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Co-Investments

Co-Investments in the Hedge Fund Context: Structuring Considerations and Material Terms (Part Two of Three)

By Lily Chang

Co-investments have been a regular feature of private equity investing for decades but historically have played a smaller role in the world of hedge funds. However, as the range of strategies pursued by hedge funds increases – in particular, as more hedge fund assets are committed to activism, distressed and other illiquid strategies – co-investments are assuming a more prominent place in the hedge fund industry. In an effort to help hedge fund managers assess the role of co-investments in their investment strategies and operating frameworks, The Hedge Fund Law Report is publishing a three-part series on the structure, terms and risks of hedge fund co-investments. This article, the second in the series, describes the three general approaches to structuring co-investments; discusses the five factors that most directly affect management fee levels on co-investments; outlines the applicable incentive fee structures; details common liquidity or lockup arrangements; and highlights relevant fiduciary duty and insider trading considerations.

The first article in this series discussed five reasons why hedge fund managers offer co-investments; two reasons why investors may be interested in co-investments; the "market" for how co-investments are handled during the negotiation of initial fund investments; investment strategies that lend themselves to co-investments; and types of investors that are appropriate for co-investments. See "Co-Investments Enable Hedge Fund Managers to Pursue Illiquid Opportunities While Avoiding Style Drift (Part One of Three)," The Hedge Fund Law Report, Vol. 7, No. 7 (Feb. 21, 2014). The third article will discuss regulatory and other risks in connection with co-investments.

Structuring Co-Investments

Like the structures of hedge funds, the structures of co-investments are driven primarily by the tax, regulatory, investment and operating considerations of managers and investors, as well as the dynamics of the investment itself. Broadly, co-investments may be structured in three ways: under the terms of a contract; via a separate vehicle; or via a separate series of a primary fund that is structured (or amended) to accommodate additional series.

Contractual Approach

With respect to the contractual approach, Robert Sutton, a partner at Kirkland & Ellis LLP, remarked, "You sometimes see co-investors coming in directly as shareholders of the target company, but subject to a management, voting or similar agreement that gives the primary fund sponsor control in terms of deciding when and on what terms to exit the investment." In this context, a contract effectively serves as a proxy granting the hedge fund manager control over relevant decisions with respect to the co-investment – timing of entry and exit, position size and changes to position size, voting of shares, other uses of position for activist or other reasons, etc.

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Separate Vehicles

Separate vehicles organized for co-investments have different features depending on the circumstances. They may be: onshore or offshore; have one investor or multiple investors; be focused on a single investment or multiple related investments; and be organized simultaneous with or subsequent to the primary fund.

Onshore, Sutton explained, separate co-investment vehicles are typically organized as Delaware limited partnerships or limited liability companies, much like onshore hedge funds. Similarly, offshore, choice of entity for co-investment vehicles is driven by the same tax and regulatory considerations as apply when choosing entities for offshore hedge funds. As Stephanie Breslow, a partner at Schulte Roth & Zabel LLP, explained, "The same types of considerations that applied in setting up the hedge fund apply in setting up the co-investment vehicle. For instance, if you have an offshore group of investors and it made sense to have a Cayman vehicle for the main investment," it would likely make sense to use a similar Cayman vehicle for the co-investment. For more on structuring Cayman investment vehicles, see "2013 Walkers Fundamentals Hedge Fund Seminar Highlights Trends in Cayman Fund Structures and Terms, Cayman and Irish Fund Governance Developments, Conflicts of Interest, Use of Advisory Boards and Fund Borrowing," The Hedge Fund Law Report, Vol. 7, No. 1 (Jan. 9, 2014). Other jurisdictions where co-investment vehicles are organized include Luxembourg, Ireland, Mauritius, Bermuda and the British Virgin Islands.

For U.S. tax-exempt investors that participate in co-investment opportunities, managers will sometimes establish offshore "blocker" corporations into which the tax-exempt investors invest, which in turn invest in the underlying investment opportunity or in another vehicle (like a pooling or master fund) that invests in the underlying opportunity. For more on the use of blockers to minimize certain categories of tax for certain investors, see "Foundation for Accounting Education's '2010 Hedge Funds and Alternative Investments' Conference Focuses on Taxation of Hedge Funds and Hedge Fund Managers, Structuring, Valuation, Risk Management, Due Diligence, Insurance and Regulatory Developments," The Hedge Fund Law Report, Vol. 3, No. 34 (Aug. 27, 2010) ("Blockers are corporations used to insulate investors from unrelated business taxable income (UBTI) and effectively connected income (ECI). (Generally, UBTI is income to a tax-exempt organization from a trade or business that is not substantially related to the organization's exempt purpose.) With a blocker, tax-exempt investors invest directly in an offshore corporation which then invests in an underlying hedge fund. This structure prevents the UBTI from flowing through to the tax-exempt investor."). See also "Bill Redefining 'Acquisition Indebtedness' for UBTI Purposes Could Diminish, But Likely Would Not Eliminate, Utility of 'Blockers' in Hedge Fund Structures," The Hedge Fund Law Report, Vol. 3, No. 9 (Mar. 4, 2010) ("[T]ax-exempt investors invest directly in the offshore corporation, which then invests in the underlying hedge fund. The offshore corporation prevents the UBTI from flowing through to the tax-exempt investor, and the tax-exempt investor receives interests, dividends and capital gains in the form of tax-free dividends. The blocker generally is domiciled in a low-tax or no-tax jurisdiction (e.g., the Cayman Islands, BVI, Bermuda, etc.) to avoid entity level tax. In addition, the blocker relies on the 'securities trading' safe harbor in IRC Section 864(b) to avoid being treated as engaged in a U.S. 'trade or business' and thereby to avoid taxation of capital gains from the disposition of U.S. securities."). See "MFA Presses for Guidance on Securities Trading Safe Harbor," The Hedge Fund Law Report, Vol. 1, No. 11 (May 13, 2008).

Separate co-investment vehicles may be organized to accommodate a single investor or multiple investors. When organized for a single investor, such vehicles may be structured as, among other things, managed accounts or funds of one. On managed accounts and funds of one, and the benefits and burdens of each, see "RCA Symposium Clarifies Current Market Practice on Side Letters, Conflicts of Interest, Insider Trading Investigations, Whistleblowers, FATCA and Use of Managed Accounts Versus Funds of One (Part Two of Two)," The Hedge Fund Law Report, Vol. 6, No. 25 (Jun. 20, 2013). When organized to accommodate multiple investors, available structures include those typically used for commingled hedge funds.

Also, separate co-investment vehicles may be focused on a single investment or multiple related investments, and may be organized at the same time as the primary fund or after – and the target and timing dynamics are related. Typically, co-investment vehicles organized at the same time as the primary fund are organized to access multiple opportunities during the life of the fund. For example, such a co-investment vehicle may be an "overflow" fund that enables the manager to make a larger investment in an opportunity where the primary fund has reached a company, industry or geographic investment limit. On the other hand, co-investment vehicles are sometimes organized after the primary fund to capitalize on one-off opportunities, or a series of opportunities. An example of a one-off opportunity may be an IPO or secondary offering by a "hot" company. A series of opportunities may involve the ability to purchase over time securities from different levels of a company's capital structure, all pursuant to a single investment thesis such as a "loan-to-own" strategy. See "From Lender to Shareholder: How to Make Your Equity Work Harder for You," The Hedge Fund Law Report, Vol. 3, No. 20 (May 21, 2010).

Timothy Clark, a partner at O'Melveny & Myers LLP, noted that organizing co-investment vehicles at the same time as the primary fund is more common in the private equity context, where the fact and types of co-investment are typically more foreseeable. Organizing co-investment vehicles after the primary fund, Clark continued, is more common in the hedge fund context, where co-investments are more typically offered in connection with ad hoc opportunities.

Regarding documentation, Breslow noted that separate co-investment vehicles typically "will have governing documents, whether they take the form of Cayman articles or a Delaware limited partnership agreement. There may be some sort of offering document – shorter than those for your primary funds – that goes with the articles or partnership agreement, and a subscription document."

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Separate Series

While less common than separate vehicles – especially for older funds – Clark mentioned that some more recent funds have been structured to facilitate the launch of additional series or share classes without creating a new fund. Such additional series or classes can, in certain circumstances, be used to accommodate co-investors. One onshore structure used for this purpose is the series limited liability company. See "Understanding the Benefits and Uses of Series LLCs for Hedge Fund Managers," The Hedge Fund Law Report, Vol. 5, No. 43 (Nov. 15, 2012). And one offshore structure used for this purpose is the segregated portfolio company. See "Cayman Islands Segregated Portfolio Companies: New Case Law Highlights Attractions for Promoters and Hedge Fund Managers," The Hedge Fund Law Report, Vol. 5, No. 29 (Jul. 26, 2012); and "Structuring, Regulatory and Tax Guidance for Asia-Based Hedge Fund Managers Seeking to Raise Capital from U.S. Investors (Part One of Two)," The Hedge Fund Law Report, Vol. 5, No. 31 (Aug. 9, 2012) ("A Cayman Islands segregated portfolio company is a type of Cayman Islands exempted company which can create and operate one or more segregated portfolios with the benefit of statutory segregation of assets and liabilities between portfolios. Each portfolio is operated as a separate 'sub-fund' and may be managed by a separate fund manager or employ a different investment strategy from other segregated portfolios of the same company. See 'Cayman Court of Appeal Holds that Soft Wind-Down of One or More Segregated Portfolios of a Segregated Portfolio Company Does Not In and Of Itself Justify a Judicial Winding-Up of the Entire Company,' The Hedge Fund Law Report, Vol. 5, No. 23 (Jun. 8, 2012). However, each sub-fund will not be entitled to be classified separately for U.S. federal income tax purposes. This may also be the case in other jurisdictions. For instance, it is unclear under Singapore law whether each cell in a segregated portfolio company would be regarded as a separate taxable entity. The current position appears to be that tax incentives (and the qualifying criteria for such tax incentives) are applied on a company-wide basis.").

Fees

Management Fee Levels

Generally – and with exceptions – management fees on co-investments are lower than management fees on primary hedge funds. However, the presence or absence of a management fee, and specific fee levels, are influenced by at least the following five factors.

Extent to Which Manager Needs Co-Investment to Pursue Identified Opportunity

As Breslow explained, "Sometimes the hedge fund manager needs the co-investment to occur because to get to the desired outcome, the rest of the position needs to be placed. If that's the case and the investor has enough bargaining power, potentially there might be low or, in some cases, no fees. In other cases, the co-investment is a pure opportunity for the investor, and the manager does not need it. In such cases, it is less likely that the manager will be willing to make that investment for free."

Whether Co-Investors Are Current Fund Investors

Whether the investor offered the co-investment opportunity is already invested in the manager's primary fund may also

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impact the co-investment fee structure. Jeffrey Tabak, a partner at Weil, Gotshal & Manges LLP, outlined this dynamic: "Most co-investments are at a reduced fee or no fee at all, but it depends on the situation. If the manager finds a co-investment opportunity and offers it to the fund's limited partners, those limited partners are already paying fees to the manager. Contrast that with a situation where an investor enters into a separate vehicle to invest in everything the manager does, but it is not otherwise an investor in the fund: that vehicle will clearly have fees involved in it, both management fees and carried interest."

Investor Size

As in the case of private funds generally, investor and investment size play important roles in fee levels. Typically, larger investors or larger investments are charged lower fees on the larger (and ideally longer in time) asset base; from the manager perspective, such an arrangement can yield more dollars and other non-cash benefits (like access, reputation enhancement and so on). "As with hedge funds in general," Breslow said, "if it's a large investor riding a large ticket, it has a better chance of negotiating a lower rate than if it's a pooled group of small investors."

Whether Co-Investment Opportunity Is Current or Prospective

In the case of co-investment vehicles organized to take advantage of prospective opportunities – vehicles, that is, organized around a theme or thesis as opposed to a specific investment opportunity, or vehicles organized with the intention of "legging" into an activist, distressed or other position over time – management fees may be charged only on capital that is invested (i.e., called) or deployed, as opposed to capital that is merely committed. Breslow observed, "When a sponsor offers a fund whose mandate is to take advantage of co-investment opportunities that have not yet been identified, sometimes the management fee on that vehicle will only be on the capital that's actually deployed as opposed to being on the capital that's promised, because it's not clear whether the money will get spent." See "Can a Capital On Call Funding Structure Fit the Hedge Fund Business Model?," The Hedge Fund Law Report, Vol. 2, No. 44 (Nov. 5, 2009).

Time Sensitivity of Co-Investment Opportunity

Generally, if the co-investment opportunity is time-sensitive and the manager needs to raise co-investment capital quickly, the manager may be amenable to lower fees. Sutton noted, "Particularly in one-off structures, co-investment opportunities often come up on a relatively short timeframe. The manager needs the money and the investor has the money. That can lead to very investor-friendly terms – unless, of course, the manager has ample interest from potential co-investors."

Incentive Fee Structures

"Sometimes co-investment vehicles will have a private equity carry structure as opposed to a hedge fund carry structure," Breslow explained. "In a classic hedge fund, you are taking your carry on a mark-to-market basis every year with a high water mark. Sometimes the co-investment vehicle will instead take carry based on how much you actually realize – the cash on cash return when you liquidate the position. You have to be sensitive to tax considerations – in particular, anti-deferral rules – if you are trying to structure private equity-style carry in co-investment situations."

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In circumstances where investors are in a strong bargaining position for size, timing or other reasons, managers will sometimes apply the benefit of a high water mark in the primary fund to the co-investment vehicle. This effectively increases the minimum performance required for the manager to earn incentive compensation on the co-investment. Jason Kaplan, a partner at Schulte Roth & Zabel LLP, noted, "We have seen some managers that are underwater in their primary funds offer netting arrangements for the co-investment deal, where they would count their high water mark in their primary funds towards the fees charged in the co-investment vehicle, and not charge fees until they made up those losses." See "What Happens to High Water Marks When Managers Restructure Hedge Funds?," The Hedge Fund Law Report, Vol. 2, No. 43 (Oct. 29, 2009).

Liquidity

Generally, the liquidity of the co-investment contract or vehicle – that is, the length of time during which invested capital is locked up – should match the anticipated time required to consummate the investment thesis. On average, Kaplan noted, this typically works out to a two- to three-year lockup period for co-investment capital.

Breslow cited two strategies in which co-investments often come into play – activism and distressed – and explained why multiyear lockups are appropriate in each case. "Once you have decided to do something activist with a portfolio company, like a proxy fight or a tender offer," she said, "you need enough time to get that done, get board members elected and then have shareholders or directors begin to make the changes that you hope the company would make. That could potentially take several years. In a distressed strategy, if you are trying to get to a particular place in a bankruptcy, often what you are trying to do is own a fulcrum security, which is whichever level of the capital structure will end up controlling the company's stake in the bankruptcy. There can be a two- to three-year period for that kind of activity." Moreover, Breslow noted that following a restructuring, the co-investment vehicle may wind up with an equity or equity-like security that it may make sense to sell or hold. Any co-investment vehicle therefore should be structured to accommodate the range of potential outcomes, including continued ownership and active involvement with the restructured company on the one hand, and relatively rapid disposal of the restructured equity on the other hand. See "Liquidity for Post-Reorganization Securities Under Section 1145 of the Bankruptcy Code," The Hedge Fund Law Report, Vol. 3, No. 26 (Jul. 1, 2010).

Even in less liquid or longer lockup co-investments vehicles, co-investors may negotiate – at the time of the establishment of the vehicle or after – to transfer their rights or positions in the vehicle, Sutton noted. In addition, investors may wish to sell their interests in co-investment vehicles in secondary transactions or on secondary markets. Managers should anticipate such potential preferences on the part of investors and address in the documentation of the co-investment vehicle the rights of investors to engage in secondary market transactions. See "Schulte Partner Stephanie Breslow Discusses Tools for Managing Hedge Fund Crises Caused by Liquidity Problems, Poor Performance or Regulatory Issues," The Hedge Fund Law Report, Vol. 7, No. 1 (Jan. 9, 2014) (subsection entitled "Secondary Market Transactions").

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Fiduciary Duty

Sutton noted that he would expect co-investments "to be made on a pari passu basis" with the primary fund because any other arrangement may result in a better deal for co-investors than fund investors (to the extent the two sets of investors do not overlap), which may conflict with the manager's fiduciary duty to fund investors. Sutton provided the following example: "Occasionally, a co-investment opportunity may arise after the manager's primary funds and other accounts have made their initial investment. For example, the primary fund may have invested up to its cap, but the manager determines that there are control-based advantages to acquiring more. In such a circumstance, the manager should consider whether making that additional investment places the primary fund at a disadvantage, for example, because the new investment would be senior to the primary fund's investment." See "What Is the Current State of Delaware Law on the Scope of Fiduciary Duties Owed by Hedge Fund Managers to Their Funds and Investors? (Part Two of Two)," The Hedge Fund Law Report, Vol. 6, No. 37 (Sep. 26, 2013).

Insider Trading

Finally, managers should be sensitive to insider trading considerations and the potential for material nonpublic information to flow to co-investors – especially in activist situations. As Breslow explained, "One thing you have to think about in the activist context is whether you are going to tell the investors coming into co-investment vehicles the identity of the asset that you are targeting. If you are doing a blind pool co-investment vehicle, then all you are saying is, 'I have a target in this general industry.' The investor does not know what the target is, does not have material nonpublic information and does not need to be restricted from trading. If, on the other hand, you are telling co-investors who your target is – and if you are not yet otherwise in a position where you have done public filings so everyone knows who your target is – then it becomes important to get a standstill from those investors, and confidentiality undertakings, so they cannot disclose the information you have given them and they cannot trade on it." See "How Can Hedge Fund Managers Apply the Law of Insider Trading to Address Hedge Fund Industry-Specific Insider Trading Risks? (Part Two of Two)," Hedge Fund Law Report, Vol. 6, No. 32 (Aug. 15, 2013).