A Close Look At Pledge Funds

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Law360, New York (May 20, 2014, 1:38 PM ET) -- Given the number of funds seeking capital in today’s private equity market, emerging managers often run into difficulty finding investors willing to fully commit their capital for 10 to 12 years in a traditional blind-pool private equity fund structure. As a result, our clients have increasingly asked us about alternatives to the traditional private equity fund model.

This article discusses one such alternative, called a “pledge fund.” The pledge fund structure enables a manager to raise fee-paying capital that can be deployed relatively quickly and efficiently but gives investors more flexibility over the use of their capital. While not the ideal structure from the perspective of a manager due to the lack of certainty as to the amount of capital it will be able to invest, a well-negotiated pledge fund can provide a manager with a stepping stone to a committed pool of capital.

What is a Pledge Fund?

Though there are a number of potential structural approaches, at its core, a pledge fund — also called a “bridge fund” or “investment club” — is an arrangement in which investors retain the ability to decide, on a deal-by-deal basis, whether to participate in investments, subject to prearranged terms and limited due diligence.

At a minimum, a pledge fund consists of (1) an agreement by the manager to give investors a first look at prospective deals, typically in exchange for a fee, (2) a set process and timeline by which investors decide whether to participate in each proposed deal, and (3) a prearranged structure and terms for
deals that get executed.

The key distinction between a pledge fund and a traditional private equity fund is that a pledge fund is not a “blind pool,” and as a result it is accepted that not all pledge fund investors will participate in each deal. Because there is no contractual capital commitment to the fund, the manager takes on significant risk that capital will need to be raised from other sources.

Additionally, because fees on uninvested capital are lower with a pledge fund (as discussed further below), the manager must generally operate on a leaner basis until sufficient capital is invested. For these reasons, despite being easier to market to investors, a pledge fund is generally considered a less optimal alternative to a traditional private equity fund.

Pledge funds can be easier to market than traditional private equity funds because they help to allay prospective investors’ concerns about committing to managers with unproven or imperfect track records. They can also be a useful structure for co-investment vehicles that invest alongside traditional private equity funds.

Structural Approaches

There are two broad approaches to structuring pledge funds. The first, and closest to the traditional private equity model, is a single investment vehicle that lets investors individually opt out of each deal the manager presents (essentially, a private equity fund with optionality).

The vehicle typically issues a separate class of tracking interests to investors that participate in each deal. This approach requires a significantly more complicated initial agreement than using an investment management agreement (IMA) (discussed below), and in our experience is the minority approach.

The second approach consists of an IMA entered into between each investor and the manager, with separate vehicles created for each individual investment (or investor). The IMA sets out the basic economic arrangements between investors and the manager (e.g., fees and expense allocation), and mechanisms for allocating investment opportunities among investors and permitting each investor to opt into investments following permitted due diligence.

In one variant, the IMA includes a pre-negotiated form partnership or limited liability company agreement to be used for each investment vehicle. This form agreement contains key governance terms and a “waterfall” allocating carried interest to the manager, and may be adjusted for each deal to reflect applicable tax, regulatory and other considerations.

Another variant uses a separate vehicle for each investor, with a waterfall specific to that investor. Because each investor has its own vehicle, this variant allows for easier “cross-collateralization” of deals for purposes of determining the manager’s carried interest. Whether deals are cross-collateralized is a negotiated point, as discussed further below.

Pledge Fund Mechanics

Regardless of structural approach, the basic mechanics of a pledge fund are generally consistent. Each investor subscribes to the pledge fund for a specific amount and the manager is obligated to present investment opportunities to the pledge fund that require equity investment of an amount up to the aggregate of all subscriptions to the fund. Once the manager has presented opportunities in this
amount, or the term of the IMA expires (typically 3 to 5 years), the manager’s obligation to present opportunities to the pledge fund ends.

Each time the manager finds a deal, it presents the investors with a due diligence memorandum describing the opportunity, and investors have a set number of days to opt in. During this opt-in period (typically 10 to 15 days), investors are permitted to conduct their own further due diligence (primarily through the manager, although possibly through direct discussions with the management team or other parties). The length of the opt-in period — and thus the amount of additional due diligence investors can perform — is subject to negotiation and set forth in the pledge fund’s governing documents.

Each investor may opt into a deal for an amount up to its maximum allotment (determined based on the size of its subscription to the pledge fund relative to overall subscriptions). If investors subscribe for less than their maximum initial allotment, other investors who opted in have the chance to subscribe for the unsubscribed amount.

If the investment is still not fully subscribed, the manager customarily will have the opportunity to take the remaining allotment itself or offer it to third parties. It is thus a key feature of pledge funds that investors have a different ownership percentage in each investment, and may not participate at all in certain investments.

Expense allocation provisions for pledge funds can be complex. Typically, expenses for an investment are shared by participating investors pro rata in accordance with their ownership percentages in the applicable investment, just as in a typical private equity fund. Broken deal expenses (i.e., expenses for investments that are not made by the pledge fund) are allocated differently, depending on whether the deal breaks before or after the expiration of the opt-in period.

If a deal breaks before the expiration of the opt-in period, or no investors opt into a deal, all pledge fund investors share in the expenses pro rata, in accordance with subscriptions to the pledge fund. If a deal breaks after the expiration of the opt-in period, the investors who opted into the investment share in the expenses pro rata in accordance with their subscriptions to the investment. This expense allocation methodology could incentivize investors to become more selective in opting into investments in order to minimize their exposure to broken deal fees.

Issues

Managers considering forming a pledge fund must consider a variety of issues that do not present themselves when raising a traditional private equity fund. A high-level discussion of these issues follows.

**Fees.** Pledge funds pay lower fees on uninvested capital during the investment period, when the manager is sourcing investments, and this lack of fee income can be a strain on new managers. A typical private equity fund charges a management fee of 1 to 2 percent of committed capital during the fund’s investment period, which compensates the manager for managing the fund’s capital (i.e., performing due diligence and making investment decisions on behalf of the fund).

Pledge funds typically charge a lower fee, closer to 50 basis points of an investor’s subscription to the pledge fund, which by contrast compensates the manager for giving investors a first look at deals it sources. This fee has more in common with an option fee than a management fee, since investors must still do their own due diligence and make their own investment decisions. As with a traditional private equity fund, investors in a pledge fund also pay a management fee — usually 1 to 2 percent — on capital
that is ultimately invested.

**Calculation of Carried Interest.** As described above, pledge fund managers are typically entitled to carried interest. The calculation of carried interest can become complicated, as each investor’s performance across the pledge fund will vary according to its ownership percentages and participation across investments.

Each investor will prefer that the manager’s carried interest be cross-collateralized across all investments in which it participates (i.e., losses in one investment are offset by gains in another). However, this requires the manager to calculate carried interest on an investor-by-investor basis, which can lead to complicated structural and administrative arrangements.

Managers typically would prefer to take carried interest on a deal-by-deal basis, making the performance calculation simpler, but also potentially leading to the manager receiving too much carried interest in respect of an investor relative to the investor’s overall profit in the pledge fund. An investor-by-investor clawback could be used to mitigate this issue.

**Track Record for Future Funds.** Pledge fund managers are highly focused on building their track records for purposes of future fundraising, typically with an eye to a fully committed blind pool fund. The pledge fund track record usually serves this purpose; however, the track record must comply with applicable U.S. Securities and Exchange Commission rules and guidelines for investment adviser advertising and that leads to two important considerations.

First, because investors have the right to opt into or out of investments, they have a de facto veto over investments, and thus the investment decisions made by the pledge fund are not solely attributable to the manager’s investment judgment. Many practitioners believe this information must be disclosed when marketing future funds based on the pledge fund’s performance.

The second consideration relates to calculating investor-level returns of the fund. Because each investor participates in different deals, there is no fund-level return. Managers will therefore often disclose returns on an investment-by-investment basis with a footnote saying that the investments were made as part of a pledge fund.

**Serial Nonparticipation.** Pledge fund managers assume risk that investors will not participate in deals, thereby reducing the capital available for investments. Many pledge funds’ organizational documents therefore include a so-called “three-strikes” rule, providing for a penalty if an investor opts out of a certain number of proposed investments (typically two or three) without good cause — which generally amounts to legal or regulatory issues.

The penalty may be structured as an increase in the fee the investor pays overall or a set fee for each additional opt-out. The manager may also have the right to exclude nonparticipating investors from future investment opportunities or remove them from the fund entirely. This gives some comfort to managers that the pledge fund is a binding commitment, but also undercuts the attractiveness of the fund for investors who are hesitant to commit their capital to a blind pool.

**Credit For Rejected Investments.** As mentioned above, pledge funds typically require the manager to give a first look at investment opportunities in an amount equal to the fund size, with precise calculation of the value of opportunities presented being subject to negotiation. Because pledge funds often pay lower fees than traditional private equity funds, investors may be concerned that managers will have an
incentive to show as many deals to the pledge fund as quickly as possible (regardless of quality), so that they can raise traditional funds.

To mitigate this incentive, investors may seek to have the manager receive less credit toward its overall sourcing obligation for deals that get turned down by a majority of investors. As with any private equity vehicle, pledge fund managers should be, and usually are, required to have some “skin in the game” to provide a disincentive to show lower quality deals.

**Winding Up.** Because of the elective nature of a pledge fund, it is important for a manager to have the ability to unilaterally terminate the investment period if there is significant nonparticipation to avoid situations where the manager is required to present opportunities to investors that are not funding them. Therefore, normally the manager will have the right to terminate the pledge fund early based on an agreed measure of insufficient participation by the investors as a whole.

**Optional Conversion to Blind Pool.** Managers that hope to transition pledge funds into a traditional structure may desire to create a mechanism in their organizational documents for conversion from a pledge fund into a traditional fund if certain benchmarks or approvals are obtained.

The advantages to the manager are clear, but the need to negotiate the terms of conversion, and the difficulty in valuing investments that are transferred from the pledge fund to the traditional fund, can pose substantial challenges and add to transaction costs for investors who are hesitant to invest with a traditional fund manager to begin with.

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