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Private Equity Co-investments Guide: Issues to Spot and Raise When Making a Direct Co-investment (and Which Often Are Not Addressed in the Drafts You Receive)

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Investors of many different stripes are eager to participate in private equity transactions as equity co-investors alongside private equity sponsors who source, lead, and execute on investment opportunities. These investors hail from portions of the financial landscape as diverse as hedge funds, strategic investors, high net worth individuals, and select limited partners in the sponsors' funds. Some investment funds themselves are dedicated to making equity co-investments as their primary investment mandate. Direct co-investment opportunities are prized in these investor communities because they offer the potential for superior economic return. Direct co-investments reside outside of the lead sponsor's fund. As a result, a co-investor's economic return is not reduced by the carried interest paid by the fund to the sponsor. The trade-off, if there is one, is that investments made outside the fund may result in greater concentration of risk than an investment made in the fund itself, as co-investors will typically invest in only some (and perhaps only one) of the investments made by the fund. Co-investors can mitigate this risk by attempting to build their own portfolio of co-investments, similar to the way a lead sponsor builds a portfolio within each fund.

The market for co-investment opportunities can be quite competitive. A user-friendly reputation and an ability to execute on deals quickly can be an important factor in attracting and securing these opportunities. Co-investors typically enter the scene later in the overall timeline of a transaction, after the sponsor has sourced the deal, completed substantial due diligence, and made significant progress in negotiating terms with the target company. Given these circumstances, co-investors may be asked to review and respond to draft documentation on short turnaround times, making decisions about what truly matters, what is a "nice-to-have" and what they can live without in the deal's terms.

This practice note is intended to provide a guide for co-investors to identify and understand key topics that should be raised in negotiating terms for their co-investments, and which initial drafts of the co-investment documents often do not address or address inadequately. This practice note contemplates a transaction structured as a minority co-investment of typically less than 10% in a private company in the United States. Needless to say, this guide is not intended to cover every issue that could arise in co-investment transactions. Other issues may be relevant depending on various factors, including, for instance, the type of security being acquired, the specific economic terms of the security, and the structure and size of the investment. The focus of this practice note is to highlight select items that are typically not addressed in the initial drafts of co-investment documents and which most lead sponsors, when asked, will address. The Appendix to this practice note is a checklist of other items that commonly appear (or should appear) in co-investment documentation.

Preemptive Rights—Holes to Plug

Even before closing a co-investment, it is not too early to think about your rights to make future investments and maintain your current ownership percentage. So-called preemptive rights or participation rights to subscribe for your pro rata portion (based on your current ownership position) of future issuances of equity and equity equivalents are almost universally offered to co-investors. You should insist on them in almost every circumstance. There are, however, at least two key aspects of preemptive rights that are often not addressed appropriately from a co-investor's perspective in the initial drafts of co-investment documentation. These aspects are discussed below.

Issuances by Subsidiaries

Preemptive rights should apply not only to issuances by the top-level company in which you are investing (i.e., the issuer), but also to issuances by any of its current or future subsidiaries. Issuers in private equity holding structures are often shell-like holding companies with all or substantially all business operations being conducted through one or more subsidiaries. Imagine a scenario where a subsidiary issues a preferred class of equity to the lead sponsor or its affiliates. Absent a preemptive right over issuances by subsidiaries, the lead sponsor has made itself senior to your investment both financially (via the preference) and structurally (as its new investment is at a level in the structure closer to the income generating assets than yours).

Issuances "in Connection with" Future Acquisitions

Among the various common exceptions to preemptive rights is one for issuances of equity related to a future acquisition of another business. This exception is often drafted as an issuance made "in connection with" an acquisition. This drafting is ambiguous and allows for two interpretations of the scope of equity issuances exempted from your preemptive rights: (1) equity issued to the target or its owners as consideration for the acquisition itself and (2) equity issued to raise capital to fund the purchase price for the acquisition. An exception to your preemptive rights in the case of (1) is common and acceptable dilution, but you should not be excluded from participating in (2), because it is a capital raise. The good news is that the drafting "fix" is relatively simple: change "in connection with" to "as consideration for" and you have limited the scope of the exception to (1) only.

Special Purpose or Co-investment Vehicles

Many co-investment transactions are structured as investments in co-invest vehicles, or "aggregator" entities, or other special purpose entities, rather than as investments by a co-investor directly alongside the lead sponsor into the same issuer entity (referred to below as the "primary issuer"). These vehicles are typically controlled and managed by an affiliate of the lead sponsor, as the managing member or general partner of the vehicle. This structure concentrates broad authority in the hands of the lead sponsor over the vehicle and the decisions it makes about the voting and transfer of the primary issuer's equity that it holds. Here again, this structure presents at least two key issues that are often not addressed in the initial drafts of co-investment documentation, from a co-investor's perspective.

Pass It On Up

The operative language for many of the key substantive co-investor rights (such as tagalong rights and preemptive rights and even rights to tax distributions) will reside in the primary issuer's governing documents. Unless these rights are "passed through" to your co-investment vehicle, you will have no independent right to determine whether to cause the co-investment vehicle to exercise them - that decision will belong to the managing member (or general partner) of the vehicle. You should request that these rights be passed through, or back-to-back rights be implemented into, the governing documents of your co-investment vehicle, so that you can effectively utilize them and make your own decision about how and when to utilize them.

Don't Hand Off the Keys

You likely decided to co-invest with the lead sponsor at least in part because of a relationship with the sponsor, which gives you a comfort level that the sponsor will do the right thing by you. But what if the sponsor assigns or delegates its rights to act as managing member or general partner of your vehicle? The governing documents for most vehicles impose tight transfer restrictions on your ability to transfer your rights, but none on the managing member or general partner to transfer or delegate its rights and authority to act in that role. You should request that the managing member (or general partner) remain the lead sponsor (or one of its affiliates) for the life of your investment or at least until the lead sponsor exits the investment to a substantial degree.

Future Restrictions—Don't Drag Me into a Non-compete

Being a co-investor almost universally means being subject to a drag-along provision, where the lead sponsor, or some coalition led by it, has the right to compel other investors to exit the investment on terms and timing chosen by the lead sponsor. Drag-along provisions typically contain broadly worded covenants requiring the dragged investors to take all actions requested, or execute all documents, or otherwise not impede the exit transaction. These provisions are also usually coupled with a power of attorney allowing the dragging investor(s) to act for the dragged investor(s). Many financial sponsors will themselves not agree to restrain their future investment options via a non-compete provision in favor of a purchaser as part of an exit transaction. They will view, appropriately, such restrictions on their future investment options as inconsistent with their fiduciary duties to their own investors. Some will agree to a limited non-solicit of the business's employees after an exit. Co-investors who are themselves financial investors or investment funds often will find their motives and needs aligned with the lead sponsor on these issues. Such provisions can be even more critical issues for other varieties of co-investors, such as a strategic investor, who cannot become restricted from competing with the divested business, if that industry is the same as or adjacent to its own, or barred from effectively hiring in its industry or adjacent ones. You should request that these broadly worded covenants exclude any requirement to become bound by a non-compete or non-solicit or similar restrictive covenant. At a minimum, you should not be required to sign any restrictive covenant if the lead sponsor will not also be bound by one of like duration and scope. If you or your affiliates have any commercial relationship with the divested company (such as a license, supply agreement, etc.)—and you may if you are a strategic investor—you or they should also not be required to modify its terms or extend or renew the commercial agreement by operation of these broadly worded covenants; those items should be expressly excluded from the drag-along's requirements as well.

Board Service—Protect Your Seat, and Know Who Is Indemnifying You

If your co-investment is substantial enough that you will be entitled to appoint a representative to the primary issuer's board of managers (or similar governing body), or you otherwise are offered a board seat and are willing to serve, here are a few items that do not always find their way into the co-investment documentation, but should.

Board Committees—Don't Be Left Out in the Cold

If board service is vital to your investment thesis, review the board's authority to delegate its powers to one or more board committees. If this occurs, and you do not have a right to sit on such committee(s), then the full board acting by (for instance) majority vote, could delegate its power to consider a fundamental matter, like a sale process, recapitalization or debt financing, to a committee, not nominate your representative to sit on the committee, and thereby effectively nullify your board seat as to those fundamental matters. Consider requesting that your board seat entitle you to sit on all board committees.

Subsidiary Boards

The same issue and risk applies to the boards of subsidiaries of the primary issuer. If a significant part of the overall business is conducted by one or more subsidiaries, substantial decisions affecting the business can be made by the board(s) of those subsidiaries. If your right to a board seat does not extend to a seat on those subsidiary boards as well, your ability to monitor and influence the direction of the business can be significantly compromised.

Know Your Indemnitor

If you have indemnification available to you from multiple sources (such as your fund or its affiliates and the issuer on whose board you will sit), it is important to request language in the issuer's governing documents delineating which indemnitor is primarily responsible for a claim related to your board service. Otherwise, your fund or its affiliates may be required to fund indemnification obligations before seeking contribution from the primary issuer based on the Delaware Chancery Court's decision in *Levy v. HLI Operating Company, Inc.* in 2007. Its implications have been written about and analyzed extensively in the intervening years, but surprisingly, you will still find initial drafts of co-investment documents which do not include so-called *Levy* case language. This language specifically delineates which indemnitor is on the hook first for an indemnity claim by a director. The primary issuer itself, or its subsidiaries, are stated to be first in line, and all other sources (including your fund, your employer or its affiliates) are expressly acknowledged and agreed to be the indemnitors of last resort. You should also request a director indemnification agreement from the primary issuer as part of your board service. That way, your rights to indemnification and advancement of expenses are a contractual promise from the primary issuer to you which cannot be modified later without your consent.

Management or Advisory Fees—Avoid Surprise Increases

You will frequently find that the lead sponsor has already included provisions protecting co-investors against transactions between the issuer (or its subsidiaries), on the one hand, and the lead sponsor and its other affiliates, on the other hand, unless the transaction is blessed by some coalition of other investors (e.g., a majority of the minority) or is a bona fide transaction on so-called arm's length terms. If some variant of that protection is not already in your co-investment documentation, you should ask for it. In cases where the protection is based on the transaction being (or not being) on arm's length terms, that is a prime opportunity to raise the issue of management or advisory fees paid to the lead sponsor or its affiliates. Various levels of management fees could be defended as "market" and therefore on arm's length terms, even if greater than the rate of management fees that pertained when you invested. Most sponsors will agree to limit the magnitude of management fees payable by a portfolio company to a defined amount or to at least a defined methodology (such as, management fees may increase based on reaching certain EBITDA thresholds, up to an ultimate cap on the amount of fees), which is disclosed up front, before you invest, and which cannot be changed without consent of a majority of the other investors. You should also request to see a copy of the management or advisory agreement itself to confirm that it terminates automatically on an exit transaction (so that the sponsor is not entitled to additional consideration, or a buyout, for agreeing to terminate it) and confirm that the lead sponsor (or its affiliates) is not indemnified for its own gross negligence or misconduct.

IPO Structuring—Don't Lose Out on the "Up-C" Benefits

For issuers that are limited liability companies or partnerships, nearly all co-investment documents will contemplate a potential restructuring of the company in anticipation of an IPO and will include provisions requiring members or limited partners to take actions to facilitate the conversion to corporate form and associated restructuring. Fewer will expressly contemplate an IPO structure known as an "Up-C." Whether contemplated in the documents or not, an Up-C structure is available on the table as a potential IPO structuring option, and the lead sponsor can always decide to pursue it, via its powers to manage the issuer, as managing member or general partner, or via control of a majority of its board seats. In brief, an Up-C structure involves creating a new corporation that becomes a member of the issuer (or limited partner in an issuer that is a partnership). The new corporation then issues shares to the public in the IPO and all pre-IPO members (or limited partners) remain as such, and the limited liability company (or partnership) maintains its status as a pass-through entity for tax purposes. This structure allows for the public to participate in the equity in a commonly accepted and understood manner (i.e., via an investment in a corporation) while also allowing the pre-IPO investors to continue to benefit from the issuer remaining a pass-through entity for tax purposes and being subject to a single layer of tax. The pre-IPO investors will then be given the option to exchange the issuer's private interests for equity of the public vehicle from time to time; each such exchange is a taxable event that results in an increase in the basis of the assets of the issuer (i.e., an amortizable tax shield). It is a relatively common practice for the public shareholders to pay for this benefit via an agreement with some subset of the pre-IPO investor(s) called a tax receivable agreement. There is no obligation that all pre-IPO investors receive a tax receivable agreement. You should consider including language in your co-investment documents to the effect that, if the sponsor contemplates causing the issuer to engage in a public offering, the sponsor will discuss in good faith with you whether to utilize an Up-C structure and, if one is utilized, and if the sponsor or any affiliate receives or benefits from a tax receivable agreement, you and your affiliates will have the opportunity to receive or benefit from a tax receivable agreement on like terms if you desire.

Conclusion

In conclusion, being aware of some of these common issues and how to address them will enable you to focus your evaluation of co-investment opportunities and the ensuing negotiations of the co-investment terms. Raising some of these questions and making some of these requests earlier on in your pursuit of a co-investment opportunity will also help to avoid surprises or unanticipated results down the road in your relationship with the lead sponsor and/or the target company.

Appendix: Co-Investments Checklist

- **Preemptive rights**
  - Rights cover issuances of equity and equity-like instruments and convertible debt
  - Rights cover issuances by the issuer and its subsidiaries
  - Rights cover issuances to anyone (sponsor and third parties)
  - Pro rata formula excludes unvested equity in denominator and numerator
  - Right of overallotment if not all eligible purchasers want to purchase their full pro rata amount
  - Exclusion for employee equity pool is capped at x%
  - Exclusion for other issuances do not include issuances to the sponsor or its affiliates
- **Transfer provisions**
  - Transfers to affiliates, and for estate planning by individuals, are permitted
- **Tag-along or co-sale rights**
  - Rights apply for transfers by any investor (preferred approach) or transfers by sponsor or any of its affiliates
  - You are permitted to sell your pro rata portion (i.e., the same percentage of your holdings as is being sold by the proposed transferor)

- If the proposed buyer does not want to purchase all of the offered shares, all proposed transferors should be cut back pro rata, based on their relative ownership
- You receive the same price and form of consideration (or should have the right to elect to receive the same form) as the proposed transferors
- You will be required to make representations and warranties only with respect to title to your equity, your authority to sell, and absence of liens
- You will not be held liable for more than your pro rata share (based on ownership) of claims regarding representations made by the issuer and will not be liable for more than the proceeds you receive

- **Drag-along obligations**
  - You receive the same price and form of consideration (or should have the right to elect to receive the same form) as the proposed transferors
  - Other co-investors should also be subject to the drag-along on the same terms
  - You should not be forced into a non-compete agreement or other similar restrictive covenants
  - You will be required to make representations and warranties only with respect to title to your equity, your authority to sell, and absence of liens
  - You will not be held liable for more than your pro rata share (based on ownership) of claims regarding representations made by the issuer and will not be liable for more than the proceeds you receive
- **Corporate or business opportunities**
  - Confirm that your obligation to present these opportunities to the issuer has been disclaimed
- **Board or board observers**
  - Are any board fees being paid?
  - Are board members' out of pocket expenses being reimbursed?
  - Do your rights extend to board committees and to boards of subsidiaries?
  - Will a sell-down of your position eliminate your board rights?
  - Is your board seat transferable with your equity?
  - Is there *Levy* case language?
  - Confirm that there is exculpation language and indemnification and expense advancement to benefit your designees
  - For LLCs and partnerships, have fiduciary duties been disclaimed to the maximum extent allowed by applicable state law?
  - If action by written consent of the board is allowed, it is required to be unanimous?
  - What is the quorum requirement and required threshold to transact board business at a meeting?
- **Transactions with affiliates**
  - Is there protection against all affiliate agreements and transactions (except those disclosed at signing) (preferred approach) or only against those not on arm's length terms?
  - Is there a management or advisory agreement with the sponsor? Does it terminate automatically on an exit?
- **Information and access rights**
  - Monthly and quarterly unaudited financials
  - Annual audited financials
  - Annual budget
  - Other financial and operating information as may be reasonably requested by you
  - Right to meet and discuss business performance with management

- **Registration rights**
  - If any investor has registration rights, you should have piggyback rights on any registration post-IPO (and on any IPO to the extent any other investors are selling shares in the IPO), whether by the company for its own account or arising from a demand right exercised by another shareholder
  - With respect to any underwriter cutbacks, you should be treated on a *pari passu* and pro rata basis with the lead sponsor
  - If there are no registration rights, there should be a covenant to the effect that if registration rights are granted in the future, you will receive customary piggyback rights on a *pari passu* and pro rata basis
- **IPO structuring**
  - Consider the Up-C structure
- **Amendments and waivers**
  - You should be protected against amendments that disproportionately impact you (or your class of investor) as compared to other investors (or classes)
  - You should be protected against amendments that [materially] adversely affect your rights and obligations
  - You should be protected against amendments that impact your specific or special rights (e.g., a board seat or board observer)

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- Side Letter for a Private Equity Fund
- Subscription Agreement for a Private Equity Fund
- Private Equity Fee and Expense Disclosure
- Investor Remedies
- What Private Equity Firms Should Be Thinking about When It Comes to Preserving the Attorney-Client Privilege?