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PROTECTING AGAINST THE UNINTENDED WHEN MAKING A PRIVATE EQUITY CO-INVESTMENT

BY JAMES A. DEEKEN, AKIN GUMP STRAUSS HAUER & FELD LLP

With the current economy's tightening of debt financing markets, constrained equity fundraising and increased desire to diversify risk, the use of co-investment capital has become an increasingly used stopgap that allows funds and sponsors to capitalize transactions. However, an investor needs to be aware of the potential for co-investments to go awry due to errors in documentation, even if the underlying investments themselves are successful.

The traditional co-investment structure is one whereby minority equity investors invest with a lead equity investor directly in a portfolio company. In other cases, a private equity fund sponsor may desire to control the voting and dispositive power of the co-investors by having them invest through a "co-investment partnership" controlled by an affiliate of the fund. In a third situation, a co-investment partnership is used, but voting and dispositive decisions are essentially "passed through" the partnership to the limited partners -- each limited partner is thus able to exercise its pro rata share of preemptive rights, co-sale rights, rights of first refusal, voting and other rights that the co-investment partnership has in the underlying portfolio company. A brief summary of relevant issues follows.

Board issues: Although a board seat can provide a minority investor a "seat at the table" in major decisions and in the proliferation of portfolio company information, an investor needs to be aware that any board designee nominated by it is not on the board to protect the specific interests of the co-investor, but rather holds a fiduciary duty to all equityholders generally. The imposition of this fiduciary duty may limit the ability of a board designee to take actions that would primarily only protect the interests of the co-investor and to share confidential information relating to the portfolio company. Because of these limitations, investors will often attempt, as well, to attain information rights and, in some cases, stockholder consent rights. If a board seat is obtained, it is important to obtain a voting agreement from the lead equity investors that is carefully crafted to avoid loopholes that are at times exploited by lead equity investors, whereby they would agree to vote in favor of the investor's board designee.

Stockholder consent rights: Aside from any large-scale consent rights, an investor will often obtain a consent right for an amendment to any applicable documents that would affect any negotiated rights specific to such investor. The issue of consent for amendment to the applicable governing documents is an item of particular note, as minority investors will often negotiate protective provisions, but overlook a general amendment section providing that the agreements may be amended with the consent of a majority of the stockholders.

Preemptive rights: While preemptive rights can provide for the ability of an investor to maintain its pro rata ownership, it is important to ensure that the co-investor will have access to capital in the event of a sudden equity round issuance. For example, if preemptive rights provide that the co-investor needs to provide notice of an election to exercise preemptive rights within 10 days, but the co-investor is an investment partnership with partnership documents that require it to give 15 days' notice to its investors, the preemptive rights provision will not work in the co-investor's favor. The same issue would present itself in the case of a co-investor that is an investment partnership with an expired investment period that no longer allows it to draw down capital.

Rights of first refusal/co-sale rights: Issues similar to preemptive rights that affect percentage ownership in a portfolio company are rights of first refusal and co-sale rights. A transfer that triggers a right of first refusal should be drafted to apply to indirect transfers as well. At times, equityholders have been able to evade the application of such rights by first transferring the securities to a special-purpose wholly owned affiliate (under an exception for affiliate transfers) and then selling the equity in that affiliate to a third party rather than to the underlying securities themselves.

Drag-along rights issues: A lead investor will typically negotiate for a co-investor to agree to a "drag-along" rights provision whereby the co-investor would be obligated to join in an equity sale of portfolio company stock. A co-investor will typically negotiate for (i) protections on pro rata treatment, ensuring that its indemnification liabilities are, at least, limited to its sale proceeds and, unless the co-investor is a large stockholder or one with active involvement, (ii) a limitation on representations and warranties and other agreements that it would need to make in connection with a drag-along sale. A co-investor may also negotiate provisions that provide that drag-along provisions cannot be used until a certain number of years have elapsed and/or a certain internal rate of return or other metric is attained.

Co-investment partnership economics: In the event that an investment grows in value, the ability of a limited partner to protect its pro rata interest directly in the co-investment partnership and indirect interest in the underlying portfolio company grows in importance. While preemptive rights can aid this, a complicating factor in the context of a co-investment partnership is that there are essentially two layers of entities involved in a co-investment partnership structure: the partnership and the underlying portfolio company. Preemptive rights at the partnership level alone are not sufficient, as a party could avoid the implication of the partnership preemptive rights by having the portfolio company sell additional securities to another affiliate of the sponsor. Thus, a well-advised co-investor will typically tailor an appropriately drafted remedy for these risks.

Co-investment partnership accounting: Private equity partnership funds will typically use "fund investment by fund investment" accounting to track ownership in various portfolio companies, as opposed to the "common pot" approach wherein investors would have a static percentage ownership in the fund across all portfolio companies as a whole. While the "common pot" may seem attractive for a co-investment, as there is only one portfolio company, such an approach can overlook the potential that the co-investment partnership may make numerous "follow-on investments" to the original investment in a different class of securities and/or at differing valuations. In those cases, it may be desirable to track the pro rata ownerships in such follow-on investments by treating each as a separate fund investment (or as separate classes of partnership interests).

Modified "fund" co-investment partnership issues: Many of the issues that present themselves in the context of co-investment partnerships are adoptions of standard issues that present themselves in a fund context and are centered around issues, such as the presence or scope of (i) mandatory additional draw-downs; (ii) performance or management fees; (iii) partnership expenses; (iv) in-kind distributions; (v) general partner removal; and (vi) transfer restrictions.

Partnership pass-through rights issues: Since pass-through rights allow limited partners the ability to cause the partnership to take certain actions, an issue arises as to whether a limited partner might be considered to be participating in control in a manner that would erode limited liability for the partner. Fortunately, a number of states have statutes on this point. For example, Delaware law provides that a limited partner "causing the taking of any action with respect to, among other things ... making determinations in connection with partnership investments; and such other matters stated in the partnership agreement" will not cause a limited partner to be participating in the control of the business of the partnership. However, it is advisable that competent counsel be consulted to ensure that any pass-through partnership provisions are worded appropriately on this point.

A successful review of co-investment arrangements that protects against unintended results with the potential of undermining otherwise-hard-earned financial results requires a careful review and consideration of the above and other relevant issues that present themselves in applicable co-investment transaction documents.

-- James A. Deeken is a partner in the investment funds and private equity practice groups of Akin Gump Strauss Hauer & Feld LLP. He may be contacted by e-mail at jdeeken@akingump.com.

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