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LENDING STRATEGIES

Simultaneous Management of PE and Private Credit Funds: Techniques for Properly Allocating Investments, Fees and Employees (Part Two of Two)

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To appeal to investors and exploit investment opportunities, fund managers will often operate multiple funds at once that may even span asset classes. That practice introduces the possibility that those funds will begin accessing common resources as part of their efforts, including sharing investors, exploring opportunities in similar industries and leveraging the expertise of the same group of employees at the firm. In anticipation of that problem, sponsors need to develop sound policies and procedures for addressing those instances and properly allocating the contested items between their PE and private credit funds.

The Private Equity Law Report spoke with a number of industry experts in a series of interviews on the array of issues that can arise when simultaneously managing PE and private credit funds. This second article in a two-part series describes techniques for mitigating conflicts that can arise when allocating shared investment opportunities, expenses and employees' time between a sponsor's PE and private credit funds. The first article detailed how parallel investment strategies introduce risks associated with the spread of material nonpublic information and how sponsors can prevent it from tainting their investment efforts.

See our two-part series on avoiding parallel fund conflicts: "New SBAI Standards and Case Study Provide Guidance for Mitigating Conflicts" (May 5, 2020); and "Specific PE, Real Estate and Private Credit Issues and Mitigation Tips" (May 12, 2020).

Investment Opportunities

Asset Ambiguity

A major topic PE sponsors need to confront when deciding to launch a private credit strategy is how they will allocate investment opportunities between their PE and credit funds. "At first glance, it appears easy – my credit fund will invest in debt instruments, and my PE fund will invest in equity," posited Ropes & Gray partner Jason E. Brown. It rarely ends up being that easy and requires careful foresight and planning by fund managers, he advised.

See "ACA 2017 Fund Manager Compliance Survey Addresses Investment Allocations, Conflicts of Interest and Valuation (Part Two of Two)" (Feb. 1, 2018).

The first issue is that certain assets have ambiguous traits that can make them well-suited to either – or both – types of funds, such as preferred equity or certain structured products, Brown explained. Distressed assets are another area where managers have multiple options, added Simpson Thacher partner Jason Herman. "Whether you place those deals in a distressed credit fund or share them with a PE fund, it's important to consider how different types of deals would be shared or allocated between the two sides of the house."

Another factor that can further muddle the issue is that a sponsor's existing PE funds will often have mandates broad enough to include some sort of convertible debt or debt-like instrument, noted Steven Schwab, director of legal and CCO at Thoma Bravo. "Unfortunately, those provisions are often not very flexible because it's very typical for a PE fund to have a priority allocation," agreed Ropes & Gray partner Jessica Taylor O'Mary. "That makes it important when launching a new private credit fund to go back and look at your priority and allocation language in your existing PE funds with that lens to ensure you have enough flexibility to add to your platform in this way," she recommended.

Policies and Procedures

As with most problems, sound policies and procedures are a critical tool for ensuring the fair and reasonable allocation of investments between credit and PE funds. "Allocation policies should take into account a number of different factors, so a sponsor can decide which fund should get it or in what percentage it should be allocated between the different funds," Herman explained, recommending that, when crafting those allocation procedures, sponsors consider how any overflow capacity will be allocated to co-investors or funds along the way.

See "The Co-Investment Continuum: Structures That Give GPs More Control and Discretion (Part One of Two)" (Apr. 21, 2020).

When preparing a set of policies and procedures, there are a number of factors that fund managers can weigh as part of the process of determining how to allocate opportunities to funds with overlapping investment objectives. Each factor has its relative pros and cons, however. For example, many managers choose to allocate primarily on the basis of available capital, said Schulte Roth partner Stephanie R. Breslow. That is a favored approach because, all things equal, it ultimately allows deals to be meted somewhat equally between funds instead of them all being directed to one of them.

Allocating based on available capital also has drawbacks, however, because differing fund management techniques can introduce inconsistencies in how available capital is determined at the fund level, Schwab cautioned. "Credit funds are often levered, and the credit facilities backing them have different advance rates; therefore, the concept of available capital can fluctuate significantly depending on the type of debt used or put in the back-leverage facility," he explained. That means available capital is not always the best approach, he continued, and any manager using it should "create a standardized way to calculate available capital so it is the same each time across funds."

Therefore, in lieu of allocating based on available capital, some managers will apportion investments based on fund timeline, expected returns, the nature of the investment, the length of time before one would be expected to realize on the investment, etc., Brown observed. There is no particular right or wrong answer, Breslow emphasized, provided that managers factor the relative pros and cons of each into their criteria and ultimately disclose the final approach to their investors. "With proper disclosure, you come up with any formula and make that work," she added.

Determining clear allocation criteria is an important first step, but another facet of the process is deciding whether to hardwire the criteria or leave enough vagueness for a governing body to implement them on a case-by-case basis. Contractually hardwiring the criteria is quite difficult and rather rare, O'Mary noted, as it brings various potential problems into play. "If you are not launching both funds at the same time, then there is a risk the second fund will not ever get raised in the allocation criteria. Also, what if circumstances change or the types of anticipated investments do not arise?" she posited.

Therefore, as people project forward and try to deal with uncertainty, there is generally a tendency to try to maintain flexibility as much as possible, O'Mary reasoned. Echoing that point, Brown explained that "arguably the more common approach is to keep the criteria vague such that potentially conflicting transactions are brought to the attention of decision makers – often an allocation committee – with decisions on how to allocate investments made based on factors in the policies."

Finally, disclosure is important to the process. That goes beyond disclosing the allocation procedures to a credit or PE fund's investors, however. In reality, it is also important that the LPs and LP advisory committees of each respective fund are aware that multiple funds with overlapping investment objectives exist and that opportunities will need to be allocated accordingly, Schwab suggested. "That is something we stress to our potential LPs when they are evaluating a fund, so we include the internal allocation document in the data room for them to review."

See "LPAC by Design: Six Recommendations for GPs to Define LPAC Features During Fund Formation" (Feb. 25, 2020).

Expenses

Another grey area for fund managers to confront is how to allocate expenses between funds for services used by each in connection with their investments or ongoing operations. Multiple types of fees can be incurred in those situations, including for the services of independent consultants or for research reports, Brown noted. In addition, there can be broken deal expenses "for experts hired to help underwrite the credit or to analyze the company before the deal fell through," Herman added.

See "SEC Enforcement Action Involving 'Broken Deal' Expenses Emphasizes the Importance of Proper Allocation and Disclosure" (Jul. 9, 2015).

Simultaneous Incurrence

The most straightforward situation is if a sponsor's PE and credit funds take advantage of a service (*e.g.*, a third-party research report) when simultaneously investing in the same portfolio company, Herman said. "A firm may have a multitude of vehicles that participate in deals together; therefore, the firm has to make a decision in real time as to how to best allocate expenses that would apply to those different funds and vehicles," he suggested. The real-time occurrence at least makes it clearer that issues need to be addressed between the participating funds.

One way to "grease the skids" for smoother allocations in the future is by exercising foresight when drafting each fund's governing documents. "We try to make the litany of permitted partnership expenses the same across each of a sponsor's funds, which makes it easier to just divide, for example, a consulting report by either net asset value or some other reasonable metric," suggested Schulte Roth partner Daniel F. Hunter. "That is theoretical," he cautioned, "because, in practice, those governing documents tend to vary based on one being negotiated more than the other."

Firms also need to document a consistent approach in their policies and procedures, which is then clearly disclosed to investors. Arguably the most equitable approach would be "for each fund to bear the expense of a service in proportion to their respective 'skin in the game' in the deal," Breslow suggested. That approach at least ensures each fund incurs costs appropriately scaled to the size of its investment.

Staggered Investing

Alternatively, multiple affiliated funds may invest – or consider investing – in the same portfolio company, but on a staggered timeline. "It can become tricky, for example, if a PE fund incurs significant due diligence costs reviewing a potential investment, but then the deal dies. The credit fund can invest in the same company mostly using the PE fund's research paid for by the PE investors," Brown suggested. Building on that example, O'Mary chimed in by noting that "the data may be stale or the credit fund may not use all of it, so how do you assess how much of it – if any – the credit fund should reimburse?"

For risks from improperly allocating expenses, see "Allegations That Private Equity Manager Misallocated Expenses and Failed to Disclose Conflicts of Interest Result in Nearly $3 Million in Disgorgement and Fines" (Jan. 17, 2019); and "Improper Expense Allocations and Careless Valuation Practices Result in Nearly $4 Million in Fines and Disgorgement for BDC Adviser" (Jan. 10, 2019).

The timing variable is material, as it may lend credence to developing a policy that causes expenses to be borne by whichever fund initiated the incurrence of the expenses. "If, for example, a PE fund orders a research report to support its pursuit of a deal, the time and cost associated with creating the document will occur regardless of whether a credit fund eventually lends to the same company," Schwab noted. "There's no incremental increase in time of the investment team members on the equity side to create a document that the debt team could possibly be looking at," he reasoned.

For that approach to be effective, however, it needs to be clearly disclosed to a funds' investors so there is no ambiguity or confusion in the future, Schwab continued. Echoing the point, Brown observed that "some firms will include disclosures to their LPs along the lines of 'in some cases we may do some work on one of our portfolio companies, and if another fund uses that research, there is not going to be a sharing of costs.'" That is certainly the cleanest and easiest way of avoiding the issue, although LPs may raise questions about how frequently it will occur and what costs are at stake.

Time of Team Members

An ongoing concern of LPs is whether critical employees of the fund manager are directing sufficient time and attention to the fund's portfolio to generate the desired returns. "Investors are sometimes concerned about whether fund managers have enough skin the game and are directing enough energy to the fund in which they are invested," O'Mary confirmed.

The concern is starker with investors in private credit funds, in part because of their different risk profiles and fee rates compared to PE funds, O'Mary opined. "PE investors tend not to be concerned, to be honest, because they're paying higher fees and are reaping higher returns, so PE investors tend to think they are pretty aligned with the sponsor," she explained. Where sponsor team members overlap between a PE fund and a credit fund, those disparate opportunities for earning carried interest can engender apprehension among private credit investors.

The easiest way to avoid the issue is to have entirely separate team members operate PE and credit funds – "people who do credit do credit; people who do PE do PE," Brown summarized. At times that demarcation occurs organically because "certain people become interested in making private credit a more significant part of their portfolio than others and drift in that direction," O'Mary explained. Other times, it is achieved by hiring an entire separate team when launching a new credit strategy, Schwab noted. "You really need a specialty team that understands the asset class and can properly underwrite those investments," he added.

For more on allocating personnel, see "How to Evaluate Portfolio Companies for Independent Contractor Misclassification Liability" (Jun. 18, 2019); and "Independent Contractors vs. Employees: What Fund Managers Must Know About Classifying Staff and Protecting Proprietary Secrets" (Jun. 2, 2016).

Not all fund managers can have separate teams for each fund, however, particularly if they are smaller or if certain key individuals possess unique sector- or company-level expertise essential to the success of multiple funds. In that case, fund governing documents will include carefully drafted key person provisions delineating how specific individuals' time will be allocated. "Fund documents will specify that Person A will spend a majority of his or her time on the fund or substantially all of his or her time on the fund, with criteria for ensuring those standards are met," Breslow explained.

The scope of key person provisions can vary dramatically, however, with potential repercussions depending on how the manager's funds and operations evolve over time. Sometimes investors negotiate tightly worded provisions that leave little flexibility, O'Mary observed. "That can be a problem when a manager attempts to launch a future fund, so that is one thing we are mindful of at the outset."

Other times, fund managers will successfully negotiate intentionally vague key person provisions that afford them room to maneuver going forward, Breslow noted. "Some managers secure language simply saying the team will dedicate their efforts to all the funds launched by the firm, in which case you have actually no assurance about a particular person on a particular fund," she explained. Either approach – not to mention variations in between – is possible, she continued, but that is something to be negotiated with investors.

See "Current Scope of PE-Specific Side Letter Provisions: MFN Clauses, Overcall Limitations and Key Person Provisions (Part Three of Three)" (Apr. 2, 2019).