“Side Car” Funds – Solutions for Sourcing Capital

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Given the current market volatility resulting from the COVID-19 pandemic, many fund sponsors are seeking additional sources of capital to protect and/or enhance their investment portfolios. There are many circumstances in which a fund sponsor may desire additional capital in the current environment, including where a fund is past its investment period and has little dry powder available to be called or recycled to support existing investments, where follow-on, diversification or other investment limitations have been reached, and/or where a fund sponsor identifies new investment opportunities that require a larger capital source than may be provided by an existing fund. There are various ways in which fund sponsors may seek additional capital sources to resolve such scenarios, including by forming additional “side car” funds, such as annex funds, top-up funds, overage funds and/or single investment co-investment funds, each of which have similar but distinct advantages and disadvantages, and all of which require consideration and analysis from fund sponsors to ensure the formation of such vehicles does not breach any of the fund sponsor’s fund documents or related agreements with limited partners (LPs).

Of course, the arrangements herein are only a few of the many options available to fund sponsors, and the appropriateness and availability of these options should be determined on a case-by-case basis. Depending on the circumstances, other potential alternative financing solutions include the implementation and/or expansion of fund credit lines, seeking requisite approvals and/or amending fund agreements to increase the fund sponsor’s ability to utilize external and/or internal recycling, seeking secondary buyer capital in connection with a continuation fund or other GP-led liquidity process, and/or obtaining preferred equity financing.

Annex Funds and Top-Up Funds. Although the terms are often used interchangeably, "annex" funds are funds typically raised after the main fund's investment period and formed to support follow-on activity in certain existing portfolio companies, while "top-up" funds are funds typically raised to participate in new opportunities alongside the main fund during its investment period in order to take advantage of market dislocation.

From the fund sponsor's perspective, both annex funds and top-up funds provide an available pool of capital in excess of the main fund that can be accessed when necessary and which, in many cases, will provide additional management fee, carried interest or other economics to the fund sponsor. From an LP's perspective, annex funds and top-up funds may be appealing given the better economic terms that often accompany participation in such funds (e.g., reduced management fee and/or carried interest).

The overall LP interest level in an annex fund will likely depend on whether it finds the fund sponsor's rationale for using the additional capital compelling (e.g., whether the LP believes that the new capital will be used to chase underperforming investments with limited upside, or conversely whether the LP believes that the new capital will be used to benefit portfolio investments or related add-on acquisitions that have significant return potential). Similarly, LP interest in a top-up fund will often be contingent on whether the LP has additional capital to allocate to the strategy and whether it shares the fund sponsor's view on the market opportunity driving the desire for additional capital.

An important preliminary consideration for fund sponsors involves determining who will be invited to participate in an annex fund or top-up fund. Subject to a careful analysis of fund governing agreements and side letter agreements, in many circumstances there will be no explicit requirement to offer such interests solely to current LPs. Nevertheless, fund sponsors may determine that from an investor relations perspective, and to mitigate conflicts of interest, it is advisable to offer any such opportunities to existing main fund LPs prior to seeking interest from third parties.

Assuming that the fund sponsor believes it will have adequate interest in an annex fund or top-up fund and has determined its desired approach to offering participation, it must navigate several legal and regulatory complexities prior to approaching LPs, including determining the following:

- whether approval for the new vehicle is required under the successor fund and/or time and attention restrictions set forth in the main fund's governing agreements (although typically not an issue for annex funds if the main fund has deployed substantially all of its capital or the investment period has expired);

- whether there are any investment allocation issues in raising an annex fund or top-up fund, including whether the main fund's governing agreements require that it receive full priority on new investments (or, in the case of annex funds, follow-on investments) prior to the new vehicle receiving an allocation;
- whether the main fund and the new vehicle must invest in, and divest from, the target investments at the same time and on substantially the same terms; and
- whether the main fund's governing agreements restrict cross-investments with other accounts and/or whether there are other restrictions or concerns regarding transactions involving multiple accounts that present potential conflicts of interest (e.g., expense sharing, portfolio remuneration sharing and/or allocation of fee offset amounts, LP advisory board determinations regarding conflicts that impact multiple accounts, etc.).

Finally, a fund sponsor should carefully consider the anticipated timeline for raising the annex fund or top-up fund. Similar to other private investment funds in which multiple third parties invest, the governing agreements of annex funds and top-up funds will typically be reviewed by LPs and are subject to LP comments and/or side letter requests. Accordingly, fund sponsors with a more immediate liquidity concern and/or a tighter deal closing timeline may consider alternative options, such as a single investment co-investment fund (discussed in more detail below).

Overage Funds. Overage funds are blind pool vehicles typically offered (or at least contemplated) during the main fund's fundraising period and generally raised side-by-side with the main fund. Overage funds are offered to investors who desire additional exposure to future portfolio investments of the main fund in excess of the concentration limits or other investment restrictions to which the main fund is subject, often with a reduced management fee and/or carried interest. From the fund sponsor's perspective, overage funds are an efficient way to access a ready source of capital for fast-moving deals that are too large for the main fund, and relieve the fund sponsor from the time intensive process of seeking third party co-investors to pick up the excess while still meeting the closing timeline of the underlying transaction.

An overage fund is typically raised alongside the main fund, and therefore the documents for each vehicle must specifically address how deals and related expenses will be allocated among both accounts (and any other accounts managed by the fund sponsor). In some overage fund arrangements, the main fund will receive full priority on investment opportunities, with any excess amounts offered to the overage fund. In other arrangements, the main fund will receive priority on a new opportunity up to a certain threshold, with any remaining amounts shared between the main fund and the overage fund until the main fund reaches its maximum concentration limit. Many overage fund arrangements will provide considerable discretion to the GP to vary from the stated allocation methodology (and, in some situations, bypass the overage fund and offer excess allocation opportunities to third party co-investors) in appropriate circumstances.

There is generally considerable crossover between the LPs of the main fund and overage fund, and therefore the fund sponsor can market both funds at once, reducing the time for negotiating documents and conserving investor relations resources. LPs can likewise review the terms of the overage fund and take the investment decision to their committees in tandem with the main fund, helping to streamline the LP diligence process. If the fund sponsor does not have sufficient overage fund interest from main fund LPs, it may seek additional commitments from third parties. In some circumstances, a fund sponsor may require any LP committing to the main fund to also make a smaller commitment to the overage fund at a ratio determined by the fund sponsor.

Although the reduced economics commonly offered by overage funds are attractive, LPs must be comfortable with the accompanying risk that the LPs will bear a portion of organizational and ongoing operating expenses notwithstanding the possibility that no (or a minimal) portion of their commitments are ultimately deployed to investment opportunities. For this reason, overage funds typically charge management fee based on a percentage of invested capital, rather than a percentage of capital commitments. In addition, overage fund LPs must also become comfortable with the increased concentration risk and conflicts of interest that can arise in connection with overage fund arrangements.

<u>Single Investment Co-Investment Funds</u>**.** Single investment co-investment funds are funds formed to facilitate a single investment in a portfolio company, whether directly or indirectly through a holding vehicle. Fund documents typically include broad co-investment rights that provide the general partner with considerable discretion with respect to how and to whom it may allocate co-investment opportunities. Single investment co-investment funds typically involve reduced management fee and/or carried interest with no obligation to pre-commit to blind pool transactions, and therefore many LPs affirmatively seek out co-investment opportunities as an added benefit of its relationship with a fund sponsor.

Prior to forming a single opportunity co-investment vehicle, it is important for the fund sponsor to consider whether the fund governing agreements include any restrictions on co-investment arrangements, including whether the fund sponsor has discretion to allocate all or a portion of specific investment opportunities away from the main fund, whether the fund sponsor is prohibited from charging management fee and/or carried interest to co-investors, and whether any formal (or informal) co-investment rights were granted to any main fund LPs that would require those LPs to get a first look at the opportunity before anyone else.

Unlike overage funds, top-up funds and certain annex funds, in a standard single investment co-investment arrangement the fund sponsor must locate potential co-investors and negotiate the terms of the co-investment fund governing agreement on the same timeline as the related transaction that requires the additional funding. Accordingly, co-investment arrangements require time to coordinate, negotiate documents, and conduct diligence, which may be critical when a fast-moving deal arises. Moreover, co-investors making significant co-investment commitments will often heavily negotiate certain terms (including “look-through” preemptive and other underlying shareholder rights, rights to receive certain portfolio company information, and certain expense-related provisions), and many co-investors will not agree to bear broken-deal expenses prior to consummating the underlying transaction, which may leave the fund sponsor and/or the main fund liable for such expenses if the co-investor walks away and/or the transaction falls apart.

Conclusion. While none of these concepts are new to the market, fund sponsors may wish to start exploring the formation of side car vehicles in order to navigate any anticipated liquidity issues resulting from the pandemic and/or general market volatility that has resulted. As previously mentioned, the arrangements described above are only a few of the many options available to fund sponsors, and the appropriateness and availability of these options should be determined on a case-by-case basis. In any event, prior to forming a side car vehicle or exploring other financing options, fund sponsors should carefully review the applicable existing fund documentation, including limited partnership agreements, side letter agreements, and any existing credit line agreements to confirm whether any approvals or consents may be required from LPs, LP advisory boards or other counterparties. Fund sponsors should then carefully consider the amount of additional capital that may be needed in the near term, and start socializing options with key LPs and advisory boards.

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