing PE Firms to ensure that they share similar investment philosophies and can work well together. Co-investors, depending upon philosophy, investment size and the nature of rights sought, may need to retain counsel to review and provide advice with respect to the portfolio company's shareholders agreement or other applicable equityholder agreements to which it is bound directly.

Operating partners often have a deeper knowledge of the industries in which "their portfolio companies" operate, and are likely to have more insight into the portfolio company's operations. Thus, operating partners will generally prefer that their co-investments be made directly. Operating partners are typically hand-selected by sponsors to fill a niche with a portfolio company or its industry. Sponsors should have an infrastructure in place that allows them to work closely with their operating partners to ensure their interests are aligned with respect to their portfolio company co-investments.

**Indirect Co-Investments.**

***General Structure***. Indirect co-investment structures can get complicated, especially when some fund limited partners and co-investors require blocked tax effect. In such circumstances, and also, if there simply are multiple co-investors, sponsors will typically use alternative investment vehicles (***AIVs***), and/or create a special-purpose co-investment vehicle (***SPV***) through which these diffuse goals can be accommodated. Generally, an SPV will be structured as a pass-through entity such as a Delaware limited partnership or limited liability company, with the sponsor or one of its affiliates acting as the general partner or manager of the SPV. LLCs are often preferred because of the flexibility they afford in crafting governance and economic arrangements within a single entity. However, some U.S. jurisdictions still tax LLCs differently, and LLCs are not always conducive to use by foreign investors, as some foreign jurisdictions do not view LLCs the same way that U.S. tax authorities do. On the other hand, while more cumbersome because of the need for a separate governing entity as general partner, limited partnerships are generally recognized as pass-through entities by the home jurisdiction of inbound foreign investors. See Figures 4 and 5 in Appendix A for illustrations of indirect co-investment structures.

***Blocker Entities***. Regardless of whether the co-investment is done directly or through an SPV, Blockers can be used if a group of investors in the fund or among the co-investors need to avoid flow-through tax treatment. In the SPV model, a Blocker can block both types of investors through the use of a single SPV (an AIV can block both types of fund investors, assuming the fund's LPA allows for AIVs). In the direct investment, the Blocker can be inserted between some of the co-investors and not others through the use of special allocations, in which case expenses of the Blocker clearly become the responsibility of the blocked smaller subset of investors. Whereas, in the indirect SPV structure, it is negotiable whether the expenses of the SPV and the Blocker are borne by (a) the fund, (b) all co-investors, or (c) the blocked co-investors. In the case of blocked and non-blocked fund investors holding their investment through a joint AIV, the expenses of the AIV and the Blocker are likely going to be fund expenses, but some fund LPAs will impose the Blocker costs on only those fund investors who elect to be blocked.

The fund LPA must have the requisite provisions that afford the sponsor the flexibility to implement many possibilities for structuring the fund's and the co-investor's joint investment, or else the structures that ultimately are used may be constrained and less efficient from a tax or administrative standpoint. It is equally important for the sponsor to take into account the possibility that the co-investors' and the fund's ownership and support for the portfolio company may encounter a fork in the road, where the fund takes one route and the co-investor(s) take another. The potential for that eventuality is one reason why the fund sponsor may want the fund's limited partner advisory committee (discussed in "Legal Issues at the Fund Level" below) to bless the structure before it is implemented.

***Practical Considerations.***

*Managing Multiple Entities.* As previously mentioned, the sponsor or one of its affiliates will generally control an SPV used as the co-investment vehicle. The co-investment SPV may be designed for a single portfolio investment, or for multiple portfolio investments. If intended for multiple investments, the SPV may be formed as a separate co-investment fund, in which case it will likely look and feel very much like the fund itself. But if the SPV does not invest in every investment that the fund makes, then the sponsor will have to share investment decision-making with co-investors and all co-investors may not agree on a particular investment. In that case, the sponsor of the fund may be better served with a series co-investment vehicle, where a separate series represents the investor group in different portfolio co-investments, the general partner of each series is an affiliate of the sponsor, and investors have different percentage ownership in each series. Usually, due to all those complications of doing otherwise, a co-investment SPV will have only one investment. For ease of presentation, the remainder of this paper assumes as much.

As a practical matter, sponsors must ensure that they can manage any co-investment vehicle and the fund simultaneously, and to consider whether that presents potential conflicts of interests or increases the sponsor's fiduciary duties. For example, while the co-investment vehicle and the fund may have overlapping investors, the investors will not be identical. In addition, where the co-investment vehicle has only had one investment, there will be no other investments in the co-investment vehicle to absorb any loss attributable to that single investment. These facts may lead to different fiduciary duties for the sponsor and require a limited partner advisory committee to oversee aspects of the co-investment. A sponsor can mitigate its liability exposure relative to co-investment vehicles by limiting co-investors to those sophisticated investors who have the experience and resources to evaluate co-investments and the financial wherewithal to bear the risk of such investments on a stand-alone basis.

*Offering of Securities in SPVs and Blockers.* Investments in an SPV generally occur around the time the fund acquires its interest in the portfolio company, although investments can be structured to occur in multiple closings if the SPV will have a large number of co-investors or to account for timing issues. To avoid securities laws issues and greatly reduce compliance costs, all co-investors of an SPV should be accredited, which allows an SPV to make sales under SEC Rule 506's safe harbor, and enables an SPV to represent to the portfolio company that the SPV and all of its investors are accredited. From the perspective of the portfolio company's securities issuance, the SPV will generally need to be looked through, as the SPV is an entity formed for the purpose of making the investment in the portfolio company, and is disregarded from a securities law perspective in the context of the portfolio company's compliance.

*Portfolio Company Rights.* Even if structured as an indirect investment through an SPV, co-investors will likely ask that certain minority shareholder rights (discussed in "Direct Co-Investments - Practical Considerations" above) be "passed through" in the SPV's governing document. In particular, a co-investor in an SPV will look to preserve economic rights and avoid dilution by requesting that a pro-rata portion of preemptive rights be allocated to each investor in the SPV. Investors in the SPV may also request a "pass-through" of information rights, tag-along rights and consent rights. Importantly, the SPV's governing document will need to address the potential for an unequal exercise of pass-through rights by co-investors, in particular with respect to the exercise of preemptive rights that cause disproportionate investments, separated by time and valuation, in the SPV. In designing the SPV, the fund sponsor needs to decide whether rights (such as preemptive rights) that are not exercised at the SPV by its investors in full will be passed to other investors in the SPV, or "cross-over" and flow to the fund.[8] Another strategy a co-investor may employ is to require side-by-side treatment with the sponsor's investment in the portfolio company, such that, for example, a sponsor cannot exit its investment without simultaneously selling the SPV's investment on the same terms and conditions. A fund sponsor needs to carefully consider the fine balance between its fiduciary responsibilities to its investors, who own an entire portfolio through a vehicle with a finite life, and its fiduciary responsibilities to investors in the SPV, which owns a single investment and which has an unlimited term.

**Costs Relating to Structuring Co-Investments.**

***Co-Investment Vehicle Formation and Maintenance*.** The structure of co-investment vehicles can be complex, depending on the tax structure of the portfolio company and the profile of the co-investors. Sponsors should consider who bears the cost of analyzing co-investment vehicle structures, establishing them and documenting the arrangements, as well as the maintenance of their legal existence and their accounting. Fund documents typically treat the costs relating to the formation of AIVs or parallel funds set up to accommodate a particular fund investor as a fund expense. Unlike an SPV, parallel vehicles invest in parallel with the fund in all investments. An AIV, like an SPV, generally invests in only one investment, but is established for the benefit of fund investors, and the fact that it may be used and that the fund will bear its costs is disclosed in the fund offering documents. Questions may arise as to whether the maintenance of the single-investment SPV co-investment vehicle should be borne only by investors in the SPV or by the fund. Usually, the outcome of this rumination is that it is not a fund expense, but there may be some justification under the particular facts and circumstances for it effectively being, at least in part, a fund expense. For example, the sponsor could negotiate with the portfolio company to cover the cost of maintaining the legal existence and the accounting of the co-investment entities on the theory that such costs are part of the costs of providing equity financing to the portfolio company. If the portfolio company pays them, then the fund is effectively bearing a portion of those costs.

In settling the expense issue, sponsors need to take into account that SPV co-investment vehicles generally have an infinite life while the fund has a finite life, and the SPV generally does not allow for future mandatory capital calls. Depending on its constituents and whether the sponsor is an RIA, the SPV may need to be audited. Even if not audited, it certainly will need to prepare and file tax returns. These routine operating costs need to be funded. The sponsor could advance such operating costs for the co-investment vehicles and be repaid when there is a liquidity event with respect to the underlying investment of the co-investment vehicles (ask whether the sponsor should charge interest on its capital before repayment). However, the risk of such an arrangement is then on the sponsor if the return on investment for the co-investment vehicles is not sufficient to cover all of the sponsor's costs. Alternatively, the SPV could provide for capital calls for operating expenses, with appropriate penalty for failure to fund, of course.

> OPERATING PARTNERS ARE TYPICALLY HAND-SELECTED BY SPONSORS TO FILL A NICHE WITH A PORTFOLIO COMPANY OR ITS INDUSTRY. SPONSORS SHOULD HAVE AN INFRASTRUCTURE IN PLACE THAT ALLOWS THEM TO WORK CLOSELY WITH THEIR OPERATING PARTNERS TO ENSURE THEIR INTERESTS ARE ALIGNED WITH RESPECT TO THEIR PORTFOLIO COMPANY CO-INVESTMENTS.

***Co-Investors' Expenses***. Sponsors also should consider who bears the costs of co-investors reviewing deal documents and documents relating to the co-investment structure. Whether the co-investment is direct or indirect, it is common for each co-investor to bear its proportionate share of an SPV's costs or, in the case of a direct investment, its own costs of investment, unless there is an agreement with the sponsor or a portfolio company to pick up such costs as part of the investment transaction. The costs incurred by the co-investor in reviewing the SPV documentation may be distinguishable from "deal expenses," which are typically allocated between the fund and the SPV, or, in the case of a direct investment, borne separately by the fund and the other direct investors, each of which pays its own expenses. See "Economic Issues - Allocating of Deal Expenses" below for additional information on deal expenses.

## Legal Issues at the Fund Level

Numerous legal issues arise in connection with a sponsor's establishment of a co-investment vehicle while simultaneously managing a fund that will invest in the same portfolio investment. As a minimum, the fund's offering memorandum and LPA must disclose the possibility of co-investments to fund investors and potential conflicts of interest related thereto, including the possibility that some fund investors and other third parties may be granted the opportunity to co-invest with the fund, and that co-investors may have different (i.e., more favorable) economic terms. The fund's governing documents should also address generally how the sponsor will allocate investment opportunities between the fund and co-investors.

> As a practical matter, sponsors must ensure that they can manage any co-investment vehicle and the fund simultaneously, and to consider whether doing so presents potential conflicts of interests or increases the sponsor's fiduciary duties.

If the sponsor grants any kind of definitive co-investment rights, they are typically set forth in a side letter with the sponsor. When actual co-investment opportunities arise, the sponsor will need to ensure that it complies with all of its various side-letter obligations. The sponsor will also need to ensure that it has satisfied its fiduciary duty to the fund under state corporate law (and the Investment Advisers Act of 1940, as amended, if the sponsor is an RIA) as well as its contractual undertakings to the side-letter recipients. Issues related to the sponsor's fiduciary duty typically arise in connection with the selection of the limited number of investors who will be afforded co-investment rights (by implication, excluding certain other investors), the relative size of the fund's investment in the applicable portfolio company as compared to the size of the co-investment, and the operation of the co-investment vehicle alongside the fund.

Sponsors will need to be mindful of the potential for other, ongoing conflicts of interest in connection with co-investment activities. For example, litigation concerning a portfolio company may arise primarily due to the actions of a co-investor. Or, the actions of the portfolio company or the SPV may give rise to a tax audit of either or both of them. Each of these examples could increase the costs of the portfolio investment that are passed onto the fund by virtue of its pro-rata investment. Sponsors should consider in advance how best to address these issues vis-à-vis its fiduciary duties to the fund, such as limiting reimbursement of SPV expenses.

Sponsors will need to consider whether, and to what extent, co-investment arrangements must or should be disclosed to the limited partner advisory committees (***LPAC***) of their funds. The LPAC will need a sufficient level of detail about the arrangements, and in some cases may have voting rights in relation to co-investments. Sponsors who are RIAs must provide adequate disclosures about their co-investment arrangements in their Form ADVs and have adequate policies and procedures about such arrangements in their compliance manuals. Due consideration should also be given to the qualification of the fund and/or the SPV as a venture capital operating company (***VCOC***) for ERISA purposes. VCOC rules are complex, and an SPV that has strong rights may undermine the ability of the fund's investment in the portfolio company to be a qualifying investment for VCOC purposes.

## Economic Issues

**Management Fees and Carry.** No matter how the co-investment is structured, questions always arise about whether the sponsor should be entitled to a management fee or carry on amounts co-invested. Investors often seek co-investment opportunities to reduce the overall expense ratio of their investments. As a result, the majority of co-investment rights are without additional economics – either management fee or carried interest – to the sponsor, on the theory that the sponsor is already being compensated for managing the portfolio company into which the co-investment dollars are flowing, and the fee/carry-free investment solidifies the relationship with the investor like very little else can. Some co-investors actually prefer that the sponsor receive a carry on co-investment dollars, albeit at a reduced level, to ensure the sponsor is properly incented to make the portfolio company a profitable investment (which the sponsor might not otherwise be in the context of the entire fund, which has multiple investments in its portfolio).

SPV structures facilitate charging management fees and carry on co-investment dollars at the outset or in the future, whereas direct investments are usually without such sponsor economics. This is frequently the subject of negotiation in establishing the SPV. If a management fee or carry is payable by the SPV, it would generally be structured in the same manner as the fund, except that the carry would be isolated and not offset by losses on other investments and is payable upon disposition of the investment regardless of whether all capital has yet been returned in the fund. This potential should be disclosed in the fund offering documents, as it creates the potential for a substantial conflict of interest. If miscalculated, the SPV carry is generally subject to clawback by the co-investment vehicle in the same fashion as the fund's carry distributions (but the risks of miscalculation are slim, since the carry becomes payable upon the exit and is part of the exit transaction's funds flow statement). Sponsors need to address how indemnity escrows will be treated for carry and clawback calculation purposes. The majority of the time, the cash is what counts, and escrowed indemnity dollars are not taken into account in determining SPV carry until released.

Indirect co-investment structures can get complicated, especially when some fund limited partners and co-investors require blocked tax effect. In such circumstances, and also, if there simply are multiple co-investors, sponsors will typically use alternative investment vehicles, and/or create a special-purpose co-investment vehicle through which these diffuse goals can be accommodated.

**Transaction Fees.** Sponsors may charge a transaction fee to the portfolio company in connection with a co-investment in the portfolio company or its sale to a subsequent buyer. Sponsors should consider whether such transaction fees, if they are charged against the co-investors' investment dollars and do not "hit" the fund's investment, should offset any other fees (such as management fees) that may be due from investors in the fund or in the SPV, and whether not having the offset creates an inherent conflict of interest. If transaction fees are intended with respect to co-investments, it is best to anticipate that and deal with them directly in the fund's LPA. In addition, caution is warranted with respect to transaction fees generally, as recent public statements by certain SEC staff members allude to a heightened level of regulatory scrutiny of transaction fees charged by sponsors. In the SEC's view, such compensation may be tantamount to 'veiled' brokerage commissions or investment banking fees, which would require their recipient to be a registered broker-dealer. Sponsors should review carefully their transaction-fee practices to ensure compliance with applicable legal requirements.

**Allocation of Deal Expenses.** Generally, deal expenses are the fees and expenses incurred by the sponsor or the fund in investigating and negotiating the investment in the portfolio company. Sponsors will typically allocate deal expenses among the funds making the investment and the co-investment vehicles established for the investment on a pro rata basis based on investment amounts. Deal expenses are typically fund expenses that are borne by all fund investors. Some direct co-investors, such as operating partners, commonly do not bear any deal expenses (other than their own counsel expenses) on the ingress transaction, but do usually bear transaction costs on the exit (as discussed below). Sponsors should examine such arrangements to ensure they are void of conflicts of interests.

**Allocation of Exit Transaction Expenses.** When a portfolio company is liquidated, the shareholders of the portfolio company will bear their pro-rata share of the expenses related to the liquidity transaction. These expenses include legal fees and costs of investment bankers. Direct co-investors will bear their pro rata share of these expenses as a shareholder of the portfolio company. Indirect co-investors holding their interests through an SPV will bear their pro rata share of such expenses that are allocated to the co-investment entity as an indirect shareholder of the portfolio company. The allocation of exit transaction expenses between the fund and the SPV will usually be based on the number of shares or percentage interest they own in the portfolio company, which is generally proportionate to the amounts invested in the portfolio company by each.

## Conclusion

Sponsors should embrace the reality that demand for co-investment opportunities is not going away any time soon, and that co-investment opportunities present a myriad of conflicts of interests, fiduciary duties and governance issues to consider. By developing a comprehensive approach to co-investment issues, sponsors will build value for their investors and goodwill in the investor community and generally better protect their fund. In addition to a relatively complicated set of economic and governance issues involved in structuring co-investments, with the ever-changing legal landscape, a constant stream of regulatory issues must be considered, particularly under federal securities laws, tax laws and ERISA regulations. All of these issues are manageable. A sponsor should address them head-on, and develop a cohesive and fulfilling, yet flexible, co-investment strategy that benefits the fund and its investors, the co-investors and the portfolio companies. Otherwise, opportunities to support portfolio investments and build relationships through a co-investment program will be limited.

## Endnotes

1. In this paper, the term "sponsor" refers to the private equity fund's sponsor and manager.
2. The observations in this paper are those of the authors only and do not reflect a detailed study of the market or any third-party data.
3. Co-investment rights are different from club deals. Club deals typically involve a group of PE Firms who pool their assets together to acquire a company collectively. Club deals allow PE Firms to own larger portfolio companies than each would have been able to acquire on its own. In most instances, each PE Firm would be active in the negotiation of the club deal investment. In contrast to club deals, co-investment rights give an investor the ability to make a minority investment, directly or indirectly, in a portfolio company. In addition, in a co-investment scenario, the fund offering the co-investment opportunity is more likely than not able to negotiate and complete the investment on its own and then offer the co-investment opportunity to the co-investors.
4. Sponsors who are registered investment advisers (***RIAs***) must have a Compliance Manual that includes policies and procedures relating to co-investments. The final stance of a fund's LPA and the related side letters on co-investment rights should be reflected in and consistent with such policies and procedures. In the annual review and update of the Compliance Manual, the sponsor's compliance officer should review whether co-investments, if any, were offered and consummated in a manner consistent with the Compliance Manual's policies and procedures.
5. Sponsors should ensure that their insurance coverages cover the risk of liability from co-investors relying on their evaluation and diligence materials. Non-reliance covenants and disclaimers are, like many liability waivers, only effective some of the time. A variety of factors, including knowledge of the co-investors' evaluative capabilities and actual reliance, can overcome the liability waiver in a non-reliance covenant and result in sponsor liability despite contractual statements of non-reliance.
6. The ability of a law firm or accounting firm to avoid liability through a non-reliance letter is generally accepted because their engagement is with the sponsor and it is the sponsor that provides the information to them, all of which enhances the sponsor's risk exposure. Discussing insurance coverage with a risk mitigation specialist (insurance broker, insurance counsel, etc.) would be advisable to ensure an insurance backstop to this risk.
7. While a co-investor may desire its own Blocker, if a holding company exists for the fund, it is rare that a separate Blocker would be created for the co-investor.
8. If the sponsor controls the SPV's exercise of rights **and** there is cross-over, the sponsor has created an inherent conflict of interest that will be problematic from a compliance standpoint.


## About the Authors.

*Pepper Hamilton partners Julia D. Corelli (corellij@pepperlaw.com) and P. Thao Le (lep@pepperlaw.com), both members of the firm's Corporate and Securities Practice Group, gratefully acknowledge the contributions to this article by senior associate Phillip T. Mellet (melletp@pepperlaw.com), also a member of the firm's Corporate and Securities Practice Group and senior associate Paul C. Dunn (dunnp@pepperlaw.com) who is a member of the firm's Financial Services Practice Group.*

*Ms. Corelli co-chairs the firm's Commercial Department and its Funds Services Group, which is part of the firm's Investment Funds Industry Group (IFIG), and is vice chair of the firm's Executive Committee. Ms. Corelli concentrates her practice in private investment fund formation, operations and compliance matters, private equity and venture capital investment transactions, and investment fund principal compensation and planning.*

*Ms. Le is a member of the IFIG working committee and concentrates her practice in private investment fund formation, operations and compliance matters, private equity investments and mergers and acquisitions.*

*Mr. Mellet concentrates his practice in the areas of mergers and acquisitions, private equity, governance matters and securities law compliance. Mr. Dunn concentrates his practice in investment management matters with a focus on the formation and ongoing representation of hedge funds, private equity funds, real estate funds and registered investment companies.*

## Appendix A
## Diagrams of Co-Investment Structures

**Figure 1: Direct Co-Investment in C-Corp. Portfolio Company**

In this structure, co-investors invest on a side-by-side basis with the fund directly in the portfolio company.

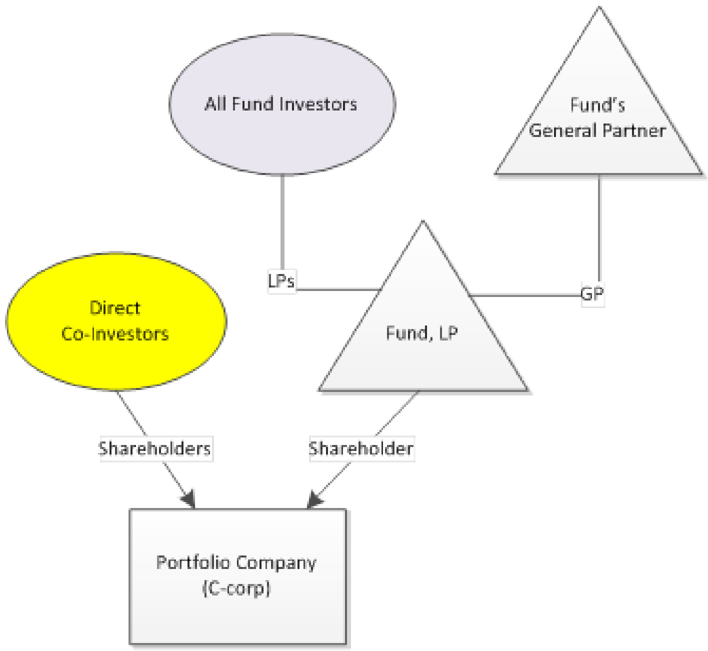


**Figure 2: Direct Co-Investment in C-Corp. Holding Company and Pass-Through Portfolio Company**

In this structure, co-investors invest on a side-by-side basis with the fund directly in the c-corp. holding company. In addition, certain co-investors (such as a fund operating partner) have a direct co-investment in the portfolio company, which is a pass-through entity (i.e., LLC). (If all co-investors invested through the holding company, there would be no other member of the portfolio company, and it would be a disregarded entity for tax, meaning that its assets, liabilities and operations would be treated for tax as those of the holding company.)

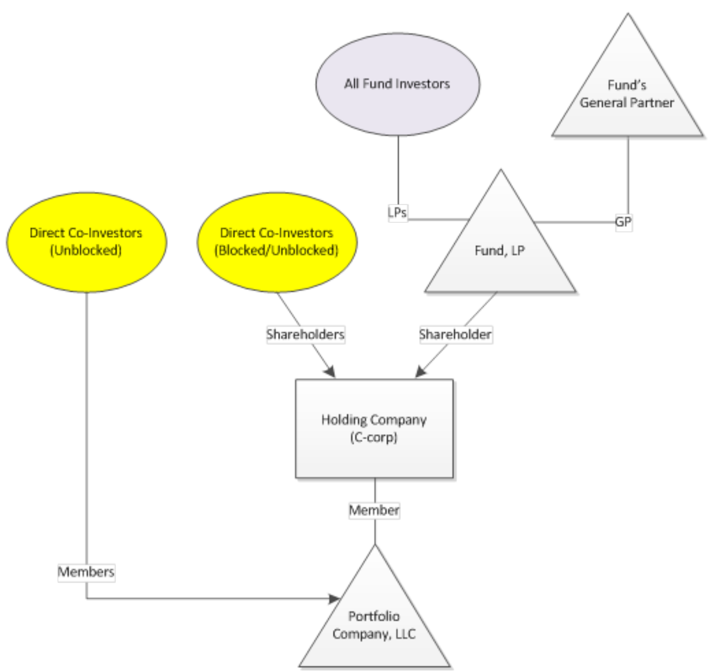

**Figure 3: Direct Co-Investment in Pass-Through Portfolio Company with Use of Blocker**

This structure uses a Blocker to facilitate the investment of co-investors who need a Blocker due to the portfolio company being a pass-through entity (i.e., LLC). The Blocker invests on a side-by-side basis with (a) the fund, and (b) those co-investors who can invest directly in a pass-through entity. Direct co-investors in the Blocker may be required to grant the fund's general partner a proxy to control the vote of their interests in the Blocker and thus control more fully the portfolio company. Similarly, direct co-investors who invest directly in the portfolio company may be required to grant a proxy to the fund's general partner so it can control the vote of their interests in the portfolio company. Either proxy allows the fund's general partner to control the direct and indirect interests of the co-investors in the portfolio company. In this case, the portfolio company cannot be a disregarded entity for tax as there is more than one member.

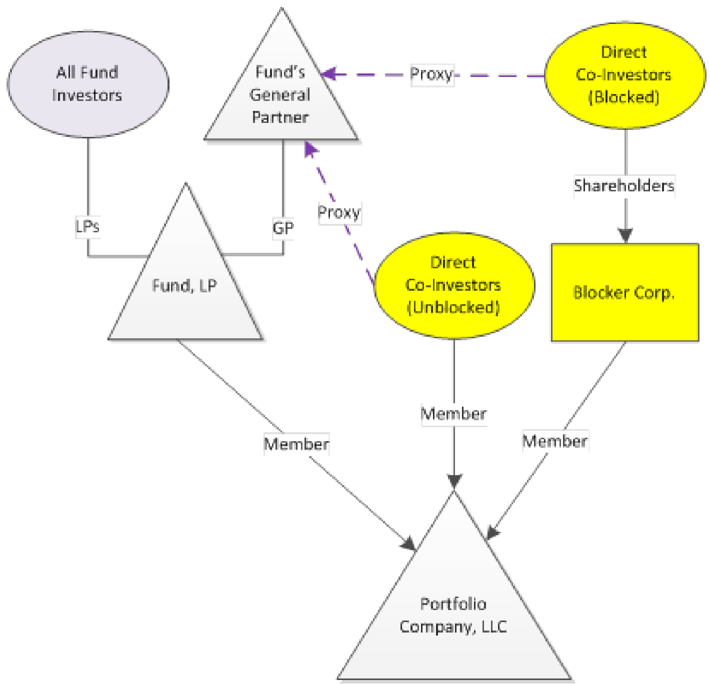


**Figure 4: Indirect Co-Investment in Pass-Through Portfolio Company**

In this structure, the fund and SPV invest on a side-by-side basis in the pass-through portfolio company. This structure assumes that all investors in the fund and all co-investors can invest in pass-through entities.

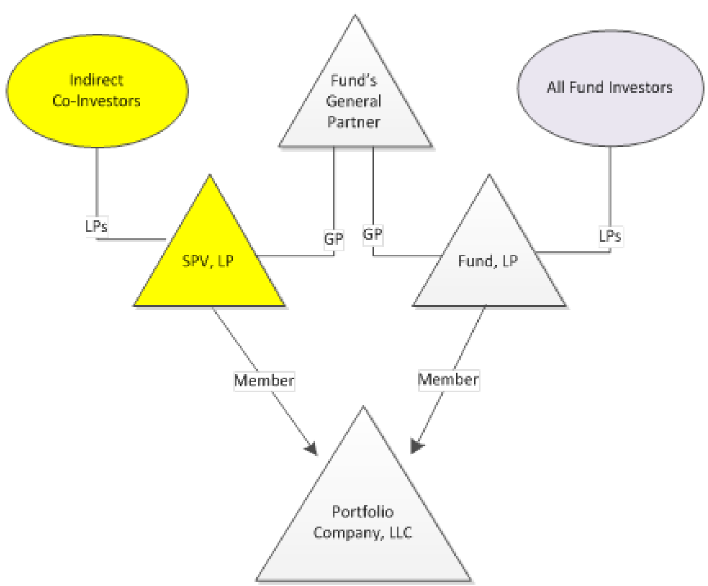

**Figure 5: Indirect Co-Investment in Pass-Through Portfolio Company with Use of Blocker, AIV and SPV Entities**

In this structure, an AIV, SPV and Blocker are used to facilitate investment in a portfolio company that is a pass-through entity (i.e., an LLC) where some fund investors elect to be blocked and some accept pass-through income tax consequences with respect to this investment. The fund is **not** itself an investor. Rather, all of the fund investors hold their interests in this portfolio company through the AIV. The SPV likewise has blocked and unblocked co-investors in it. The AIV and SPV invest on a side-by-side basis with a portion of each of their interests running through the Blocker. Investors in the AIV or SPV who desire to be blocked for this investment will have one class of interests and will be allocated and distributed all income that comes from the ownership of the interest held through the Blocker, and those investors in the AIV and the SPV who do not want to be blocked will have an indirect investment in the portfolio company through only the AIV and SPV, respectively, and will be allocated and distributed all income, deductions, etc. that come from the AIV's and SPV's direct ownership in the portfolio company.