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Special Purpose Vehicles: Making the Most of Participation Rights

Smaller venture capital funds face some special challenges that their larger brethren mostly don't. One such challenge comes up when a portfolio company seeks downstream financing. The problem is this: while the pro rata participation rights built into their initial investment terms are nice in theory, smaller funds often lack the dry powder to exercise them. In down rounds, they are exposed to getting washed out, and in up rounds, being left behind. Both scenarios can make for some serious gnashing of teeth.

In recent years the Special Purpose Vehicle (SPV) has emerged as a device to quiet those gnashing teeth. Originally, SPVs were mostly used by loose groups of angels to facilitate an investment in a specific emerging company, most often in a seed or other very early round. They are still used in that scenario, but more recently are being employed in later rounds by smaller funds that participated in earlier rounds but lack dry powder to either protect themselves in down rounds or double-down in flat and up rounds.

The SPV as a downstream investment vehicle works like this. Suppose Seed Fund, a $10 million seed fund with a $5 million institutional lead investor (Lead I), a $2.5 million family office investor (Lead II), and two dozen or so smaller individual investors invests $1.0 million in NewCo, as the sole investor in a round that values Newco at $3 million pre-money. Seed Fund, thus, obtains a 25% equity stake in NewCo and, being well managed enjoys a pro rata participation right in future financings of NewCo.

Now, suppose NewCo blows past its milestones for the seed financing, and is now considering an offer sheet from MegaFund for a $20 million round. Seed Fund is excited about the prospect of doubling down on its NewCo investment, and co-investing with MegaFund. Alas, Seed Fund has nothing like $5 million of dry powder available to exercise its pro rata share of the $20 million round. This is particularly troubling to Lead I and Lead II who, in fact, have

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more than enough dry powder outside of their investment in SeedCo to take SeedCo's full pro rata share.

Enter SPV NewCo (SPVN). SPVN is a new fund vehicle, managed by Seed Fund, with two LPs, Lead I ($3.33 million) and Lead II ($1.67 million). SPVN's sole purpose is to invest in NewCo as per Seed Fund's participation right. Voila, interested investors in Seed Fund with available capital can now double down on their NewCo investment. (Note: if every LP in Seed Fund wanted to double down its NewCo investment, they could also participate in SPVN pro rata based on their respective interests in Seed Fund.)

The SPV can be even more important in a down round scenario (not very common these days, but the market cycle will turn at some point, trust me) where "pay-to-play" provisions are involved. The pay-to-play provisions provide that if current investors, as Seed Fund in the example, don't take their full pro rata share of a future down round, they lose some or all of their important preferred stock rights and privileges. Thinks like anti-dilution protection, voting rights, and liquidation preferences. Ouch. In these situations – and really, trust me, they will be common again in some future world where the venture cycle has turned for the worse, just as they have been in the past – the SPV can be a boon to even those Seed Fund investors who are not part of the SPV.

The SPV is a good solution to a real problem, but it is not without its own issues. Most of those issues involve the management of SPV. Typically, an SPV is managed by the manager of the investment fund (let's call it the Legacy Fund) that spawned it. Let's call that the Legacy Manager. How should the Legacy Manager be compensated? And how might that impact the investors in the Legacy Fund?

The most obvious answer to the compensation question – give the Legacy Manager a carry and management fee as per the carry and management fee associated with the Legacy Fund – is problematic. In terms of the management fee, why give the Legacy Manager an extra fee – which could, depending on the size of the SPV's investment in NewCo, be comparable to or even greater than the Legacy Manager's fee for running SeedCo – for managing an investment it is already managing for SeedCo? And as well, a management fee for a single investment, rather than a portfolio of investments as in the Legacy Fund itself?

As for the carry, you get a similar question: why give the Legacy Manager a hefty carried interest when the decision to do the deal is left up to the folks investing in the SPV? And even beyond that, if you do give the Legacy Manager a carry on the SPV you are, in effect, giving them a "one-off" carry on the NewCo deal such that if SeedCo's portfolio on the whole is a loser, the Legacy Manager might still enjoy a rich pay day if one company (NewCo) is a big winner. For an investment (the original investment in NewCo) that was likely a small fraction of the SeedCo investment in NewCo.

The management fee and carry issue suggest that a real conflict of interest can arise when a Legacy Manager manages an SPV on behalf of the Legacy Manager's "parent" fund. Surely, at a minimum, the Legacy Manager's fee and carry for the SPV should be substantially less than the fee and carry for the parent fund. How much less? A good question – that investors in both the parent fund and the SPV should be sure and work through, carefully, with the Legacy Manager.

My bottom line on the SPV financing scenario in the downstream vehicle is pretty positive, particularly when the parent fund includes one or more significant investors who are likely to have interest in SPVs (and capital available to humor that interest) on a deal-by-deal basis. At the same time, investors in Legacy Funds, whether they are possible investments in any SPVs spawned by those funds, should be careful to structure their Legacy Fund investment terms so as to limit potential abuse by Legacy Fund managers.

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