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Co-Investments: Positives and Pitfalls

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With direct investments, co-investors have direct ownership interest in the portfolio company (or a holding company) alongside the sponsor's fund. While this has its advantages, it has its disadvantages as well. The co-investor will need to be at least somewhat actively involved, since its investment will not be controlled by the sponsor, and the documents of the underlying portfolio company (or holding company) will need to be tailored to address the needs and rights of minority co-investors (tag-along rights, preemptive rights, registration rights, information rights, veto rights, etc., all as more fully discussed below). Another complexity is that management often holds its interests at this level, and as a result, the documents can become very involved very quickly.

Another alternative is investing through one or more sponsor-controlled vehicles. In this scenario, the sponsor controls the investment much like it would a fund investment. While this structure may seem convenient, the co-investor will want to make sure it is essentially in the same place it would have been (from a rights perspective) had the investment been made directly. This means making sure all rights at the portfolio company (or holding company) level flow through the SPV to the co-investor (e.g., flow-through of preemptive, tag-along, registration and information rights). This is often a somewhat tedious task and one that most likely has not been at the top of the sponsor's "to do" list.

Whether structured as a direct investment or as an investment in one or more sponsor-controlled SPVs, the legal expenses incurred by the co-investors are likely to be significantly greater than with an ordinary fund investment, with that expense, however, obviously being more than offset by the fact that most co-investments are on a no-fee, no-carry basis. The time required to complete a co-investment will also generally be longer than for a typical fund investment.

Another decision to be made is how much the co-investor should be involved in the underlying transaction. Should it perform due diligence on the portfolio company? Should it review and comment with regard to the underling transaction documents? Should it just close its eyes? Some co-investors are actively involved, while others totally rely on the sponsor. A middle-ground approach that is often taken entails speaking with the sponsor's deal counsel about its due diligence approach, reviewing its formal due diligence materials on a high level and following up with any noted concerns. A similar approach is often taken with regard to the underlying deal documents (discussion of structure and documents with the sponsor's deal counsel, high-level review of key documents, etc.).

No matter the structure or what level of due diligence is done, the critical requirement is that the interests of the co-investor and the sponsor be aligned as closely as possible. Perhaps most importantly, the entry and exit rights of the co-investor and the sponsor must be in alignment. This means making sure it is required that the securities held by the co-investor be bought and sold at the same time and on the same terms as those held by the sponsor and that the co-investor is protected against future dilution from other vehicles controlled by the sponsor (including any sponsor fund). Along these lines, the co-investor should have tag-along rights (conversely, the sponsor will likely want drag-along rights) and appropriate registration rights. To make sure the co-investor is not unfairly diluted or treated, it should also seek preemptive rights from the company and rights of first refusal on sales by other investors (if such sales are allowed). The co-investor would be well-advised to seek veto rights (at least requiring the affirmative vote of a majority of non-sponsor investors) over certain fundamental events (e.g., fundamental change in the business of the underlying company). The co-investor should also make sure sufficient information is to be provided to it, with regard to the vehicle in which it is directly investing, as well as with regard to the underlying entity/business. Additionally, express provisions should be included relating to transactions with affiliates and limitations on fees paid to sponsor-controlled entities.

In summary, while co-investments offer a terrific opportunity for potential co-investors, care should be taken with respect to the economic terms of the investment, the structure of the investment, the due diligence performed and the terms of the underlying transaction documents to make certain the co-investor is really getting the benefit of the bargain it thinks it has struck.

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