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PURSUING CRISIS-RELATED INVESTMENT OPPORTUNITIES – CONSIDERATIONS FOR PRIVATE EQUITY FUND MANAGERS

To Our Clients and Friends:

I. Overview

The coronavirus pandemic ("**COVID-19**") has had far-reaching implications on virtually every aspect of the global economy, and the private equity industry has faced its share of challenges. As investment advisers and private equity fund managers navigate this uncertain terrain, many have identified alternative types of investments, including private investments in public equity ("**PIPEs**") and various types of debt investments, as promising alternatives to their existing funds' original investment strategies. With private equity firms holding an estimated $2 trillion of 'dry powder' and companies in dire need of capital, it should come as no surprise that, since late March, companies have raised approximately $8 billion from private equity funds in PIPE transactions, as sponsors eye dividends and an eventual equity stake in lieu of a more customary control investment approach.[1] This client alert identifies a number of issues fund managers should consider as they evaluate opportunities outside of their existing funds' primary investment focuses.

II. Investment Program

A. Investment Objective

Fund managers should first evaluate whether the relevant disclosure and partnership agreement language is flexible enough to permit alternative investment types. This evaluation should focus on whether the fund's investment objective is sufficiently broad to accommodate the desired types of alternative investment strategies (such as a carve-out to allow the fund to invest in "other assets," or similar language). Any fund manager that pursues alternative investments for a fund that fall outside of the fund's primary investment strategy should consider whether the current disclosure documents adequately discuss the risks inherent in such types of investments, or whether such disclosure should be supplemented.

B. Investment Restrictions

Sponsors should also be mindful of applicable investment limitations, whether contained in the partnership agreement or in investor side letters. These provisions are often drafted to allow the fund's limited partner advisory committee ("**LPAC**") or limited partners to waive the restrictions on a case-by-case basis, and fund managers should consider whether to request such a waiver in light of other requests they may be making (*e.g.*, waivers of the requirement to hold an annual meeting, extensions of fundraising and investment periods, *etc.*) and how they can make their requests more appealing by, for instance, including a time limitation that stresses the unique nature of the opportunity being pursued and assures the investors that the drift in investment objective will be temporary in nature.

Of particular concern to fund managers in this respect will be restrictions in investing in marketable securities, or otherwise investing in publicly traded securities in the open market. While these restrictions would typically apply to investments in publically traded debt, they generally would not apply to investments in PIPEs, as such transactions do not involve open market purchases.

Should the fund's documentation permit the sponsor to pursue alternative investments, the sponsor may wish to consider whether any of its existing portfolio companies would benefit from a debt investment (including a bridge financing) as a means of providing working capital. Before pursuing such opportunities, however, sponsors should carefully review the fund's governing documents to ensure that there are no relevant restrictions (*e.g.*, a cap on follow-on investments or a requirement that they must be in the form of equity).

C. Alternative Vehicles and Supplemental Fundraises

The creation of annex or ancillary investment vehicles may provide relief to a fund manager that is not necessarily restricted from investing in PIPEs or other alternative investment strategies in an existing fund, but the existing fund is near the end of its investment period or has limited available capital (even taking into consideration recycling mechanisms and scope to complete follow-on investments).

1. *Co-Investment Vehicles*

To the extent that a fund lacks the flexibility to pursue a compelling opportunistic investment strategy (whether due to fund-level investment restrictions or a lack of sufficient capital) and is unable to (or otherwise does not wish to) seek relief from its LPAC or limited partners, the fund manager may wish to consider allocating the remainder of the targeted investment to a newly formed co-investment vehicle. This approach has the benefit of allowing the fund to take only as much of the targeted investment as the fund manager deems appropriate (due to capacity constraints, investment restrictions, or other factors). The approach has the additional advantage of allowing the fund manager to raise additional capital relatively quickly (particularly to the extent the manager has an established form of co-investment agreement and has completed co-investments with its existing limited partners in the past). Sponsors should of course first evaluate whether the fund documents (including investor side letters) permit the formation of a co-investment vehicle and whether they obligate the sponsor to offer co-investment opportunities to specific investors.

2. *Annex Funds*

To assist in raising additional capital, fund managers may also wish to consider forming an annex fund, which is a newly formed fund vehicle intended to supplement the existing fund's investment program. Annex funds are typically first offered to the existing fund's investors on a *pro rata* basis. Investors who already subscribed are then offered their *pro rata* share of any unclaimed capacity, and any remaining capacity can then be offered to outside investors. Management fees and carried interest are typically heavily reduced (or, in the case of management fees, eliminated entirely).

3. *Independent Investment Vehicles*

Even if the fund documentation permits the manager to pursue its desired type of alternative investments, the manager may wish to create a completely independent investment vehicle focused on such alternative investments. While this approach should allow the manager to achieve economics that are not obtainable in the co-investment or annex fund contexts, establishing a standalone investment vehicle has a longer time horizon than the alternatives discussed above. This approach also presents the most risk, particularly in the current uncertain fundraising climate where travel and the ability to conduct onsite due-diligence with prospective investors may be drastically curtailed.

4. *Supplemental Fundraises*

Finally, to the extent practicable, sponsors may wish to consider conducting a supplemental fundraise within the sponsor's existing fund. Assuming that there is no outer limit on the period during which the sponsor may accept new investor commitments (or the limited partners or LPAC have agreed to an extension of such period), the sponsor may allow existing investors to increase their capital commitments (or, potentially, allow a select number of new investors to join the fund). While this may allow the sponsor to maintain the core economics of the existing fund and to raise new capital quickly, it involves a number of important questions that must be addressed, including whether the increasing (or new) investors will be able to dilute existing investors in existing investments.

Under any of these approaches, sponsors will likely want to raise capital in an accelerated timeframe in order to capitalize on the applicable opportunities. Accordingly, we recommend that interested managers immediately begin preparing highly tailored marketing presentations that provide detailed overviews of the relevant opportunities and schedule virtual conferences with lead investors in order to address any questions or concerns. Sponsors should also be mindful that an effective ancillary vehicle will not simply duplicate the primary fund's terms, but rather adjust them in a manner that reflects the relevant facts in order to minimize investor negotiation and proceed quickly to closing. Additionally, even if a sponsor is not looking into alternative investments and is not preparing for a traditional fundraise, we encourage a careful review of the existing fund's terms and structure in order to be prepared to quickly return to market as desirable opportunities arise, given the current uncertainty in the market.

The formation of annex or ancillary investment vehicles requires careful consideration of a number of potential hurdles, as discussed more fully in Part III below.

III. Time and Attention and Related Considerations

A. Time and Attention; Key Person

Before forming a new investment vehicle to pursue alternative investment strategies, a fund manager should analyze a number of provisions in its existing funds' governing documents. Chief among these are the key persons' time commitment covenants, which are often heavily negotiated and should be analyzed carefully if the fund's key persons are expected to play significant roles in the new investment vehicle. For example, a key person essentially would be precluded from involvement in the new investment vehicle if an existing fund's partnership agreement requires that the key person devote "substantially all" of his or her business time and attention to the fund's affairs. However, a key person clause that only requires a "reasonably necessary" amount of time offers more latitude, particularly in a scenario where, for example, the existing fund only has enough dry powder to make one additional investment. Sponsors should also consider their fiduciary responsibilities when evaluating time and attention and key person obligations to a fund. Time commitment requirements typically are customized so these analyses tend to be highly fact-specific. We are very familiar with helping fund managers analyze the relevant considerations.

B. Successor Fund Restrictions

Sponsors should also consider whether and to what extent successor fund restrictions may limit flexibility to establish a new vehicle. Many partnership agreements restrict fund managers from forming new vehicles with investment strategies that are "substantially similar" to the current fund's investment strategy, until the current fund deploys a specified amount of capital or reaches the end of its investment period. This of course requires careful consideration of how the documents describe each fund's investment objective, as discussed in Part II above. Co-investment vehicles are often specifically carved out from the definition of "successor funds" (*i.e.* permitted), but annex funds typically are not. In many cases, a fund's LPAC has the explicit ability to waive this restriction, which may be the most efficient option for managers interested in setting up an annex fund (or a co-investment vehicle, to the extent it is not already carved out).

C. Allocation of Investment Opportunities

Finally, fund managers should be mindful of potential conflicts of interest and restrictions that may arise when allocating investment opportunities among the manager's various funds and clients. A fund's partnership agreement may require that the fund manager allocate to the fund any investment opportunities that fall within its investment mandate (subject to exceptions), regardless of whether such opportunities were primarily envisioned when the fund was created. Managers should seek to articulate a clear rule that identifies investment opportunities that fall outside of an existing fund's investment objective and that can be allocated to a new vehicle. Deal allocation provisions may create substantial hurdles for managers looking to create new fund vehicles to pursue alternative investment types. Managers must carefully analyze the existing fund's deal allocation requirements, including a review of both the existing fund's partnership agreement and disclosure documentation and the manager's allocation policy. Similar issues may arise when allocating an investment between the existing fund and a co-investment or annex fund.

IV. Conclusion

COVID-19 has created a tremendous amount of uncertainty in the global economy, causing many private equity fund managers to pursue new, attractive opportunities outside of their traditional investment objectives. Such managers should carefully review their funds' governing documents and disclosure materials to determine whether and to what extent it is possible to pursue such opportunities. Sponsors should also maintain an open dialogue with limited partners and clearly communicate the desired strategy in a concise, focused manner, including a consideration of the various tools at the sponsor's disposal, as outlined above.

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[1] Crystal Tse and Liana Baker, *Buffett-Goldman Redux: Buyout Shops Fight for Lifeline Deals*, Bloomberg (Apr. 27, 2020).

Gibson Dunn's lawyers are available to assist with any questions you may have regarding the issues and considerations discussed above. For further information, please contact the Gibson Dunn lawyer with whom you usually work, or the following authors:

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