Morgan Lewis

VENTURE CAPITAL & PRIVATE EQUITY FUNDS
DESKBOOK SERIES

Reopening Old Funds, Preferred Interests, and Annex Funds

As fund managers survey their existing portfolios, a few are finding that some of their portfolio companies, even promising ones, are not able to secure adequate financing or are very concerned that they will not be able to do so in the foreseeable future. Many of these funds are already tapped out, having made initial and even follow-on investments with the expectation that the portfolio companies would eventually become self-financing or seek additional financing from third parties. Faced with this dilemma, fund managers are in some cases opening their older funds to allow new commitments from new and existing investors, securing a much-needed source of additional capital to fund portfolio companies in a frozen financing market.

Traditional solutions to this dilemma have always had their shortcomings. One traditional solution employed by fund managers has been to form an "annex fund" specifically designed to provide later-stage follow-on financing to the portfolio companies of a particular fund. Fund managers and limited partners alike, however, struggle with the constant tension (i.e., conflict of interest) between the old fund's wanting a higher valuation and the new fund's wanting a lower valuation. Another less-favored approach has been to allow cross-fund investing, where a newer fund with available capital is allowed to invest in the portfolio companies of an older fund managed by the same fund manager. This too has been frowned upon by the limited partner and the fund manager communities due to the inevitable conflicts that arise.

A new solution is emerging: opening up the closed fund for new money. Commitments can come from existing investors, but the secondary fund investors are a significant new potential source because their core expertise is in the valuation of existing portfolios. It's like a new round of Series B financing in a portfolio company. While conflict issues are not entirely eliminated, they are generally confined to the single transaction, and are akin to those faced in any financing transaction. New money is committed to a fund and made available to finance its existing portfolio. And as in any financing, the terms of such an investment can vary widely, covering a spectrum that balances preference for the new money with future participation in the upside.

At one end of the spectrum, we see investors buy in on a pro rata basis at a negotiated valuation of the current portfolio with no preference. This is much like buying into a hedge fund at its current market valuation, the caveat being that the valuation is significantly more speculative. At the other end of the spectrum, we see investors buy a preferred interest that carries a very high preferred return that is paid prior to existing investors, but returns to the new investors are capped once a new investor receives its full preference. This would be akin to a traditional preferred stock and has the advantage that no agreement has to be reached on the valuation of the portfolio. Between these two poles is a wide range of potential structures that can strike a balance between preference and future profit participation, resulting in the functional equivalent of a participating preferred. An investor could receive all or some subset of investment proceeds from the fund until receiving back all its contributed capital and a negotiated rate of return. After that, existing investors in the fund could catch up, and then both new and old investors would share pro rata at a negotiated rate based on the portfolio value or some premium to it. As the emphasis is shifted to upside participation, the valuation of the existing portfolio becomes more critical; conversely, as the emphasis is shifted toward the priority return, pressure is taken off the precise value of the existing portfolio.

Any scenario worked out by the new investors and the fund manager will need to get approval from the existing limited partners, just as Series A shareholders in a portfolio company would have a veto right over the issuance of Series B shares. The level of consent needed will vary from fund to fund and be entirely dependent on the details of the amendment provision of each fund's partnership agreement. Many agreements will provide that a simple majority-in-interest can amend an agreement, others may require a super-majority for all amendments or for amendments to allocation and distribution provisions, and still others will require consent from each limited partner whose entitlement to distributions is adversely affected, resulting in a potentially prohibitive unanimous approval requirement. Even in the latter cases, creative solutions may be found that avoid facing the unanimous approval requirement.

One other option being employed is negotiating a sale of some or all of the portfolio interests held in some or all of a fund's portfolio companies to a secondary fund. Here, the secondary fund manager and the fund manager can negotiate a full or partial liquidation of the fund's portfolio using either a subset of portfolio companies or a "strip" (whereby a fixed percentage of each interest in the portfolio is transferred). Because this is a disposition of a portfolio interest within the fund manager's discretion, it will typically not require any limited partner approval. In these transactions, the interests are usually housed in a new acquisition vehicle to which additional commitments for follow-on financing may be made, which can be managed by a third party (sometimes called a "fund manager for hire") or, in some cases, the current fund manager. Current fund managers may have the opportunity to "reset" their carry in the new vehicle by charging a carry based on a new lower valuation at the time of transfer, but any transaction involving the fund manager as a manager of the new vehicle will typically be subject to approval by the transferring fund or its advisory board as a conflict-of-interest transaction or competitive fund and may face the same conflict issues going forward as the "annex fund" described above if there is any overlap in resulting portfolios.

In any of these transactions, the terms of both the existing fund documents and any amendment to them are critical and need to be drafted with an eye toward this new type of relationship. For instance, if negotiating a senior interest, the investor may seek covenants that protect that seniority and the assets that will fund it, such as borrowing restrictions or restrictions on affiliate transactions in the portfolio or even restrictions on financings at the portfolio company level. Here, the concerns of the investor are similar to those of a mezzanine lender. The investor may also focus on the potential use of funds. Changes will likely be necessary not only to allocation and distribution provisions, but also to other terms such as clawbacks, preferred return formulas, and default remedies that may be perfectly appropriate in their original context but are no longer adequate in the context of a senior security.

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For more information on the issues discussed here, please contact your Morgan Lewis [Private Investment Funds Practice] attorney.

About Morgan Lewis's Private Investment Funds Practice
Morgan Lewis has one of the nation's largest private investment fund practices and is consistently ranked as the "#1 Most Active Law Firm" globally based on the number of funds worked on for limited partners by *Dow Jones Private Equity Analyst*.

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