Private Equity Law Report
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May 12, 2020

SIDE-BY-SIDE MANAGEMENT

Avoiding Parallel Fund Conflicts: Specific PE, Real Estate and Private Credit Issues and Mitigation Tips (Part Two of Two)

By Dietrich Knauth and Vincent Pitaro, *Private Equity Law Report*

Each asset class in the private funds industry faces different risks related to parallel funds and conflicts of interest. Hedge funds, for example, are more likely than PE funds to have multiple funds share investment strategies despite being at different stages of their investment cycles. Although PE funds confront those risks less frequently, they can certainly still arise when a fund attempts to add a supplemental round of investors before its final close or when a sponsor raises a new vehicle for a co-investment.

Those scenarios, among several, are described in a recent case study (Case Study) published by the Standards Board for Alternative Investments (SBAI) on conflicts of interest when managing parallel funds. This second article in a two-part series describes common scenarios in which conflicts of interest may arise between parallel funds and near-parallel funds in PE, real estate and credit funds. The first article summarized the SBAI's newly released standards and its suggestions for mitigating conflicts of interests while operating parallel funds, including how to determine when two funds are sufficiently "similar" for that purpose.

See our two-part series on PE sponsors with private credit strategies: "What Must a PE Sponsor Consider Before Launching a Private Credit Strategy?" (Feb. 4, 2020); and "Four Common Fund Structures to Mitigate ECI Risks When a PE Sponsor Launches a Private Credit Strategy" (Feb. 11, 2020).

PE

PE sponsors tend to confront fewer conflicts of interests pertaining to parallel funds than other asset classes, suggested Akin Gump partner Fadi G. Samman. "The issues highlighted in the Case Study are things to which PE investors have always been attuned, and protections are largely built into the contracts to varying degrees to prevent those issues."

Those risks are avoided, at least in part, because a parallel vehicle in the PE context tends to be raised at the same time as a sponsor's primary PE fund, observed Samman. "It would be unusual in a PE structure to have a side fund with a similar strategy that is investing in the same investments but on a different track."

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Because the vehicles are launched at the same time, the parallel vehicle tends to operate in lockstep with the main PE fund in most material respects other than for specified tax, regulatory or other legal reasons, explained Samman.

Mitigation in Fund Documents

PE funds typically have successor fund provisions that limit a GP's ability to raise concurrent funds that could create conflicts of interest when allocating investment opportunities. "That provision makes it a lot easier to label something a 'parallel fund' in the PE context as opposed to with hedge funds where there is more of a sliding scale of similarity," observed Schulte Roth & Zabel partner Stephanie R. Breslow.

Among other approaches, successor fund provisions usually prohibit a GP from raising a new fund until 75 percent of the earlier fund's capital has been invested or its investment period has ended, noted Breslow. In addition, those provisions typically prohibit a successor fund from investing in the same investments in which the predecessor fund was invested unless the LP advisory committee (LPAC) has waived the conflict of interest.

See our two-part series on the evolution of LPACs: "Trends Toward Robust Procedures and Accountability for LPAC Members" (Oct. 8, 2019); and "Grappling With GP and LPAC-Member Conflicts of Interest While Avoiding Liability" (Oct. 15, 2019).

When a PE sponsor launches a fund to invest alongside the main fund – usually for tax or regulatory reasons – then it will typically be exempted from the main PE fund's successor fund provision. Conflicts of interest can still exist, however, often because of the same tax or regulatory reasons, Breslow cautioned. For example, a parallel fund might wind up with a different range of investments than the main PE fund, or may see a lower return on its investment because of its different tax treatment or any blocker structures in place.

See "SEC Fines PE Fund Manager for Failing to Equitably Allocate Fees and Expenses to Its Affiliate Funds and Co-Investors" (Mar. 26, 2019).

Two useful approaches to addressing potential conflicts of interest in this context are clear disclosure to investors and clearing conflicts of interest through a fund's LPAC, advised Breslow. "PE fund offering materials should describe the possibility of parallel funds, successor funds and overlapping funds, as well as the reality once they exist," she explained. "In addition, getting prior LPAC approval to invest in a specific opportunity can be a useful method for dealing with any conflicts that investment may generate."

Investing Before a Final Close

Conflicts of interest involving parallel funds most commonly arise early in a PE fund's life when a sponsor is pursuing deals while seeking capital commitments from new investors, noted Breslow. A sponsor might know that structuring the main PE fund as a Delaware partnership, for example, is advantageous for most of its investors but could attract other investors that prefer a different structure during its fundraising period.

In that case, the sponsor may launch a parallel fund to better serve the needs of those investors, Breslow said. "Although both funds may end at the same time, they might not start

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at the same time," she observed. That mismatched timing could allow the main fund to acquire assets before the launch of the parallel fund. "At that point, the sponsor needs to decide whether to accept that difference in the portfolios and leave the assets in the main fund or, as is often the case, to rebalance assets between the two funds."

Rebalancing brings the parallel funds into longer-term alignment with the main fund, but it creates a point of potential conflict because the GP must determine a fair value for the assets in the main fund. The sponsor may choose to sell those assets at cost or cost-plus-interest, or it could attempt to make a more nuanced determination of a change in value of the assets since the purchase date. Those decisions can have a disparate impact on investors in the main fund and the parallel fund, which the PE sponsor needs to be attuned to preventing, Breslow said.

See "Recent Trends in Key PE Terms Impacting Alignment of LP and Manager Interests" (Nov. 19, 2019).

If a PE sponsor can find an equitable way to handle the mismatched timing of a main fund and its parallel fund, then there are typically fewer conflicts of interest in the management of the two funds, noted Breslow. "Once the parallel fund and the main fund are up and running together and those investments have been rebalanced or not, the potential for conflict is a lot lower."

Parallel Funds and Investor Voting Rights

Certain investors, whether due to a large commitment or a long-standing relationship, negotiate parallel fund vehicles for their commitments. That approach can afford those investors certain fee breaks or more control over their investment, noted Breslow.
Even if those vehicles operate entirely in parallel with the main fund, the investors could be granted certain rights (*e.g.*, to terminate the investment period for the parallel fund) that could create a conflict of interest with the main PE fund. Terminating the investment period of a parallel fund could force a GP to adjust its plans because of the change in available capital, and could even force it to sell assets that other investors may not want to sell, noted Breslow.

Those are the types of ramifications PE sponsors need to consider as they negotiate voting right provisions of parallel funds with investors, cautioned Breslow. "You need to think through which things should be decided on a vehicle-by-vehicle basis and which things should be decided in the aggregate across the vehicles," she advised. "A GP may be able to ensure that some votes are taken by the combined LPs in all of the parallel funds, while other votes are specific to the fund vehicle."

For more on LP negotiations, see "Trends in PE Fund Governance Terms and Implementation of Key Investor Protections" (Feb. 4, 2020).

Nearly Parallel Funds

In addition to parallel funds, PE funds typically have language allowing them to use other structures that invest alongside the main fund without dividing the GP's attention or loyalty. For example, a GP may choose to create a one-off alternative investment vehicle (AIV) for specific investments with special tax or regulatory considerations.

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See "What Legal, Regulatory and Operational Challenges Do Single-Asset Funds Present for Managers?" (Mar. 24, 2020).

Similarly, a GP typically has the ability to raise a co-investment vehicle that allows it to put additional capital into certain deals, often on a lower-fee basis than the main fund's investment. Those co-investment vehicles may be structured as one-off AIVs or as "spillover" funds that pre-commit investor capital for a series of co-investments, but they are typically designed to operate in lockstep with the fund's investments like a parallel fund.

For more on co-investment vehicles, see "The Co-Investment Continuum: Structures That Give GPs More Control and Discretion (Part One of Two)" (Apr. 21, 2020).

As a result, those nearly parallel AIV and co-investment funds may raise similar conflicts of interest to traditional parallel funds in the private funds context. To address those issues, SBAI separately published a memorandum on co-investments in December 2019 addressing key structuring, disclosure, governance and compliance challenges associated with co-investments.

See our two-part series: "Investment Vehicles, Investor Rights and Restrictive Covenants in PE Co-Investments" (Jun. 18, 2019); and "Regulatory Risks and Important Tax Considerations in PE Co-Investments" (Jun. 25, 2019).

Real Estate

Because of resulting tax ramifications, real estate funds are particularly prone to conflicts of interest even if they have parallel funds operating substantially in lockstep. In the U.S., the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) disincentivizes foreign ownership of U.S. real estate and often necessitates blocker structures that reduce returns for non-U.S. investors.
For more on FIRPTA, see "PE Real Estate Funds: Structuring by Investor Type and Distinct Statutory Considerations (Part One of Three)" (Aug. 13, 2019); and "Tax Expert Provides Insight Into Recent U.S. Tax Court Decision on Taxation of Foreign Investments in U.S. Partnerships" (Dec. 7, 2017).

In addition, real estate funds are also prone to the types of conflicts of interest posited in SBAI's Case Study when funds with strategies delineated by a geographic focus have overlapping strategies. "The main fund could be pursuing a broad, global swath of real estate investments, while a parallel fund only invests in a portion of those opportunities located in North America," noted Breslow. "Then, you have to think about how much capital each fund has available for each investment opportunity that arises."

Fund managers can help ward off second guessing of their allocation decisions by putting clear policies in place in advance, as well as by documenting the real-time justifications for those decisions, advised Breslow. It may also help to have regional caps in the broader strategy, for example, which could be used to explain why an opportunity went to a regionally specific fund rather than the global fund, she added.

For more on real estate funds, see "PE Real Estate Funds: Private REITs and Other Potential Investment Vehicles (Part Two of Three)" (Aug. 27, 2019); and "Monument Group Roundtable Explores PE Trends Related to Emerging Managers and Real Estate Investing (Part One of Two)" (May 21, 2019).

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Private Credit

Credit funds also face conflicts of interest related to parallel funds, and those risks can be more similar to the hedge fund context than PE, said Samman.

This is driven, at least in part, by credit funds typically not being subject to the same restrictions on successor funds that exist in the PE context. “We often see parallel vehicles – usually in the form of separate accounts or funds of one – raised alongside the main private credit fund,” noted Samman. “They aren’t parallel funds in the traditional sense that they are raised at the same time and required to invest in lockstep, so credit managers definitely face the issues highlighted in the Case Study more acutely.”

Although private credit managers may face a higher risk of conflicts from parallel funds than PE sponsors, they also have more options for mitigating those risks, clarified Samman. Private credit funds tend to have more liquidity than traditional PE, real estate or other private funds, and they can turn to third-party valuations to assure investors “In some ways credit is an easier asset class to deal with because the assets are more straight forward to value where you can look at the loan – it’s got a face value, a coupon, etc.”

Finally, direct lending funds are another area where parallel funds are common, observed Breslow. Here again, tax considerations factor heavily into optimal structuring for U.S. and non-U.S. investors, which can necessitate having parallel vehicles in place.

See our two-part series on direct lending funds: “Structural Approaches to Address Liquidity Considerations and Ensure Regulatory Compliance” (Dec. 3, 2019); and “Five Structures to Mitigate Tax Burdens for Various Investor Types” (Dec. 10, 2019).

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